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# You Need to Condition Customers to Pay

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**Interviewer: Mr. Nagle, purchasing organizations and consumers today know exactly where to get the lowest prices. Many managers complain, therefore, that they can no longer get reasonable prices for their products. Are they correct?**

**Nagle:** It is certainly very difficult to have more information than your customer these days. That worked only so long as customers could compare only a few dealers or suppliers in their local area. The increased transparency, however, is no threat to profitability. For businesses, it even offers new opportunities.

**Interviewer: But isn't a low price particularly important for most customers?**

**Nagle:** Only for a few is it really important. Many businesses make the mistake of allowing this small contingent of customers to dictate their price strategy. Under threat of losing some customers or a little market share, they drop their prices. Yet the prices are often not at all too high. The problem is that often a company has not explained to the customer how valuable the product is.

**Interviewer: Is that a way to achieve higher prices?**

**Nagle:** Yes. **When the product performs better, when you make it easier for people to purchase something or if you have exceptionally fast delivery, you can charge a higher price.** This is how many Internet sellers are slowly recognizing that they can be competitive, even if they do not have the lowest prices. I just bought flowers over the Internet for my wife in the USA. And I didn't go to the lowest-cost provider; rather, I went to the one that had the best delivery guarantee. Even though I did not pay a super premium price, I'm sure that the florist made a great profit. The reason is that the florist no longer needs to store flowers in a retail shop; rather, they are shipped from a centralized warehouse. The increased transparency is no threat to profitability, only to outdated business models.

**Interviewer: Today's businesses have many more competitors using low prices to gain market share. How does one respond to these types of competitors?**

**Nagle:** One strategy would be to simply ignore the most price-sensitive customers because you don't make much profit on them anyway. However, this allows your competitor to establish himself with a low-cost pricing model that, over time, will undoubtedly move up-market. The answer can, therefore, only be to have a more strongly segmented pricing strategy. The base price is very low, and a premium is charged for whatever creates incremental value for the customer. The basic product is sold only to create a market presence. Profits are made on the sources of differentiation that are not offered by the competition.

**Interviewer: That is becoming more difficult. Technical advances are often copied by competitors within a few weeks.**

**Nagle:** Managers, in the search for differentiation, are often too focused on product features. One example: A former client of ours manufacturers parts for air conditioners. One day, their biggest customer announced that he could purchase the same parts in China at substantial savings. He gave our client a choice: Either drop your prices 30% or immediately lose half of the contract.

**Interviewer: What did they decide to do?**

**Nagle:** There was a third option. They had to ask themselves why the client didn't move the entire contract to China, given the phenomenal cost savings. The reason was the long delivery times. The customer manufactured primarily in the month of May and had to place orders for parts in December, without the possibility of being able to order more afterward. Thus, he wanted to cover a portion of his needs with the Chinese supplier. Also, he could not receive any technical advice from China. Our client was able to ask for a price premium based on these points of differentiation. Today, there is a 25% discount for any orders received before January. There is now a 20% premium for deliveries with lead times of five days or less. Free technical service is only available for customers who are loyal to our client. All others need to pay extra for it. As a result, prices dropped by 11% instead of 30%. At the same time, costs also dropped since capacity is used in the winter when in the past it stood idle. Our client is now more profitable than before.

**Interviewer: It's not always so easy to respond to customers?**

**Nagle:** **Many manufacturers are conditioning their customers — especially their biggest ones — to believe that the price paid is a function of the size of the transaction, and not the value of the product.** When a buyer asks for a discount and threatens to go to a competitor, management starts a discussion on whether they can afford to lose the customer. This is how a customer learns that price is a function of buyer power. So he starts to play games. For example, he might contact a competitor to create

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a credible threat. The only solution is to reverse this dynamic. The customer has to understand that the price is based on the value delivered, not the ability to negotiate. He will learn this when a rebate is available, for example, only when he commits 100% of his business, and not because there is a second supplier.

**Interviewer: How can managers determine what a customer will pay for their product?**

**Nagle:** There are thousands of marketing research organizations that study what a customer will pay. But the answer is always the same: As little as possible! That is a bad methodology. **Most firms start to think about their value proposition only when they are standing in front of the customer and need to justify their price.** That is too late. They have to start much earlier by speaking with a customer and perhaps negotiating a long-term contract. To this customer, they need to say: "I'd like to provide better service; I need to know how I can create value for you." Because there is no price negotiation involved, the customer will be more truthful. This is how you can determine your value proposition in a sensible manner.

**Interviewer: Do you have examples?**

**Nagle:** We just advised a business that sells paper for catalogs. In order to create a successful price strategy for this commodity-like product, we have to understand how paper can influence the profitability of the catalog company. It turns out that there is huge value in being able to deliver paper within nine days instead of 30 days, since the shorter delivery time provides the catalog company an extra 21 days to make changes to the content. Another point is the quality of the paper: It is more important that the color not bleed through in clothing catalogs than in travel catalogs. When the paper manufacturer approaches the customer with this knowledge, he can say that fast delivery time is of huge value and that his company only charges a 20% premium.

**Interviewer: Advantages like delivery times or services are easy to measure. But for many products, those do not play any role. What other options are there for selling to a customer?**

**Nagle:** Psychological or social value drivers are indeed hard to measure. But even here, managers have to understand the needs of their customers. They should think why, for example, does someone purchase a car? Is it because it is a comfortable means of transportation? Does it enhance the owner's image? Does it communicate financial status? These are all ways to create points of differentiation. Then you have to conduct interviews with potential customers in which you do not ask about cars, but about products that they think influence their self-image. They may speak about their clothes, and when you ask in a targeted manner, you will be able to determine what status is worth to them. But there are fundamental differences in the way these values are communicated. Instead of hard numbers, customer profiles are more suitable.

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**Interviewer: Many businesses give rebates in order to maintain market share. Are there any alternatives?**

**Nagle:** Managers are often too fixated on their market share. But market share does not say anything about profitability. We have even advised some clients to raise their prices by 20%. By doing this, they may have lost 20% of their customers, but their profitability increased. In order to meet short-term volume goals, many managers sacrifice their price integrity. And that is very difficult to regain. A couple of months ago, a new spaghetti sauce appeared in the U.S. market. It cost three dollars — a dollar more than the norm. I was ready to pay the price. But a couple weeks later, I could purchase two jars for five dollars. What did I do as an intelligent consumer? I bought a case! When I went to the register, I saw that many other customers had the same idea. I'll bet that there was a product manager at the manufacturer who was complaining that customers don't want to pay for quality anymore because sales volume always declines when there are no discounts. Yet he has conditioned customers to act in this manner.

**Interviewer: Several companies are successful with a low-price strategy. What are they doing differently?**

**Nagle:** Wal-Mart or Dell had from their beginnings different business models that substantially lowered their costs. Because they could achieve economies of scale, they managed to keep their prices low. But in the long-run, it is almost impossible to achieve profitable growth only through an aggressive pricing strategy. Rock-bottom prices are only sensible in the context of a specific strategy. Microsoft, for example, offers the Windows operating system at a low price, but sells expensive software. Amazon has sold books at low cost in the U.S. for a long time in order to build a base of customers that now also purchases more expensive items.

**Interviewer: Do customers willingly pay for the status that a particular brand conveys?**

**Nagle:** In fact, they insist on it! **Status is hard to beat as a generator of price premiums.** People want to differentiate themselves from each other, but they do not want to offend anyone. It is absolutely impolite to tell your neighbor that you earn more than he does, or to give your girlfriend cash to show how valuable she is to you.