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A BEGINNER'S GUIDE TO VALUE-BASED STRATEGY

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10 NOV 2022

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Business Strategy, Economics for Managers, Strategy

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Whether you're a new product manager about to launch a product or service, an entrepreneur getting your venture off the ground, or a business leader reevaluating your company's direction, it's crucial to have the right business strategy to maximize profits.

A value-based pricing strategy offers your organization a practical path forward. Below is an in-depth examination of value-based pricing, including an overview of the value stick framework and the different components that make it so effective.

WHAT IS A VALUE-BASED PRICING STRATEGY?

Value-based pricing is a business strategy that primarily relies on customers' perceived value of goods or services to determine cost.

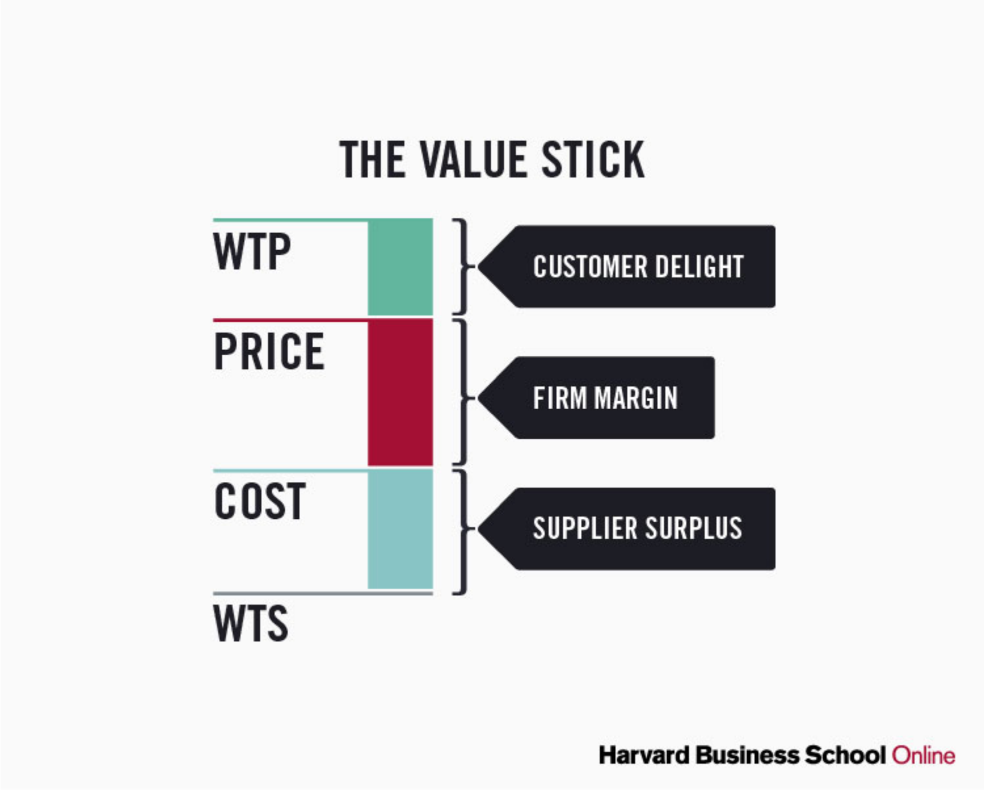
"Value for customers is the difference between their appreciation of a product or a service and what they have to pay for it," says Harvard Business School Professor Felix Oberholzer-Gee in the online course Business Strategy.

The value stick framework offers a helpful way of visualizing the tenets of value-based pricing and how firms can maximize profit margins while creating more value for customers and suppliers.

THE VALUE STICK

The **value stick** is a visual representation of a value-based pricing strategy's different components. At the top of the stick is the value that's been captured by the end consumer, called customer delight. In the middle is the value captured by the firm, called the firm's margin. At the bottom of the stick is the value captured by the firm's suppliers, called supplier surplus.

The value stick comprises four components: willingness to pay (WTP), price, cost, and willingness to sell (WTS). Where on the stick each of these points falls determines how a sale's value is split between a firm, its customers, and suppliers.



Here's a more in-depth look at each component.

1. Willingness to Pay

Willingness to pay is the highest price a customer is willing to pay for your product or service. Customers are more likely to make a purchase when companies charge any amount up to that threshold. Charging even a cent above heightens the risk that customers will decide against purchasing. This could not only deter current and potential customers, but also affect your business's impact on the competitive market.

The difference between the customer's willingness to pay and the final price of the purchase is known as customer delight. This is the level of goodwill, loyalty, and brand enthusiasm the customer feels after making a purchase, which is typically tied to the value they've claimed from the transaction.

2. Price

Price refers to the final price a company charges when it sells a product or service. As such, price is the point on the value stick that a firm has the most control over. It can be set at any point between a firm's cost of production and its customers' willingness to pay.

When a firm sells a product or service, the value is split between the customer and the firm. As explained above, customers receive the difference between their willingness to pay and the actual price, while the company gets the difference between the price it charges and the costs associated with creating the product. This is referred to as the firm's margin. Where the company chooses to set its price determines how value is shared with the consumer.

Naturally, companies aim to maximize profits from each sale. But they also strive to boost customer delight to build brand loyalty and turn single purchases into repeat ones. This creates a level of competition wherein a firm must find the optimal point on the value stick to achieve both goals.

3. Cost

Cost refers to how much money goes into producing a product or service, including all of its components. This includes physical costs, such as the various nuts, bolts, and widgets that make up an item, along with non-physical costs, such as utilities and rental space.

The lower a firm's cost, the higher the value it can share with its target customers. This creates competition between a firm and its suppliers that work to drive the price up to maximize value.

4. Willingness to Sell

Willingness to sell, also known as willingness to accept, is the lowest price a firm's suppliers are willing to accept in exchange for the raw materials needed to create products. While many suppliers would like to sell goods for the highest amount possible to maximize profits, most are willing to reduce prices to a certain extent to make a sale. Their willingness to sell represents the lowest point they're willing to drop before it no longer makes sense to pursue a sale.

The difference between the suppliers' willingness to sell and what they charge the firm is known as supplier surplus—or supplier delight—and it represents the value captured from a sale at the firm's expense.

USING THE VALUE STICK TO DRIVE VALUE CREATION

When the four points above are plotted along the value stick, they create three wedges: customer delight, firm margin, and supplier surplus.

Firms that embrace value-based business strategies can manipulate these wedges in one of two ways. They can either adjust where the points of cost and price fall on the value stick, or they can increase the length of the stick, and the total value shared by all parties, by increasing customers' willingness to pay and decreasing suppliers' willingness to sell.

According to the HBS Online course Business Strategy, there are four strategies companies can use to increase profit margin with the value stick framework:

1. Raise Prices

A firm can easily increase profit margins by raising prices without changing anything else. This allows them to capture a greater share of each transaction's value at customers' expense.

2. Raise Customers' Willingness to Pay

Firms can increase customers' willingness to pay, in effect lengthening the value stick and increasing the total value that can be split. This enables them to raise prices and increase potential profits while delivering enough value to keep customers excited and delighted about the purchase.

3. Lower Costs

Firms can lower their costs by paying suppliers less, without changing anything else about the equation. This allows them to capture more value at the suppliers' expense.

4. Lower Suppliers' Willingness to Sell

Firms can lower their suppliers' willingness to sell, in effect lengthening the value stick and increasing the shared value. This allows them to pay a lower cost while increasing the supplier surplus.

Of the four strategies outlined above, numbers two and four allow firms the opportunity to increase the value for all parties. This enables them to maximize profits without negatively impacting others. Business strategies one and three, on the other hand, allow firms to maximize profits at the expense of customers and suppliers, growing their own value while shrinking others'.

USING VALUE-BASED PRICING STRATEGIES FOR YOUR BUSINESS

The real benefit of leveraging a value-based pricing model for your business is that it forces you to truly understand the motivations of all parties involved in a transaction—your company, suppliers, and customers. This knowledge empowers you to make intelligent decisions around how you price your products or services and often leads to more beneficial outcomes.

Are you interested in learning more about value-based pricing and other key frameworks? Explore our seven-week Business Strategy course, and other online strategy courses, to learn more about how to develop effective pricing strategies.

This post was updated on November 10, 2022. It was originally published on November 3, 2020.

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Tim Stobierski is a marketing specialist and contributing writer for Harvard Business School Online.

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