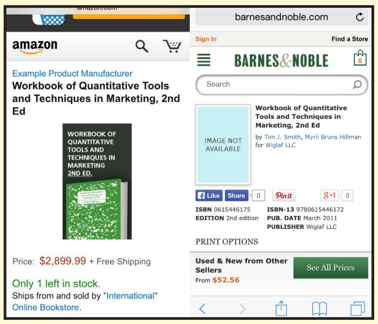
Value-Based Pricing for Multi-Product Retailers and Distributors



More so than in other industries, multi-product outlets question the usefulness of value-based pricing. However, once we accept the reality that price image determines customer purchase rates as opposed to the prices themselves, we have opened the door to value-based pricing for multi-product outlets, as the author explains. Tim J. Smith is the managing principal at Wiglaf Pricing, adjunct professor at DePaul University, and Academic Advisor for the Certified Pricing Professional designation. He will be leading a workshop entitled "Pricing & Corporate Strategy" at the PPS 26th Annual Fall Conference in San Francisco. His most recent book is *Pricing Strategy: Setting Price Levels, Managing Price Discounts, & Establishing Price Structures* (South-Western Cengage Learning, 2012). He can be reached at tsmith@wiglafpricing.com.

More so than in other industries, distributors and retailers herein referred to as multi-product outlets question the usefulness of value-based pricing. They ask:

Does value-based pricing work in retail and other distribution oriented businesses?

- Can the value-based pricing be reconciled with the prevalence of competitive pricing?
- Can holiday and seasonal sales be aligned with value-based pricing?
- And if value-based pricing can even overcome these hurdles, how would it work for companies managing thousands if not millions of shop keeping units (SKUs)?
- What follows is some of what is known.

Value-Based Pricing

Value-based pricing aims to price offerings at the highest price customers are willing to pay.

Repeatedly, I hear challenges to the concept of value-based pricing from people working in multi-product outlets. They point out that in multi-product outlets, competition is intense and customers are able to compare prices easily between stores, and even more through apps and showrooming. In such an environment, people question if value-based pricing applies and point to the importance of competition.

I hear and acknowledge these concerns. But, perhaps further consideration is necessary. Or even more subversively, perhaps they are trying to do value-based pricing but didn't know the term covers their actions. As Mark Stiving states, "Value Base Pricing is Only an Attitude."

Take the central equation that defines the price customers are willing to pay under a value-based pricing approach.

$$P_F \leq P_A + (B_F - B_A)$$

It states that the highest price customers are willing to pay (P_F) is the price of the nearest competing alternative from the customer's perspective (P_A) adjusted for the perceived benefits differential ($B_F - B_A$). This price represents the firm's best estimate of their willingness to pay. And, value-based pricing aims to price offers at this PF, the highest price customers are willing to pay.

Value-based Pricing and Seasonal Sales

With respect to seasonal or holiday sales, we have two issues that impact the potential price-capture for many multi-product outlets: competitive dynamics and buying occasion.

During the seasonal and holiday seasons, competitors are holding sales and therefore the benchmark prices are lowered. In these situations, the only rational approach to attracting target customers for many multi-product outlets is to lower prices to a position which maintains the perceived benefit differential, if any, in light of the competitor's lower prices.

During industry wide discounting periods, multi-product outlets must match the relative depth of holiday discounts to maintain their price positioning, stay competitive, and win the target customers.

That explains why almost all multi-product outlets hold seasonal and holiday sales in unison. It doesn't explain why they are necessary and perhaps even beneficial for their industry in the first place. To explain the profit enhancing potential of seasonal and holiday sales, we need to examine the buying occasion. Let's look specifically at holiday sales in retail environments, and you will see they are aligned with the principals of value-based pricing.

During the holiday season, consumers increase their purchases on goods (gifts) for other people. According to the four-funds of expenditures concept (*Pricing Strategy*, p. 82), people tend to be more price sensitive when spending their money for other people

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than when spending their money on themselves.

Also, in gift giving situations, the concept of "benefits" shifts when spending money on other people from "how good is this product" to "how much will the recipient like the product, and therefore appreciate me or the effort I went to get it." In these situations, we can predict that showy things tend to sell better than useful and practical items. The second half of the four-funds of expenditures theory should indicate the types of products that are discounted more than others in retail environments, but the first half explains why we see holiday sales in the first place.

As for pricing, the fact that a higher proportion of purchases made during the holiday season are made in an increased price sensitivity context implies that retailers overall will have a higher incentive to provide discounts and sales on their merchandise.

Overall, discounting is likely to have a higher impact on sales volumes for retail sales during holiday gift-giving seasons than during other periods.

Similar arguments can be used for other seasonal sales at the retail level and even for distributors.

For Multi-Product Outlets, the Profit Impact of Value-Based Pricing Is in the Details

Note that the impact of the seasonal purchases may not be felt consistently across categories or even across products within a category. Certain categories will have very few shoppers buying for gift giving reasons (groceries, fans, or transformers); other categories will have a much higher proportion of gift-giving shoppers (sweaters, jewelry, or tradeshow tchotchkes). And even within certain categories, certain items will have different proportions of gift-giving customers (luxury nighties vs. practical pajamas.)

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For the multi-product outlet executive, thinking about the buying occasion of the target customers and their product selection reveals opportunities for targeted asymmetric price differentials. If a product has high practical value but little gift value, it may retain its pricing power even during the seasonal sale period.

Hence, a real driver for adopting value-based pricing at multi-product outlets is that value-based pricing gives multi-product outlets a framework for drilling down and identifying where they might have a little pricing power, and therefore can charge a little more for an item, and where they don't. Just as with location, selection, display and customer service, so it is with pricing: retail is detail.

Value-based Pricing in Highly-Competitive Environments

Multi-product outlets often state that they can't price things above their competitors. For multi-product outlets, the alternative for a customer to buying from one outlet is to buy the same, or almost the same product from a competing outlet. Since the competing outlets basically carry the same items, multi-product outlets often feel they must have basically the same prices, if not try to be cheaper and use price as a means to capture customers.

There are obvious examples of multi-product outlets that do price above competitors (convenience stores, premium retailers, and flagship outlets for example). I am willing to grant that many multi-product outlets cannot, or at least that they could but it would not be as profitable as their current practices given their current customer base.

When they don't price above their competitors, when multi-product outlets attempt to match or beat a competitor's price, what they are saying is that the benefits of shopping at their outlet are not higher than those of shopping at a competitor's outlet, at least for their target customer.

For these target customers, the benefits differential goes to zero and the multi-product outlet's price must match or beat the competitors to win their business.

In fact, one can legitimately claim that all competitive pricing approaches are just a subset of value-based pricing approaches. It is a special case of value-based pricing wherein the differential benefits are zero (or negative), and the firm is aiming to price at (or below) what the competition charges.

As stated, taken from the viewpoint of competitive pricing, the benefit differential between different outlets is assumed to be zero and value-based pricing encourages multi-product outlets to basically have the same price as their competitors, if not lower.

Hence, from this viewpoint, the only research a retailer or distributor needs to do is watch their competitor's prices and match or beat them — a pure form of competitive pricing.

But this sophomoric line of thinking is not the end of the story.

Pure competitive-based pricing assumes that customers price-compare voraciously, and all competing outlets basically offer the same customer experience. Both of these assumptions are wrong.

Key questions in value-based pricing include "Who is the target customer?" and "Why are they buying?" If a multi-product outlet is selling something unique and customers are buying the item for themselves, the customer may be willing to pay a premium. Or, if a multi-product outlet is targeting the time-pressed customer that doesn't want to wait in lines but does want and is willing to pay for service, then that multi-product outlet can charge more.

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For the executive, thinking about the differential benefits delivered to their target customers at their multi-product outlet reveals their needed price positioning. If location, surroundings, service, environment, selection, or other attributes impact the shopping experience in a positive manner, that multi-product outlet may find some pricing power.

Moreover, by digging a little deeper, many multi-product outlets have found a lesser known but highly impactful source of pricing power.

Only a Minority of Customers Price-Compare Voraciously

Research has repeatedly demonstrated that only a minority of customers voraciously price-compare between multi-product outlets.

Even in this time of showrooming, only a minority of customers will actually pull out their cell phones and check prices online before buying in a store. I know it sounds crazy that people won't take the five seconds required to scan an item and check prices, especially given ubiquity of smart phones and the number of apps designed to do exactly that, but it is true.

Rules of thumb, which vary depending on who is reporting the statistics and the study being done, indicate that only 20-30% of customers are price sensitive enough to price-compare individual items, and even then the price-comparer segment rarely compares prices on everything. This is found in online environments as well as offline, and for distributors in business to business markets as well as consumer retail. Granted, price-comparers are a large segment of the market, but it is still a minority and even they don't do it all the time.

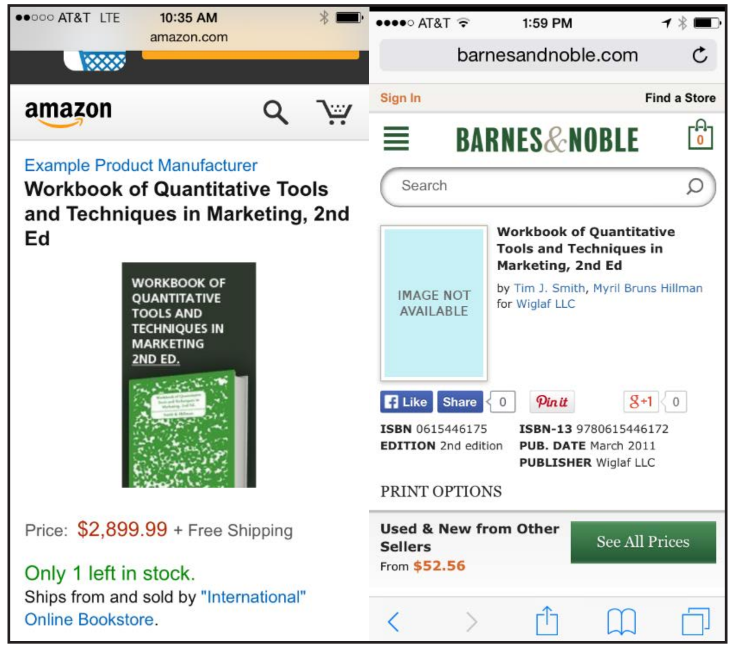
Most customers form a price image of an outlet and use that price image to anticipate the price competitiveness on individual items.

A price image is the general belief of the overall level of prices that consumers associate with a particular outlet [Hamilton & Chernev, 2013]. This price image does not necessarily reflect the actual price positioning of an outlet compared to its competitors. It does reflect the attitude of customers, which may or may not be accurately based in reality. And, price images can be shaped through the environment, marketing communication, and even signpost pricing itself.

The fact that the price image impacts the perception of prices more than the actual prices on items represents both a challenge and opportunity for retailers and distributors. Some low-priced outlets may have a high-price image and some high-price outlets may cultivate a low-priced image. Business people can actively cultivate the price image they desire. And, if they don't, they may get a price image that they don't want.

As business people, we cannot lament the issue price images as the deliberate manipulation of customers by competitors. Our job is not to change human behavior; that would be manipulative. Our job is to serve the humans in the way they behave. That meets the existential purpose of a firm: to serve customer needs profitably. If customers respond to price image more than actual prices, then business people have a responsibility to actively manage their price image.

Figure 1



Managing price image is more important for attracting customers and growing market share than managing every individual price to be competitive for multi-product outlets since most customers don't price-compare every product they buy.

Price Image and Value-Based Pricing

Once we accept the reality that price image determines customer purchase rates as opposed to the prices itself, we have opened the door to value-based pricing for multi-product outlets.

Price image has been found to be impacted by some items more than others in multi-product outlets. In particular, the prices of frequently purchased consumables are found to impact price image more than infrequently purchased items. Therefore, it has been proven that high-priced multi-product outlets can craft a low-priced image by maintaining competitive prices on frequently purchased items while holding relatively higher prices on infrequently purchased items.

And purchase frequency is only one of many factors that determine the impact of an individual item on a store's price image. There is also the issue of product popularity, product price as a percentage of category spending, price and proximity of competitors, and much, much more. Even lighting has an effect.

This and other facts explains why Amazon.com, Wal-Mart, and others are known to have low prices on some items while maintaining higher prices on others, and still be popular retailers.

I myself have consistently noticed my popular textbook, *Pricing Strategy*, is priced competitively compared to college bookstores at Amazon.com while my highly unpopular (but useful) manual on Excel 2010 for Marketers being touted (temporarily) for an incredulously high price. I doubt anyone purchased at this price at Amazon.com. And, to be fair, it is from an "International Online Bookstore", not Amazon.com itself. But still, it was priced far above its Barnes & Noble competitor. See Figure 1 and be shocked.

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Value-Based Pricing in Practice at Multi-Product Outlets

When executives realize they should focus on managing price image, pricing itself must move from cost-plus pricing and move towards value-based pricing.

Most retailers and distributors price from a peanut-butter cost-plus mentality.

In the peanut-butter cost-plus approach, the cost of an item is known by the multi-product outlet by its purchases from the origination manufacturer. Given the fixed cost nature of that retailer or distributor, that outlet knows the gross margin it must achieve on average to cover its costs and possibly make a profit. With that target margin in mind, the multi-product outlet marks-up every item to achieve a uniform gross margin. Like spreading peanut-butter on bread, margins are spread uniformly across all products.

(Some call this butter-and-jam pricing. I like peanut butter more.)

Even in category management, a highly popular and growing field for consumer retailers, a slightly modified peanut-butter margin approach is highly common. The modification they make is this: some categories get a slightly higher margin than others, but all products in a category get the same margin.

But multi-product outlets can do, and some have done, much better.

Some retailers and distributors have been able to consistently (over the span of several years that is) raise margins and increase market share simultaneously. What is their secret? They noticed that some specific items could be priced with relatively high margins while other specific items had to be priced highly competitively with a commensurately low margin to capture customers.

That is, they choose to use chunky peanut butter rather than smooth in spreading their margins.

(Now, do you see why I like the peanut butter metaphor?)

Chunky Peanut Butter Pricing

The chunky-peanut-butter margin approach is a type of value-based pricing. One where those multi-product outlets noticed that some products will still sell even with higher margins while others would not. That is, for some of their thousands of SKUs, multi-product outlets found that customers would express a relatively higher willingness to pay than others.

Now how did they find this? How did they find which of their thousands to millions of SKUs could be sold with a higher margin and which cannot? Insight, Experimentation, Measurement, and Results Driven Decision Making.

That is, they applied the principles of continuous improvement to pricing.

The steps to a continuous improvement cycle are usually defined as Plan, Do, Study, and Act. In chunky peanut butter pricing, pricing managers formulate an insight on which products might be able to carry a higher margin. That insight may really just be a guess, but it is enough to start. With that insight, they design an experiment, a price test, to see if their insight is correct. With that experiment Plan, they run it in the Do step. Once completed, they collect, analyze, and Study the results to determine if there was a connection between the hypothesized insight and the achieve results. From that study, they make a decision: repeat, improve, or discard and try something else. That is, they Act.

Sometimes this requires a "big data" approach, but other times not. Sometimes the experiment will go spectacularly well, but other times not. The key to this approach isn't to get it perfect every time, but rather to be willing to make recoverable mistakes and let the data be the guide on the path to improvement. The outcome is not only a learning organization, but insight into the multi-product outlet's customers and what drives their behavior. Oh, and they also tend to end up with better profits and happier customers.

This approach is likely to require statistical analysis of historical pricing, sales, and competitive data. But notice it doesn't talk about customer research in the forms of surveys or focus groups, things that have been classically taught regarding pricing and marketing. No, this is different. And this is ok.

Value-based pricing isn't just one technique or methodology; it is a philosophical approach to pricing things where customers are willing to purchase, profitably. Hence, it shouldn't surprise anyone that that goal can be achieved through different methodologies, and much less that the methodology needed in some businesses are different than that needed in others.

Yes, retailers and distributors can do value-based pricing and make it work. In fact, some have. The form it takes in multi-product outlet environments is generally different than that used by their suppliers, but the customer orientation and profit outcomes are shared.

Care for some thick and chunky peanut-butter margins anyone?

References

- Hamilton, Ryan; Chernev, Alexander; "Low Prices are Just the Beginning: Price Image in Retail Management", *Journal of Marketing* 77 (November 2013), p 1-20.
- Smith, Tim J. *Pricing Strategy: Setting Price Levels, Managing Price Discounts, and Establishing Price Structures*, Mason, OH: South-Western, Cengage Learning, (2012).