Book The 1% Windfall

How Successful Companies Use Price to Profit and Grow

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Recommendation

Many companies don't realize how much more profitable they could become through creative pricing. Even just a single percentage-point price increase can make a big difference to your bottom line: McKinsey & Company found that a 1% uptick in prices translates to an average 11% rise in operating profits. Pricing expert Rafi Mohammed shows you how to maximize your gains with "value-based pricing" and how to implement a range of pricing strategies and tactics to attract new customers and keep current clients buying. Although the prose can be dry at times, this manual provides crucial points to consider. *BooksInShort* recommends it to those who set their products' prices, including CEOs, CFOs, managers, entrepreneurs and marketers.

Take-Aways

- Implementing even a 1% price increase could substantially boost your company's profits.
- Set your prices based on how much customers are willing to pay for your products, not on what it costs to produce them.
- To derive "value-based pricing" – which reflects what shoppers are willing to pay for your goods rather than what they cost to produce – show how your product is distinctive.
- "Pick-a-plan" pricing allows customers to choose a price that works for them.
- Examples of pick-a-plan pricing schemes include "all-you-can-eat" deals, "flat rate" pricing, and "ownership alternatives" like renting or time-sharing.
- Offer premium and stripped-down versions of your product at varied price levels.
- Use "differential pricing" for the same product to attract different kinds of customers.
- Forge ahead with offensive pricing strategies to establish profitable margins.
- During a recession, focus on defensive tactics to keep customers, but don't slash prices across the board.
- Make tactical pricing part of your corporate culture. Regularly re-evaluate your prices.

Summary

Pricing Your Way to Higher Profits

Pricing your product or service appropriately is an excellent way to increase your profits. And it's not just about raising your prices, although the "1% windfall" is illustrative: The average bump from a 1% price increase is an 11% gain in profits. And if Sears, Amazon or Walmart raised their prices by just 1%, their operating profits would soar by 155%, 23% and 18%, respectively, based on the effect an income increase would have on their market capitalization. Pricing is a corporate and marketing strategy that offers a wide variety of tactics and options for boosting profitability.

“Value-Based Pricing”

Don’t just use cost-plus pricing that reflects your expenses. Instead, use value-based pricing, which reflects what customers are willing to pay for your product rather than what it costs you to produce it. If you charge only one price, you may miss out on business from potential customers who want to pay more or less than your set fee. Street vendors understand this concept: They raise the price of umbrellas when it rains since they know passersby will pay extra to stay dry.

> “When it comes to setting a price – how businesses get compensated for their hard work and financial risk – most companies drop the ball.”

Identify the customers you wish to reach and their “next-best alternative” to your product. Make sure the price you set is what customers realistically will pay. Unfortunately, no one has a magic formula for calculating how much customers will pay: Use your judgment, market research or both to determine appropriate value-based pricing.

> “Critical pricing decisions are often made using arbitrary ‘this is the way we’ve always done it’ methods. Companies are shortchanging themselves every day.”

Although many managers are afraid to raise prices, customers are willing to pay for what they want. If they purchase your product instead of your competitors’, it’s because they believe you offer the best value, regardless of your actual price. This frees you to consider various pricing options. For instance, you could use “one-on-one pricing” that tailors your prices to individual shoppers. Or, you could try “multicustomer pricing” by setting a price that maximizes the number of units you can sell. This is the tactic most sellers use, even if they have other options.

> “A value-based price is the price that the majority of customers purchase a product at and is the foundation of every company’s strategy.”

To vary your pricing, show consumers how your product is distinctive. Its differentiating features may include brand name, quality, service and style. In an example of the power of a brand famed for “trust, quality” and “style,” a reporter bought a one-carat diamond ring from Tiffany for $16,000. Appraisers valued the stone alone at $10,000. A similar one-carat diamond sold for $6,600 at Costco. A gemologist who judged both diamonds said, “It’s a little bit of a surprise. You wouldn’t normally consider a fine diamond to be found in a general store like Costco.”

> “The law of demand...offers a key pricing principle: Some customers are willing to pay more than others.”

Raising prices will give you a higher profit margin, but perhaps fewer sales. Ideally, you want to set your prices to earn the most profit, so adjust your value-based prices as necessary. Like stocks, products’ values increase and decrease over time, depending on customers’ budgets, preferences, alternative products or economic conditions.

“Pick-a-Plan Pricing”

This is one of the “variable pricing” alternatives that includes “versioning” and “differential pricing.” Pick-a-plan pricing, which can draw potential customers who are wavering about buying, gives consumers the option of selecting price levels that work for them. Choose among four pick-a-plan options:

1. **“Ownership alternatives”** – When customers want a product but either can’t afford it or don’t want the responsibility of ownership, they can lease or rent. Many people prefer to lease cars or rent houses so they’re not burdened with maintenance costs. Vacation time-shares and fractional jet ownership are also popular “interval ownership” options. Numerous firms have adopted “the Netflix model” of paying a set fee for using a variety of exchangeable items, like handbags or video games.
2. **“Uncertain value”** – Customers may not be able to assess the ultimate value of some goods or services. “Future purchase options” reach those who want to buy at today’s price for future needs. In one example, consumers can buy low-cost health insurance now, knowing that owning it allows them to upgrade to better, more expensive health insurance later if needed. “Success fees, licensing and auctions” are also uncertain-value models. A success fee makes you responsible for delivering a successful outcome regardless of the situation; both law firms and clients benefit when attorneys get paid only if they win a case. Licensing allows you to sell intellectual property rights, such as franchises, trademarks or technology, to others in return for a share of revenues. If your item for sale is hard to price, auction bidders can determine its value quickly.
3. **“Price assurance”** – To eliminate price uncertainty completely, use package options such as “flat rate, peace-of-mind guarantees, all-you-can-eat and two-part high/low pricing.” Your customers may prefer knowing how much a project will cost up front rather than worrying about hidden costs. With a flat rate, they pay a fixed price regardless of how long you take to complete a project or how much your supplies cost. Peace-of-mind pricing, which locks in a set price for a specific time period, is similar to flat-rate pricing; both protect customers from price fluctuations. All-you-can-eat pricing is a great strategy for reaching cost-conscious customers who like to sample different products. Long popular among buffet restaurants, this strategy is now common among cellphone and Internet providers, which offer their customers variations on one price for as much data as they can consume. Two-part high/low pricing “involves charging an up-front price and then setting low second-part variable prices.” Costco, for example, employs this strategy: It requires shoppers to pay membership fees before entering its stores to shop for low-priced items.
4. **“Financial or other constraints”** – Financing options allow customers to purchase products on different schedules. Credit and “layaway” options help shoppers time their payments over a specific period. “Prepaid plans,” like those for telephone service, let consumers pay in advance for a product or service until they’ve exhausted their credit. AutoNation’s “job loss protection” option promised car buyers six months of waived payments if they were to become unemployed. The firm estimated increases of 10% to 15% in sales from this pricing program.

“Versioning”

Another pricing strategy is versioning, in which you offer a core item at one price but add or subtract different features based on customers’ preferences and charge accordingly. You have three main choices, and some companies use all of them:

1. **“Premium”** – These options include higher quality or faster products as well as “guaranteed” or “priority access.” Premium options appeal to current customers

who love your product, new clients attracted to the additional amenities and those who opt only for the best. Examples of premium options include Ralph Lauren's high-end Purple Label collection and the services of a law firm's partner rather than those of a first-year associate. Express train tickets cost more, but passengers reach their destinations with fewer stops. For a $1 extra fee, moviegoers can buy tickets online through Fandango and get guaranteed seating. In Chicago, Six Flags amusement park charges $54.99 for general admission, but an additional $245 grants VIP priority access to rides and attractions.
2. **"Stripped down"** – Frugal customers appreciate basic versions of products in return for a reduced price. Examples include restrictions, "off-peak pricing" and "unbundling." Airlines charge leisure travelers less but place limits on their tickets, while business fliers pay more without restrictions. Electric utilities companies now offer discounts for usage during low-demand periods, and buyers can download individual songs rather than an entire CD.
3. **"Unique customer needs"** – Versioning also encompasses pricing strategies designed to target certain customers based on their preferred "bundle." Bundling lets clients save money when they purchase several products at once; the telecommunications industry bundles telephone, TV and Internet together for one price.

"Differential Pricing"

Because some customers will always pay more than others for the same product, you're giving up revenue opportunities if you sell at just one price: You'll miss out on those who would have paid more, as well as on those who would have bought more at a cheaper price. So, set different prices to attract more buyers.

> "When a new competitor enters the market, it's natural to consider offering discounts to keep customers from defecting. Resist this temptation."

Businesses create "hurdles" for price-sensitive consumers willing to go through extra steps to get a discount. These obstacles may include rebates, coupons and "price-match guarantees." Prices based on customer characteristics might factor in clients' locations, organizational affiliations or payment history. For instance, Florida residents pay reduced fees at Orlando-based Universal Studios; members of the American Association of Retired Persons (AARP) get discounts on hotel rooms; accident-prone people pay higher insurance premiums than those who rarely make a claim.

> "A friendship predicated on offering discounts has no loyalty."

You can also charge different prices based on how you sell products. For example, you may offer a discount for large quantities or "mixed bundling," which "involves selling products both individually as well as together in bundles." Fast-food restaurants sell "value meals" because the higher margins on french fries and drinks more than compensate for the lower bundled price.

"Use Price to Profit and Grow"

To go on the pricing offensive, start with a value-based price. Allow customers to select among your pick-a-plan options. Offer different versions of your products. If appropriate, adapt your product and its "differential price" to customer requirements. Review your offerings for "profit cannibalization," which happens when too many customers pay a low price instead of a full price. Defensive pricing strategies come into play during economic downturns, when customers often "trade down": They'll opt for a four-day weekend trip instead of a weeklong vacation, or they'll choose generic items over brand names. Firms should resist the temptation to slash prices during tough economic times because customers will resist paying full price once the recession ends.

> "Better pricing is powerful and easy to implement, quickly produces results, and focuses a company on creating and capturing new value."

Consider offering a "fighter brand" – a stripped-down version of your current product – to attract price-sensitive customers. For example, corporate behemoth Procter & Gamble offers Luvs diapers and Gain laundry detergent as cheaper substitutes for their Pampers and Tide signature brands. Consider "sales, coupons and rebates" to increase your business traffic. Help consumers through tough times by offering financing programs. Resist raising prices during a recession – even if the slump drives more business your way – for two reasons: First, if the situation worsens, consumers will abandon your now higher-priced goods and, second, if the situation improves, clients will drop you to return to their usual purveyors.

Profit as Part of Your Corporate Culture

Make profitable pricing part of your corporate culture by dispelling myths and re-evaluating initiatives. These six common pricing myths can interfere with growth:

1. **"Setting prices involves marking up prices (cost-plus)"** – Instead, decide on value-based prices by analyzing how much your customers are willing to pay.
2. **"Increasing market share involves a trade-off between price and share"** – Don't assume you must lower your prices to raise your market share. Instead, offer different prices to attract different customers.
3. **"The highest volume customers should receive the lowest prices"** – Save your discounts for your on-the-fence or price-sensitive customers and prospects.
4. **"Discounting to get in the door will lead to premiums once a product proves its value"** – Salespeople often think that if prospects try a product at a lower price, they will like it enough to pay full price later on. But convincing clients to pay more is difficult. Instead, offer money-back guarantees, rebates or trial sizes.
5. **"Higher operating margins signify pricing excellence"** – Not always; they may indicate that you should consider discounts for price-conscious customers.
6. **"Lower prices to regain lost volume"** – Focus your strategy on particular areas of lost volume rather than slashing prices across the board.

> "Now is the time to reap a pricing windfall."

About the Author

Rafi Mohammed, PhD, founded Culture of Profit LLC, a consulting company that helps businesses design pricing. He also wrote *The Art of Pricing*.