The PRICING ADVISOR

PROFESSIONAL PRICING SOCIETY

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*This article highlights the application of Value Based Pricing approach to evaluate a project. Applying this approach helps pricing managers overcome the drawbacks of certain pricing techniques such as cost based pricing and enables optimization of prices for evaluating products. Author Megha Joshi, CPP, is Assistant Manager, Genpact Smart Decision Services. Her expertise includes driving best in class pricing practices and developing new methodologies for pricing in services industry globally. She can be reached at megha.joshi@genpact.com.*

## In This Issue:



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# Value Based Pricing Proposition for Evaluation of Projects

### 1. Pricing Methods

No matter what type of product you sell, the price you charge your customers or clients will have a direct effect on the success of your business.

Pricing decisions often require time and in-depth research of intertwining factors such as competitive landscape, market dynamics and overall objectives of the organization. The typical tendency for many companies is to benchmark prices against prevailing market prices or against own costs of goods, and to focus on other areas – such as cost reductions, revenue increases – to increase profits and sales. **Many companies forego a significant profit potential by not including the benefit to the customer as part of their price mechanism.**

To set the specific price level that achieves their pricing objectives, managers may make use of several pricing methods. These methods include:

- Cost-plus pricing
- Target return pricing
- Value based pricing

Out of these, value based pricing is the method least adopted by companies. **Part of the reason is that value based pricing can be difficult to sell to customers, who may be wary that they'll end up paying nosebleed prices rather than amounts based on what it cost the manufacturer to make their products.** Figuring out the value of a product also isn't a simple matter. One really has to start with an understanding of their customer, and that takes a lot of work. Adding up one's costs and putting a (profit) margin on top of that looks much easier and more precise.

This whitepaper focuses on the highlighting the importance of the value based pricing approach and its advantages, followed by a case study elaborating its application.

## PPS Happenings

Serving the Pricing Community Since 1984

### Upcoming Events

• **8th Annual Conference on European & Global Pricing** – Amsterdam Marriott Hotel, Amsterdam, The Netherlands / 4 December - 6 December 2012. 6 Workshops plus the Global Pricing for Executives Summit are available on Tuesday 4 December or Wednesday 5 December.

For the most up-to-date information about PPS events and programs, please visit our website at www.pricingsociety.com frequently.

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**2. Value Based Pricing – Approach and Advantages**

**Value based pricing sets selling prices on the perceived value to the customer, not just based on the actual cost of the product, the market price, competitor's prices, or the historical price.** Price for any individual customer can be customized to reflect the specific value delivered.

Customers may evaluate a product based upon its performance, services attached, price, risk, etc. Value Based Pricing techniques like Conjoint Analysis, Buy-Response, Financial Evaluation and Scenario analysis may be used for valuation and price setting.

They are summarized as follows:

- Conjoint Analysis: The consumer quantifies the economic value of the perceived utility for each product attribute, making it possible to determine the ideal pricing of each product configuration.
- Buy-Response: Price comes out from market research estimating the consumer's intention to buy at different price levels. The outcome is a quantification of perceived value.
- Financial Evaluation: The analysis of a project for checking whether the project is profitable or not before taking the project in hand. One can also review the project by investigating its cost, risk and return.
- Scenario Analysis: One can analyze possible price points by considering a gamut of alternative possible outcomes (scenarios). One can suggest a range of optimal prices dependant upon the variation in the input (such as costs, competitors' prices and technical parameters).

Value based pricing is intended to make companies become more competitive and more profitable than using simpler pricing methods. It can also be used in product development and product management to configure products to maximize value for specific customers.

Some industries which apply this pricing technique are: Industrial Manufacturing, Services, Pharmaceutical, Airlines and Hotels (the case study at end of this whitepaper explores the application of value based pricing method in Renewables industry). For example, a pharmaceutical company wanting to launch a new drug may use this technique to justify a higher price than the company might otherwise get from its medical insurers: studies which show that the new drug could help patients avoid expensive surgery, which in turn would lead to lower costs for insurance companies.

> Value based pricing can be the only way to price new product lines or "breakthrough" products as the data for value to the customer is easy to extract using this method.

**Some of the advantages of this technique are:**

- It takes into account industry structure, segmentation, competitor pricing practices, and substitutes and alternatives, all of which can make pricing more coherent and complex. An example which highlights this advantage is in Renewables sector, where by increasing a factor by approximately 1% improves the energy output of an equipment, such that the margin increase opportunity is about 3% to get returns as expected by customer.
- Value based pricing can be the only way to price new product lines or "breakthrough" products as the data for value to the customer is easy to extract using this method.
- Pricing can be based on several customer-focused methods: expert opinion, customer surveys, price experiments (for example by using conjoint analysis theories and techniques), and analysis of past, present and expected market data and conditions.

**However, some disadvantages of this technique are:**

- It requires more data gathering and analysis than market based or cost-plus approaches.
- It uses all of market data available, thus making it more complex than other approaches.
- This method is difficult to do by itself. It requires relatively specialized methods (systematic business intelligence), adequate level of expertise and coordination between different functions/departments to convert raw data to information to knowledge.

**3. Building the value proposition – The way ahead**

If you have clearly-defined benefits such as cost effectiveness or superior technology that give you an edge over your competitors, you can charge according to the value you offer customers. Value based pricing offers some excellent opportunities for optimizing or increasing the profit margins as it depends on the strength of the benefits you can prove you offer to customers.

For pricing to become a core competency in any business, pricers must incorporate the "5C's of Value" into their practices:

- Create Value for Customers
- Comprehend Value to Customers
- Communicate Value to Customers
- Convince Customers They Must Pay For Value
- Capture Value with Strategic Pricing

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Based on Value, Not Costs.

Companies that made the choice to invest in such analytics would certainly get huge returns in the long run. The case study below attempts to reiterate the same.

## Case Study

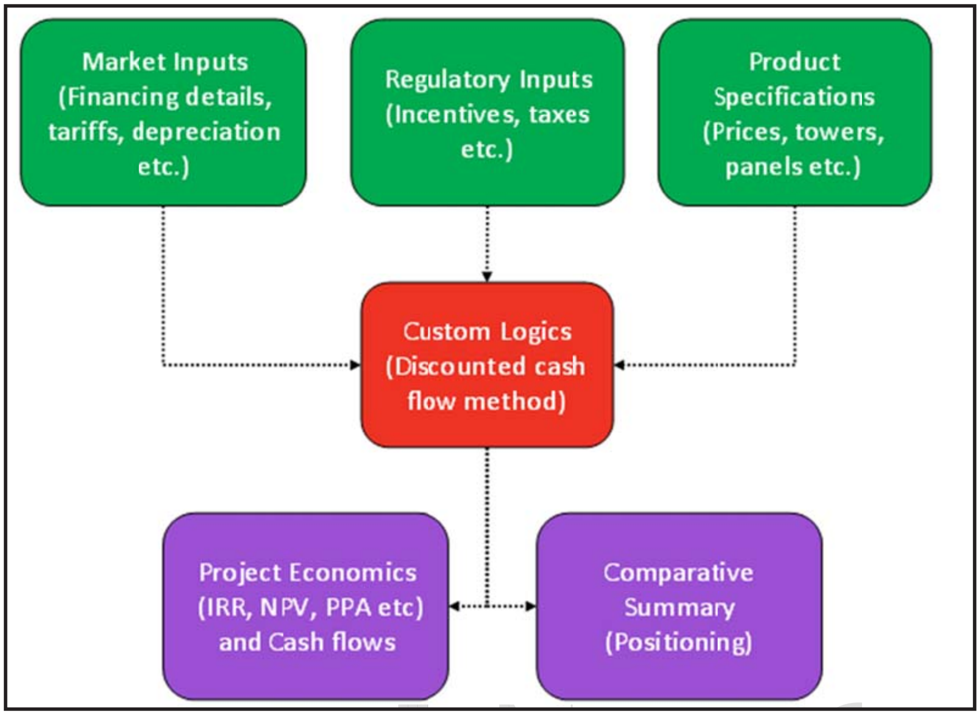
A renowned manufacturing company with global presence catering to the renewables sector was facing problem in evaluating their projects due to limited knowledge about competitive positioning and hence pursued cost-based pricing. They wanted to move from their usual margin based targets to deal price based targets and evaluate deals on an individual basis than following their generic pricing guidelines.

Various challenges were identified such as inconsistency in the way each product or deal was priced and existence of local spreadsheet models which gave limited exposure to the pricing managers on pricing practices followed. They engaged a pricing consulting team which understood that positioning their products against competition would require a value based pricing approach rather than a cost-based pricing approach, in conjunction with their engineering, marketing and pricing teams.

A robust methodology was developed for customized analysis by studying an end to end view of existing processes. Inputs were categorized into three types – market inputs (financing details, tariffs, depreciation etc.), regulatory inputs (incentives, taxes etc.) and product specifications (prices, towers, panels etc.). Once the inputs were collated for all regions, custom logics were built based on a discounted cash flow concept of capital budgeting.

Following this, an easy-to-use financial model was developed with an easy to use interface to estimate the value of the projects and evaluate prices and project economics. This methodical approach enabled users of any region to generate outputs of their interest, such as prices, capital expenditure, tariff (power purchase agreement), IRR (internal rate of return – rate of return on an investment), NPV (net present value – an indicator of how much value an investment or project adds to a firm) for Pricing / Sales / Commercial Operations teams and enabled analysis such as product and market benchmarking for Marketing teams.

**Figure 1: The Logic Behind Value Based Pricing Model for Power Generation Projects**




An interesting observation was that the value based pricing model's results helped the manufacturer's pricing managers and customers understand the value of projects better and hence enabled year on year increase in price quotes by 15%.

The different teams across locations could use the model for:

- Customer perceived value analysis
- Product and Market benchmarking
- Product Value Optimization
- New Product Introduction
- Competitive Positioning
- Sensitivity to various factors affecting economics

For example, for a deal in US, the manufacturer quoted budgetary price for the equipment scope based on a standard contribution margin in range of 15-18% due to uncertainty of a factor affecting the annual energy output. While using value based pricing approach, several simulations were run for price by varying the factor. The simulations suggested that there was an opportunity to increase the price of the equipment, thus improving margins by 20% to 25%.

As seen from the above example, we may conclude that a Value Based Pricing technique helps one estimate the value of their product effectively and hence price it accordingly to one's benefit.