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Retail Price Optimization: 5 Steps to Effectively Improve Profitability

Retailers face new challenges in determining the optimal price for products because traditional pricing methods no longer deliver the desired results. Driven by technological innovations and educated by retailers to search for the best price alternative, it is now the consumer who controls the retailer. In this article, the authors explain how retailers can regain control of their pricing power in despite increased consumer price sensitivities. Ronald Molenaar MSc is a senior consultant and Marjolijn Timmermans MSc is a consultant at Simon -Kucher & Partners. Molenaar specializes in retail pricing. Timmermans specializes in value-based pricing for consumer goods. They can be reached at amsterdam@simon-kucher.com.

It will be difficult to find retailers nowadays that do not make influencing consumers' price perceptions a priority on their agendas. Since retailers successfully changed power positions with suppliers during the nineties, the power balance now seems to switch to the consumer. Driven by technological innovations and educated by retailers to search for the best price alternative, it is now the consumer who controls the retailer. The use of smart pricing applications and the possibility to shop globally online are examples of how consumers set the rules and retailers follow. The last resort to obtaining customer loyalty for retailers seems to be a robust pricing image, often realized only through lowering prices. However, price image is something completely different than actual price levels (see French example in Fig. 1). This article looks beyond price image and focuses instead on a Smart Pricing approach that enables retailers to price for profit without hurting the price image. Based on industry experience, a margin improvement of one to three percentage points can be realized by using this approach.

Challenges

In general there are three major price-setting methods: cost-plus, competition oriented and value based (see Fig. 2). **Retailers face new challenges in determining the optimal price for products because traditional pricing methods no longer deliver the desired results.** Prices based on general margin guidelines, such as those determined using the costplus method, do not leave room for differentiation in profit margin between products (and categories). Competitor benchmarks turn out to be counter-productive as well; the only result with this strategy has been vicious circles of price decreases. When emphasis is put on setting prices as low as possible to realize a high volume, less attention is paid to profit. This volume-driven philosophy generally comes with extreme promotional strategies. But when do prices reach their limit? At a 50% discount, 60%, or maybe even 70%? Discounts have not been as effective in the last years as they were in the past. Opportunities to differentiate are ignored by limited use of thoughtful customer- or product segmentations.

As a result of these improvident tactics consumers no longer have an accurate view of the value of a product. They are approached with price instead of value persuasions, which only encourages price sensitivity and makes customers increasingly unsure of the suitable price. The insecurity that follows influences the willingness to pay negatively. When consumers are uncertain about offered prices they inevitably make even more comparisons thinking this will get them the best deal! This is how the vicious circle starts.

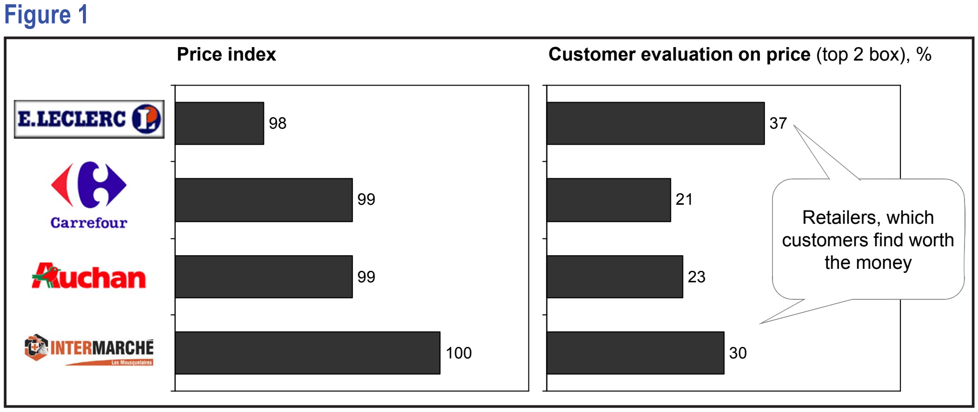
Five steps in Smart Pricing

Traditional methods for pricing are no longer sufficient. The Smart Pricing method consists of five steps to secure an optimal price for retail products:

- **Step 1** – Segment products according to their strategic role
- **Step 2** – Classify products in proportion to their price sensitivity
- **Step 3** – Choose a strategy based on pricing freedom
- **Step 4** – Optimize the final price
- **Step 5** – Test and evaluate the selected price levels

The first step is to establish pricing objectives and the implications for each category and each product, which then makes it possible to segment offerings. The strategic role of a product depends on (pre) defined category roles, for example, a destination or convenience role. This process needs to be performed carefully as an abundance of destination

Figure 1



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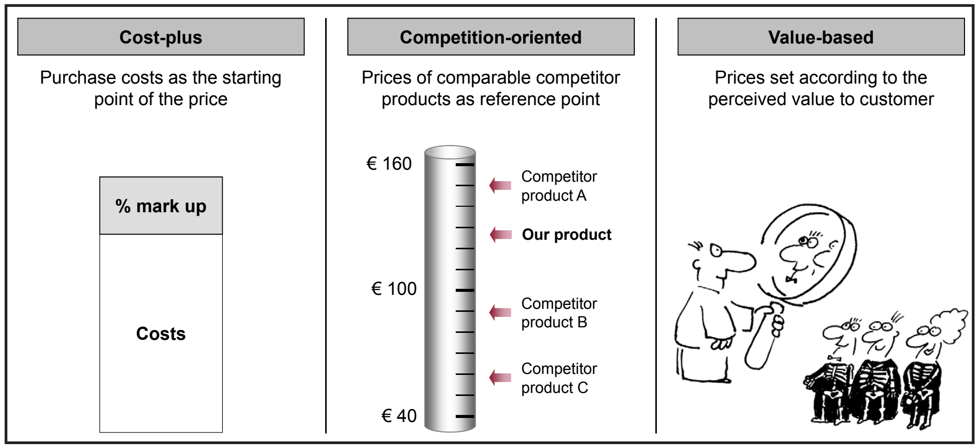
categories can result in margin erosion. A target group is subsequently formulated for each product. Based on these target groups retailers need to decide who will be the most important competitor. One competitor for each target group is enough; the position of 'cheapest' is reserved for only one retailer in the market, all the other players will not win with this strategy.

Step two is to classify products based on price sensitivity. This classification can be obtained by looking at the relative buying frequency of products within the sub-category and the degree of comparability within the market. Attention can additionally be turned to the relative height of the price of the offering within the product category and whether the product is a main or a sub-product. It is important to choose variables that fit the retailer's specific needs and situation. The variables, preferably quantitative, need to appropriately forecast the price sensitivity of products. Based on their sensitivity the products will be divided into various price sensitivity classes (see Fig. 3).

The strategic role of the product in combination with its price sensitivity gives the retailer a certain degree of freedom with regard to pricing their products. Exactly this pricing freedom forms the foundation for selecting the most effective pricing approach in the third step. There are two ways to decide on the optimal price. The first focuses on competitor prices and the second uses the conceived value for the customer as a starting point. Products with limited pricing freedom are priced on a preset interval from the competitor. Products with a high degree of freedom are priced based on consumer value (profit optimal).

The forth step of the Smart Pricing approach is optimizing prices. Knowledge on the psychological price thresholds for consumers is applied to the process and optical price points are used for rounding purposes. Knowledge on price thresholds is often underestimated but it is a powerful tool to distribute categories of groups of products in several consumer-relevant price intervals.

Figure 2



The final step of the Smart Pricing method is evaluating the price level. Often prices are determined once and never adjusted to changing market conditions. **Periodically, it is essential to measure the impact of new prices on revenues and profits, and particular attention should be paid to price levels of focus products.** The best solution is to test these upfront, which is possible through differentiated pricing at individual stores. Fear to adjust prices of focus products often leads to an impasse, while a simple price test often yields valuable information necessary for making the best possible decision.

Conclusion

Applying the five steps of the Smart Pricing approach makes it possible to determine and implement profit-generating prices and leaves companies too afraid of acquiring a bad pricing image far behind. Consumers are less and less sensitive to the pricing instrument than originally perceived. Quality and service are far better tools, and a differentiation strategy based on these two levers, combined with a healthy price level, is a considerably smarter retail strategy. By following the Smart Pricing method the first essential step is made to optimized prices and sustainable improved profit.

Source

http://www.insideretailing.com.au/Latest/tabid/53/ID/9771/Top-11-Retail-Trends-for-2011.aspx

Figure 3