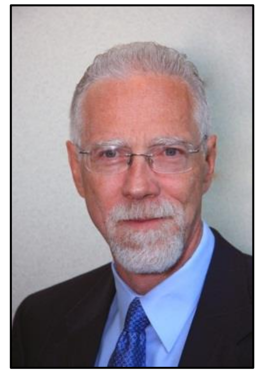
Price versus Value Management – Know the Difference

By Thomas Nagle, Ph.D.



Dr. Nagle founded the Strategic Pricing Group in 1987, the year he published the first edition of The Strategy and Tactics of Pricing. He provides the intellectual leadership for the firm's consulting projects and is a highly sought-after speaker and author, both in the U.S. and abroad. A long term sponsor of the Professional Pricing Society, Dr. Nagle is a frequent keynote speaker at their annual conferences. Prior to founding SPG, Dr. Nagle was a professor of marketing and strategy at the University of Chicago and Boston University. He is a graduate of Penn State University and received his PhD from UCLA.

Pricing software has evolved immensely in its use and sophistication over the past twenty years. Initially, businesses launched software based on the silly idea that they would "optimize" price for each customer. That idea died pretty quickly on the realization that customers will adapt their behavior to avoid being treated unfairly. Today, software can enable a firm to implement and enforce complex pricing policies, can enable a sales rep to justify price based on value, and can track whether what customers pay is actually what they agreed to in a contract. But, contrary to what a vendor may claim, pricing software will not necessarily make your business more profitable.

At one of my seminars, an attendee from a national distribution business told me about his company's experience. After repeated complaints from the field that sales were lost because of a 24-hour delay involved in getting central approval for "special pricing" for a customer, the company purchased software that enabled someone in a field warehouse to request a special price and get a response within minutes, while the customer was still in the field warehouse store. The software worked great and sales increased. But the increase in volume was much lower than the increase in the share of sales now done at a discount. The software made it more convenient to ask for a better deal, so many more customers asked.

The fault was not with the software; it was with the strategy. Before purchasing software to solve a problem, one needs first to have an idea of the solution that he or she wants the software to enable. Recently, I was consulting with a large, multi-divisional equipment company which asked me this question: "Which software should we buy for value-based pricing?" The answer lies in the particular problems that you are hoping to overcome by using the software. Creating a successful value-based pricing strategy involves five very different activities (see Figure 1 below).

The most common use of software is for *management of prices and pricing policies*. The goal of price management is to ensure that your sales and distribution organization is actually doing what you want them to do with regard to price management. The same software can help with price policy formulation by enabling you to track the impact of changes in policy on sales. If you put in an end-of-quarter discount, it is easy to see the increase in end-of-quarter sales. It is very difficult, without software, to track the extent to which an end-of-quarter discount actually increases sales overall, or just shifts sales to an earlier quarter at a huge cost in forgone margin. Finally, the same software can help to monitor the effectiveness of your price structure. Are customers buying your product offers in the locations where you expected, or are they "leaking" into other offers and locations that are cheaper? The leading suppliers of price management software include PROS, Vendavo, and Zilliant.

Much less common is the use of software for *value management,* even though value management is as important an element in value-based pricing as is price management. Value management involves creating the potential for profitable pricing that price management enables the firm to realize. The two obvious aspects of value management are value creation and value communication.

Activity	Question	Solution
Value Creation	Are you developing products with benefits that align with what customers are willing to pay for?	LeveragePoint, in-house solution
Value Communication	Are you communicating how your differentiating features and services impact your customer's bottom line?	LeveragePoint, in-house solution
Price Structure	Do you have a way of charging customers that tracks the value you deliver across customers and applications?	PROS, Vendavo, Zilliant
Pricing Policy	Do your discounting policies tell your customer that price is determined by value, rather than aggressive negotiation?	PROS, Vendavo, Zilliant
Price Management	Are you ensuring that pricing is implemented as intended, and that price level changes reflect true market conditions?	PROS, Vendavo, Zilliant

Figure 1. The five components of a successful value-based pricing strategy

Value creation involves including only those elements in a product or service that a fully-informed customer should be willing to pay for — which is what we call "value". I say "should be" because what customers will actually pay depends upon how the product is marketed and is usually somewhat short of the full value. A great new product that promises huge benefits is only a promise. For example, willingness-to-pay will fall short of value, but will move much closer to value if the product comes with a money-back performance guarantee. Aligning what you offer with what customers value requires modeling the impact of the various benefits on a customer's economics. For B2B customers, the process is conceptually easy. In my book, *The Strategy and Tactics of Pricing*, I call it Economic Value Estimation®; some others call it "economic value to the customer". It is not a measure of the price you can charge, but a measure of the relative price potential that a feature or service enhancement could represent for different segments of customers.   Companies that lack a way to interject a measure of value into their product development process have a tendency to create products that represent "the best that money *can* buy", rather than products that represent the "best value" that customers *will* buy.

Value communication involves communicating credibly, *in monetary terms,* the differentiating benefits of your product. The goal, particularly for a higher-priced product, is to establish for the customer the "value" identified during the value creation stage. Without that, you run the risk that the purchasing department does not know the value of your differentiating benefits to their company, or that they will not acknowledge the value, even if they do know what it is. Once you have established the economic value, or at least have opened a discussion about what it is, you no longer need to justify your price premium relative to the competition. Instead, you can sell or promote your discount relative to the added value that you deliver. Or, to describe value communication in the negative, you can show that your lower-priced competitors are none-the-less overpriced because the savings from buying their products is insufficient to compensate for the value lost by not buying your product!

Companies that lack a formal method for marketing to support value communication in the sales process are vulnerable to purchasing departments that commoditize the differentiation of their products. For example, the purchasing agent claims "If your more durable product lasts 30% longer, I will pay you a little less than 30% more", ignoring what are likely economic benefits associated with greater reliability that are worth multiple times the savings associated with having to purchase the product less frequently. Even some within the pricing field try to sell this simplistic idea, which will lead a company with a differentiated product to undervalue it substantially.

The reason why many companies fail to capture superior profitability, even after buying price management software and implementing tight pricing, is because these first two elements of value management—"vale creation" and "value communication" have not been adequately addressed. The responsibility for value management resides with the marketing department. The reasons are that (1) the design of product offers must usually be made well in advance of sales, and (2) it is much more efficient and cost effective for a product manager to build one model for value quantification than for multiple sales reps each to create their own. The challenge for product managers is that they are usually separated from customers. Thus, all too often they make value management decisions without adequate understanding of what value means to customers, rather than to engineers. And, even when they do understand customers and create good value, they struggle—particularly when the value story is complex—to communicate the story effectively via the sales organization.

Most companies struggle when they attempt to formalize value creation and value communication, often with different people using their own approach. Even if they all adopt a legitimate approach to value estimation, the value model created by one person for one product is likely to "look and feel" very different from the one created by another product manager or sales engineer. Only the creator of each one is likely to understand it well enough to use it in the sales process. A sales person who has five new products to sell is usually unwilling to invest in understanding five different value models that seem very different. When sales reps do use a value model, they are likely to learn that parameters of the models, such as the cost of labor or the cost of a shutdown due to a part failure, differ by customer and by application. That is valuable information that could enrich the model for future use, but in most cases is not captured and communicated back to the model creator to become part of the organization's knowledge base. Unless, of course, there is a value management system to standardize and support these processes.

The only software I know that supports the value creation and value communication steps in a value-based pricing strategy is LeveragePoint. Putting the EVE® for every product on the LeveragePoint platform gives them all the same "look and feel", enabling a sales rep who has learned the EVE® for one product to easily pick up and work with EVE®s created for other products, resulting in more frequent and credible value communication during the sales process. The software saves a value formula created for one customer application (e.g., how a 5% increase in labor productivity converts to dollars of added profitability when used in a particular application) for use when creating value models for other products used in the same application. This not only saves time and effort, but creates consistency in the terminology and logic across products and applications (see Figure 2 below).

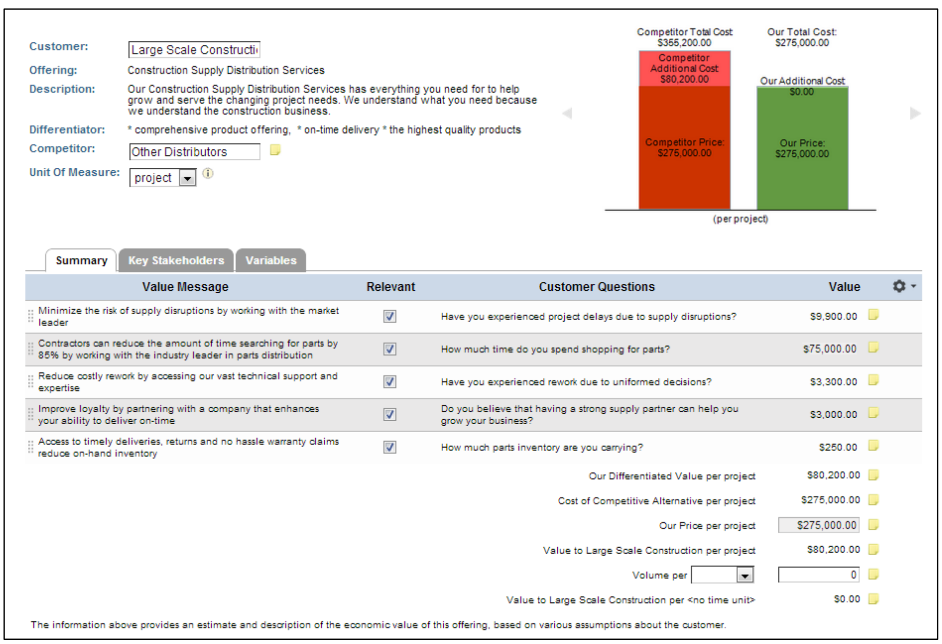


Figure 2. A sample value proposition for sales from LeveragePoint

Finally, the LeveragePoint software gives the product manager, the creator of an EVE®, visibility into the customer inputs and adaptations that are happening "in the field". For example, a sales rep may discover a new value driver or learn that an assumption about the cost of an input is not realistic for some customers. That information can help the product manager to update an EVE®, to segment the market for value communication and pricing more realistically, and even to guide engineering to design product options that reflect that difference in value.

In order to implement and execute a successful value-based strategy, it is critical that you address value management—not just price management—systemically. Failure to include an understanding of value in offer development and customer communication activities will result in a disconnect between what product teams are building, what marketing is communicating, and what sales is selling, leading to fewer profitable sales and poorer financial performance. Other than home-grown spreadsheets, the only software solution I know that supports this "value management" challenge is LeveragePoint. They provide a cloud-based, subscription solution that enables product, marketing, and sales to collaborate on creating and executing a value-based strategy. Their value modeling methodology is based on the Economic Value Estimation™ (EVE®) I introduced in my book, *The Strategy and Tactics of Pricing*.

CONTACT US
35 Medford St, Suite 301
Somerville, MA 02143
(617) 945 – 7075
info@leveragepoint.com | www.leveragepoint.com