Excerpt from 'Price Management – Strategy, Analysis, Decision, Implementation'

Hermann Simon

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by Hermann Simon and Martin Fassnacht

This article is an excerpt and sneak preview from the new book by Dr. Hermann Simon and Professor Martin Fassnacht entitled Price Management – Strategy, Analysis, Decision, Implementation *(New York: Springer Nature 2019, 558 pages). Detailed author biographies are included at the end of the piece. Hermann Simon is the founder and honorary chairman of Simon-Kucher & Partners, and can be reached at hermann.simon@simon-kucher.com. Martin Fassnacht is the Otto Beisheim Professor of Marketing and Commerce at the WHU Otto Beisheim School of Management in Koblenz, Germany, and can be reached at martin.fassnacht@whu.edu. The book is available for purchase here: https://amzn.to/2XE5nYV.*

Price as a Marketing Instrument

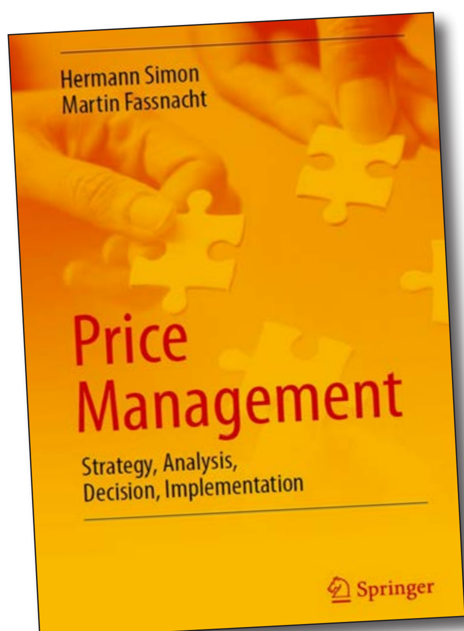
If prices were pre-determined by the market, management would not need to devote much attention to them. We encounter this situation with pure commodities which are traded on exchanges. The only things that matter with such goods are cost efficiency and volume adjustments.

However, even within commodity markets, there are still ways to use price movements to one's own advantage. With better price forecasts, for example, one can improve the timing of price and delivery agreements.

In modern product and service markets, price is typically a parameter whose management, flexibility, and effects offer very interesting opportunities:

- Price has a strong influence on volume and market share. For consumer goods, the price elasticity is on average 10 to 20 times as high as the advertising elasticity and roughly eight times as high as the sales force elasticity. That means that the effect of a price change, on a percentage basis, is 10 to 20 times stronger than the effect of a similar percentage increase in the advertising budget, and eight times stronger than the effect of a comparable percentage change in the sales budget. Sethuraman et al. have even determined that advertising budgets would need to increase by 30 percent in order to match the effect of a price decrease of one percent. The level of price elasticity varies by product category and product.

- Price is an instrument known for its fast applicability. In contrast to changes to a product (innovation), an advertising campaign, or a cost-cutting program, prices can be readily adjusted on short notice as new situations arise, apart from long-term contractual agreements or catalog periods. The internet has only increased the speed of these adjustments. A company can change prices in a matter of seconds. The same applies to retailers whose scanner systems have electronic displays at the shelf. Such changes have also been a topic for gas stations. Germany has a price registration database in operation, which consumers can access via an app to find up-to-the-minute fuel prices at around 14,500 filling stations. On the one hand, this increases price transparency for consumers, but at the same time, it also reveals price differences for competitors. In order to reduce the number of price changes, the Australian government limits price changes to one per day. The concept of dynamic pricing takes advantage of the ability to change prices quickly by adjusting prices to the prevailing supply and demand situation.



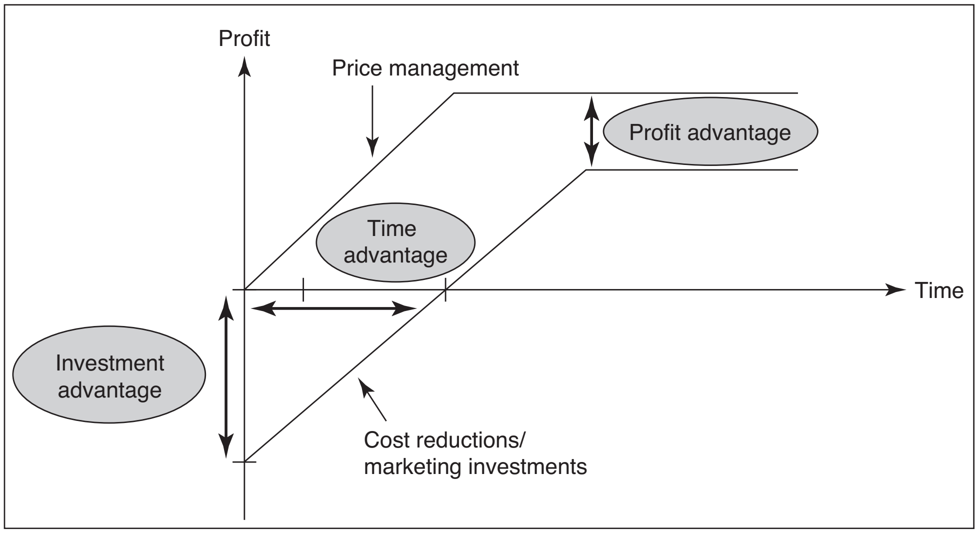
- The effects of price manifest themselves quickly on the demand side. If a gas station changes its prices and the local competition does not follow, market shares can shift significantly in a matter of minutes. The same goes for the internet, which has created unprecedented price transparency. With one tap or keystroke, a consumer can call up the current prices for a vast number of suppliers and can make an immediate purchase decision. This has advanced to the point where a consumer can scan the barcode of a product in one store and find out instantly what the product costs online or in nearby stores. In the case of other marketing actions such as advertising campaigns or new product introductions, the response from the demand side often comes with a considerable time lag.

- The flipside of quick price actions with rapid demand responses is that competitors can act just as swiftly with their own prices. Such price reactions often happen quickly and can come with such an intensity that they may ignite a price war. Because competitors can respond to price changes almost instantaneously, it is hard to achieve a sustainable competitive advantage purely through price measures. That would require a cost advantage which prevents competitors from maintaining low(er) prices for very long. A Big Data analysis by Feedvisor tracked ten million Amazon products over a period of ten months. It found that over 60,000 price wars occur every day. On average, 92 percent of those price wars happened between two competitors, and 72 percent lasted less than six hours. Usually the price wars follow predefined rules; however, the level of knowledge about competitive behavior is low.

- Price is the only marketing instrument which does not require upfront expenditures or investments. This makes it possible even for cash-strapped companies (start-ups or companies launching a new product) to implement the optimal price. In comparison, it is rarely possible to optimize instruments such as advertising, sales, or research and development – which require upfront investments before they earn a return – when a company has limited financial resources.

- Cost reductions and rationalization are vitally important goals for many companies. These efforts are always ongoing, but in many companies, the residual cost savings potential is limited, if not already exhausted. Furthermore, in mature markets it is difficult to capitalize on the third profit driver, which is volume. Mature markets are generally characterized by a zero-sum game, which means any volume increases must come at the expense of competitors, who will defend their market shares. The improvement potential in price management, however, is not even close to being exhausted in many cases. Figure 1 shows the advantages which pricing offers as a marketing tool compared to cost reductions or to investments in other marketing instruments such as advertising or sales. The investment advantage means that price optimization requires little upfront capital, unlike cost reductions or marketing investments. The time advantage implies that pricing has a positive effect on profit sooner than the other measures. And the profit advantage expresses the fact that price measures often lead to higher profit increases.

Figure 1: The three advantages of price management compared to cost reductions and marketing investments



- Pricing plays a standout role as a marketing instrument, but it also has an important meaning to customers. The price is the "sacrifice" which the customers must accept when they acquire a product. The higher the price is, the greater this sacrifice. Figure 2 shows how consumers in different countries (130,000 respondents) reacted to anticipated price increases.

- According to this study, German and Chinese consumers tend to react to a price increase by buying a less expensive product at the same store, or switching to a store which offers lower prices. American consumers respond less strongly to price increases.

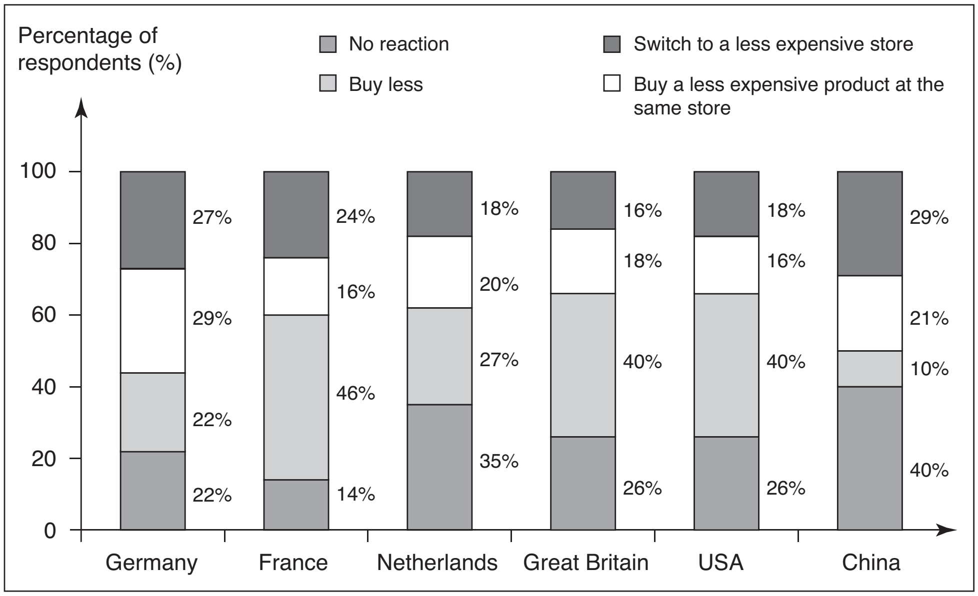
- In light of the outstanding role of price as a profit driver and the notable ways it affects a business, one should expect that managers and even top executives would devote a lot of attention to pricing. But in practice, this is often not the case. Instead, management continues to commit the greatest attention and energy to another profit driver, namely, to costs.

- "As a manager, it is easier to work on the cost side than on the revenue side," said the CEO of an airline. Companies also tend to spend more time and energy on increasing volume (e.g. through investments in sales and advertising), than they do on price management. Many companies give pricing neither the professionalism nor the seriousness it warrants.

- Take, for example, the response of a large engineering group to a question about how the company arrives at its actual transaction prices: "Essentially we proceed like this: we apply a factor of 2.5 to the manufacturing costs, and leave the rest to the sales force." Such a process makes no sense. A closer look at this company's performance uncovered that it was sacrificing a large amount of profits, or "leaving a lot of money on the table," as the business cliché goes. The following statement from a board member of one of the world's 100 largest banks is also eye opening in this context: "This bank is 125 years old. To my knowledge, this project marks the first time the bank looks at pricing in a professional manner."

- In the recent past, especially since the Great Recession, however, we observe that top management shows increasing interest in price management. A large number of CEOs have spoken openly about pricing in recent years. Their comments have come in interviews, road shows, at shareholder meetings, and during conferences with analysts. Our impression is that such comments come predominantly from companies with above-average profits. That leads to the conclusion that these companies, or more precisely their leaders, have understood – better and sooner than companies with lower profits – the critical role that price plays as a driver of both profit and shareholder value.

Figure 2: Reactions of consumers to anticipated price increases



Hermann Simon

Hermann Simon is the founder and honorary chairman of Simon-Kucher & Partners, the world's leading price consultancy. Ranked on the Thinkers50 list of the most influential international management thinkers, he is considered the world's leading authority on pricing.

Simon has published over 35 books in 26 languages, including the worldwide bestsellers *Hidden Champions, Confessions of the Pricing Man, Power Pricing*, and *Manage for Profit Not for Market Share*. From 1995 to 2009 he was the CEO of Simon-Kucher & Partners. He has advised many of the world's leading companies, and has served as a board member of foundations and corporations.

Before committing himself entirely to management consulting, Simon was a professor of business administration and marketing at the Universities of Mainz (1989-1995) and Bielefeld (1979-1989). His visiting professorships include Harvard Business School, Stanford, London Business School, INSEAD, Keio University in Tokyo, and the Massachusetts Institute of Technology.

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Martin Fassnacht is the Otto Beisheim Professor of Marketing and Commerce at the WHU Otto Beisheim School of Management in Koblenz, Germany. He ranks as one of Germany's most influential economists. Under the motto "We Inspire Marketing," he and his team at WHU generate fresh ideas for research, practice, and teaching in price management, retail marketing, and luxury brand management.

He serves as a strategic advisor to consumer goods manufacturers and retailers, and he and his team conduct projects in cooperation with partners from industry and trade. He is also the author of numerous publications in international magazines and peer-reviewed journals.

Fassnacht is the scientific director of the Center for Market-Oriented Corporate Management at WHU and the academic director of WHU's MBA program. He is the chairman of the Advisory Board of Henkel Center for Consumer Goods (HCCG). At the German Marketing Association, he is board member for research/innovation and the speaker for the association's marketing and sales group. ❖