Value Creation and Estimation

Samuel Engel

Pricing—Class 4

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Tools For Financial Analysis of Pricing

1. BE Sales Change – Basic Calculation

2. Calculating Actual Change in Profit

3. BE Sales Change – With Change in Variable Costs

4. BE Sales Change – With Incremental Fixed Costs

5. BE Sales Change for Reactive Price Change

6. Simulating Change in Profit Scenarios

7. Constant Profit Curves (with Demand Curve Overlay)

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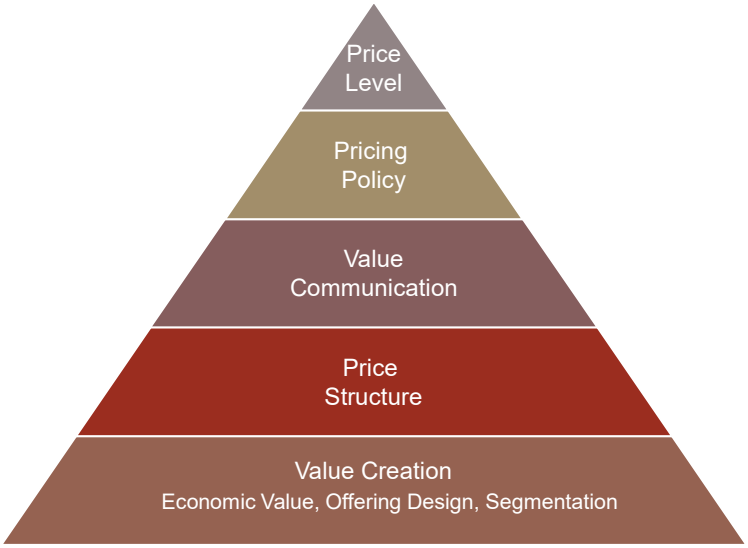
The Pricing Pyramid



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What is Value?

Value is….

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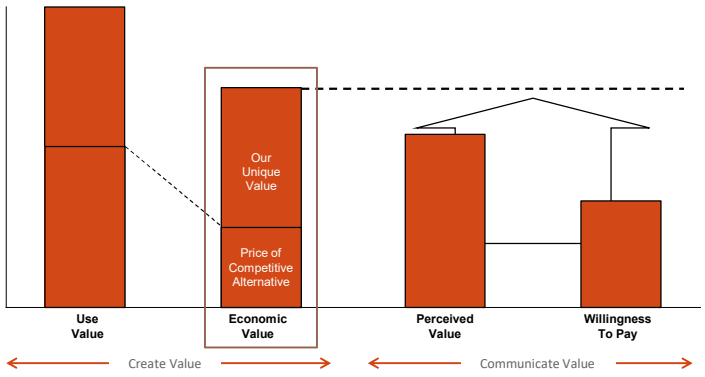
Defining Value in Pricing



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Understand how value is created

Features
What does it do?

Benefits
How useful is it to customers?

Value
What is it worth to the customers?

The Product → The Customer

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Features-Benefits-Value (FBV Analysis)

	Hypothesized Features – Benefits – Value			Hypothesized Importance	Value Algorithm
	Differentiated Feature	Benefit	Value Driver		
Cost Savings	Higher precision, accuracy, <2% of standards	Higher Production Yields for OEM Customers	Raw material savings from less waste, due to higher firing temperatures.	20%	[(Unit Raw Material Cost) ÷ % (Yield Rate) x (# of Units Per Run) x (# of Production Runs)] ÷ # Units
Cost Savings	Smaller installed footprint, less space	OEM customers can design smaller products, cost savings	Bill of Material (BOM) Savings	10%	[D Unit Raw Material Costs x Units Per Run x Production Runs] ÷ # Units
Cost Savings	Closed Housing Design	Safety, Quality of Workplace	Lower accident incidence, and lower accident insurance premiums.	5%	[(D Accident Incidence x Workplace Acc Ins Prem x # Workers) + (D Workplace Acc Ins Prem x # Prodn Workers)] ÷ # Units
Revenue Gains	Superior Field Engineering	Faster Design-In into OEM end-product designs	Time To Market --> Category Share Gains	40%	[D Category Share x Total Category $ Sales x %GM] ÷ # Units
Revenue Gains			Time To Market --> Premium Price Gains (4 Months)	25%	[(D 1st 4 Months Share x Lifetime Category $ Sales x D $ Price Premium)] ÷ # Units
				100%	

Adapted from: Dr. Gerald E. Smith

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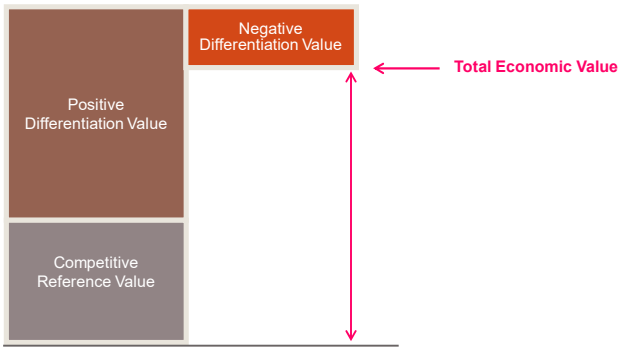
Set Price Relative to Economic Value



Adapted from: Forbis and Mehta (1981); Smith and Nagle (2005), Nagle and Hogan (2006).

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Estimating Economic Value: Reference Value

Reference Value:

- Cost of Closest Competitive Substitute
- Cost of Buyer's Custom Process
- Cost of Alternative Frame of Reference

Adapted from: Forbis and Mehta (1981); Smith and Nagle (2005), Nagle and Hogan (2006).

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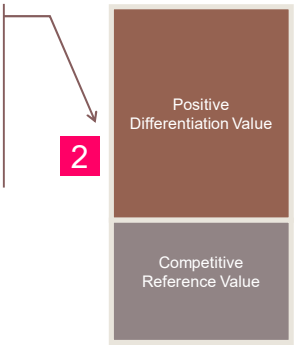
Estimating Economic Value: Positive Differentiation Value

Positive Differentiation Value Drivers:

- Superior Performance
- Savings (reduced costs)
- Gains (increased revenue)



Adapted from: Forbis and Mehta (1981); Smith and Nagle (2005), Nagle and Hogan (2006).

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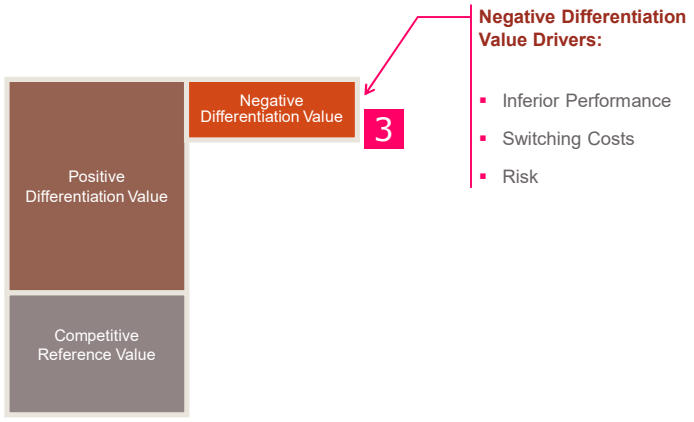
Estimating Economic Value:
Negative Differentiation Value



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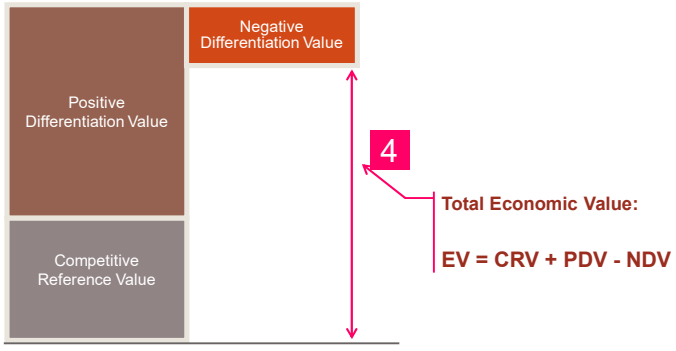
Estimating Economic Value:
Total Economic Value



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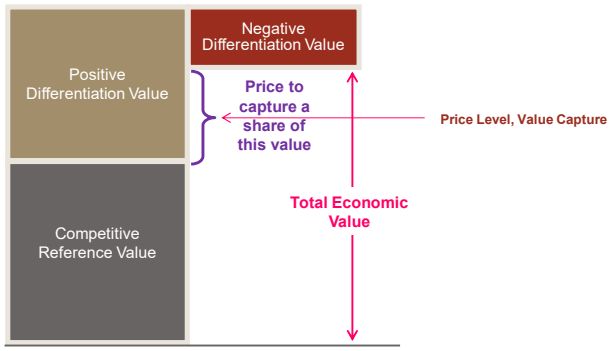
Economic Value Estimation® Framework



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Positive Differentiation Value: Types of Value Drivers

Cost-Driven

- Cost Savings

Revenue-Driven

- Sales Volume Gains
- Margin Gains

Adapted from: Nagle and Hogan (2006), and Smith and Nagle (2005) 18

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Positive Differentiation Value Drivers: *Cost Savings*

Capacity Constraints	Savings in overtime, temps, independent contractors, etc.
Employee Turnover	Savings in finding, recruiting
Worker Productivity	Savings on wasted tasks, inefficient use of employee time, task yield
Resource Reallocation	Savings on salary and compensation of misallocated personnel
Training/Learning	Savings on training and education expenses
Ancillary Services	Savings on ancillary services not central to the organization's strategy
Equipment/Inventory	Savings on unnecessary capital or inventory investment
Reliability/Durability	Replacement savings, better yields

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Positive Differentiation Value: *Revenue/Margin Gains*

Faster Go-To-Market	Gains in sales volume, market share, channel and market penetration
More Cost Competitive Product	Gains in sales volume, market share, channel and market penetration
More Differentiated Product	Gains in margins, sales volume, market share, channel and market penetration
More Profitable Customer Mix	Gains in margins and customer profitability
Marketing Efficiencies Gains	Scale economies due to gains in sales volume, market share, channel and market penetration
Market Impact Gains	Gains due to simultaneous selling to multiple market segments
Customer Loyalty Gains	Gains in margins, sales volume, market share due to repeat purchase and loyalty
Customer Networking Gains	Gains in sales volume, market share due to word-of-mouth, opinion leader effects

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Peterbilt Tractor

New Model

Why Switch?

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New Warranty Program

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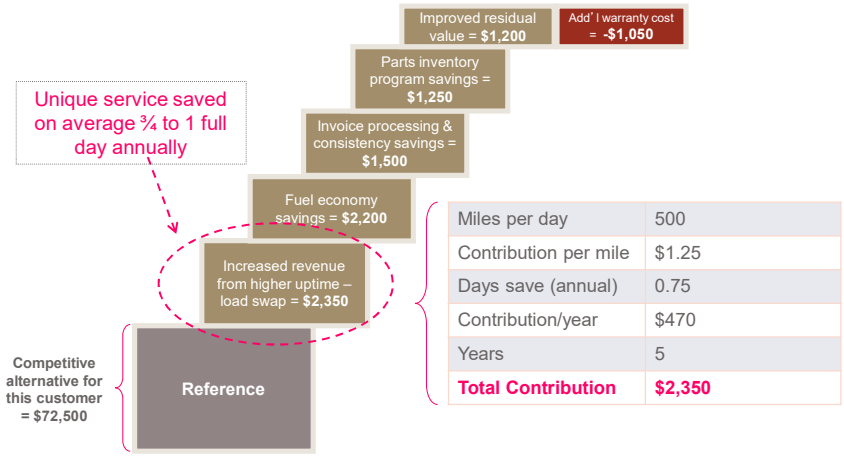
EVE – Calculating Value Drivers



Miles per day	500
Contribution per mile	$1.25
Days save (annual)	0.75
Contribution/year	$470
Years	5
Total Contribution	**$2,350**

Adapted from Strategic Pricing Group, a member of Monitor Group

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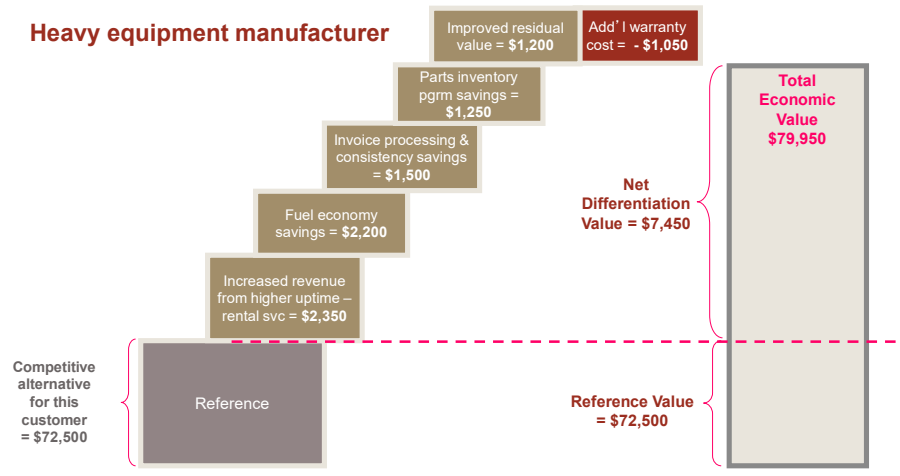
Economic Value Estimation



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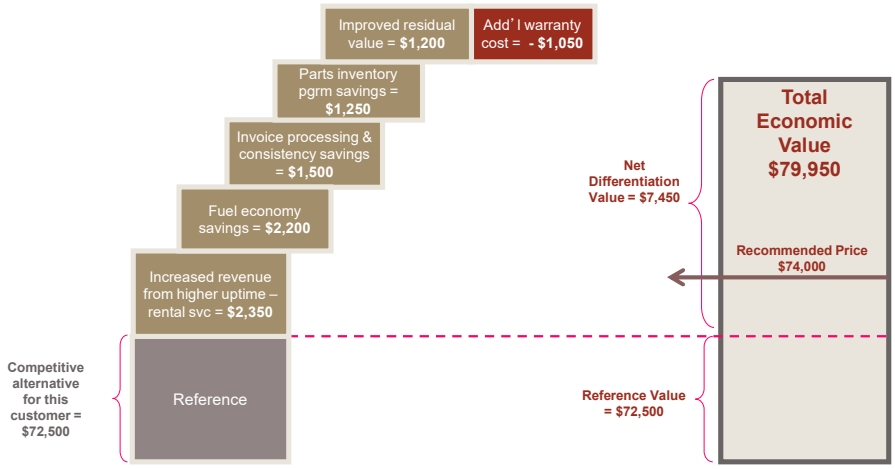
EVE – 3 Value Price-Setting Metrics



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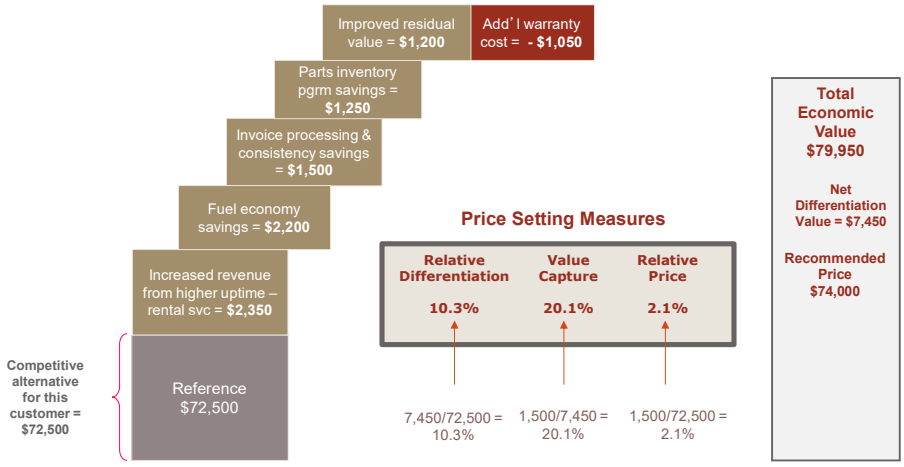
EVE – 3 Value Price-Setting Metrics



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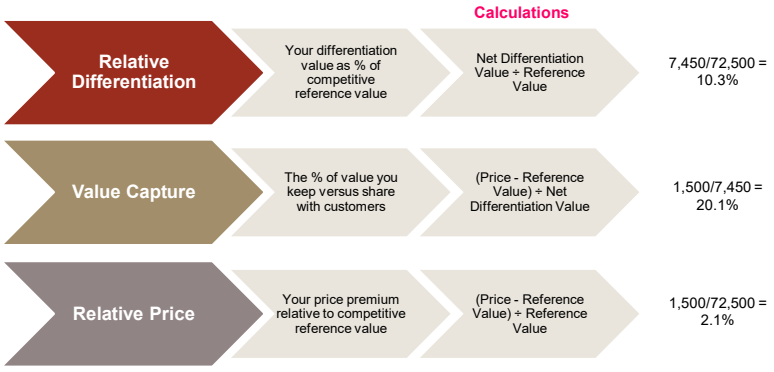

Adapted from: Dr. Gerald E. Smith

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Value Capture Examples

Market	Value Capture Rates	Notes
Enterprise Software	20 – 50%	High variability due to negotiated pricing and large value differences between customers
Heavy Manufacturing	10 – 30%	Falls to low end of the range for large, powerful customers
Process Manufacturing	10 – 20%	Relatively low because few companies capture the value of bundled services
Computers	20 – 40%	Relatively high, although the amount of differentiation is generally very low leading to thin margins
High Technology	5 – 50%	Tend to take profits early in lifecycle but give them up rapidly to defend share over time
Professional Services	10 – 40%	Higher end of the range for proven firms with well known brands
Distribution	5 – 20%	Tends to be low because of competitive pricing and failure to price for total solution value
Pharmaceuticals	30 – 50%	Relatively high if value (in clinical benefits or cost savings) can be documented at launch. Lower if cannot be documented. Also depends upon whether payer is driven by cost minimization or attracting members quality of coverage.

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Calculating Value
Why bother?

- Establish a value-driven pricing culture
- Develop value-driven pricing skills
- Train the salesforce
- Properly educate the customer
- Anchor the product's value in the market
- Negotiate value: capturing versus sharing

Adapted from: Dr. Gerald E. Smith; Photo by Annie Spratt on Unsplash

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