Introduction: Price strategy is emerging as the most important resource for companies to increase their competitive advantage. The vast majority of companies have spent years achieving gains through cost cutting, outsourcing, process re-engineering and the adoption of innovative technologies. However, the incremental benefits from these important activities are diminishing, and companies need to look at other areas to improve their business results. Today, companies are looking to serve well-defined market segments with specialized products, messages, product variants and services, and to earn superior profit margins while doing so. Savvy companies are implementing price optimization schemes and focusing on building their organization to serve their most profitable customers. Many are even "firing" customers who are unprofitable. All too many companies, however, use simplistic pricing processes and cannot even identify their most profitable customers or customer segments. This lack of information means that all too many management teams have their sales staff focusing the bulk of their time servicing the least profitable of their customers. Some companies even embrace policies and pricing strategies that drive away their best customers, and then they wonder why their profits are not growing.

In the course of our engagements, we have seen examples of good and bad pricing policies. The following is a list of ten of the most common mistakes companies make when pricing their products and services.

Mistake #1: *Companies base their prices on their costs, not their customers' perceptions of value.*

Prices based on costs invariably lead to one of the following two scenarios: (1) if the price is higher than the customers' perceived value the cost of sales goes up, discounting increases, sales cycles are prolonged and profits suffer; (2) if the price is lower than the customers' perceived value, sales are brisk, but companies are leaving money on the table, and therefore are not maximizing their profit.

Costs are only relevant in the pricing process because they establish a lower boundary for the price. In certain circumstances, there are strategic reasons a company may decide to sell a product below its cost for a period of time, or to a certain market segment as a "loss leader." However, when a price is set according to the perceived value of the product or service, sales are brisk, and profits are maximized.

One Atenga client manufactures audio components. Across their product line, they set prices according to a multiple of the parts cost. When the market for high-end audio components boomed, the company did well enough. But as competition began to increase, sales stagnated and profits evaporated. Our research showed that particular products were perceived by certain segments of the marketplace as "priced too low." Repricing of those products created enough additional revenue to pay for the launch and marketing of a new line of products and restored the company's leadership position in its niche of the industry.

Mistake #2: *Companies base their prices on "the marketplace."*

The marketplace is often cited as the "wisdom of the crowds," the collective judgment of the value of a product. **But by resorting to "marketplace pricing," companies accept the commoditization of their product or service.** Marketplace pricing is a resting place for companies that have given up, and where profits end up being razor thin. Instead of giving up, these management teams must find ways to differentiate their products or services so as to create additional value for specific market segments. The marketplace is full of companies that have managed to drag themselves out of commoditization and establish a unique value proposition. They have then gone on to capture that unique value at prices higher than those of "the marketplace."

The best-known case of reverse commoditization is Starbucks. By rethinking the entire experience consumers of coffee engage when they consume a cup, the company has produced prodigious growth and outsized profits. A Starbucks cup of coffee delivers a unique value proposition that engages millions of consumers daily (including this author!), and they happily pay $3.00 to $4.95 for what used to be a nightynine-cent cup of coffee.

Mistake #3: *Companies attempt to achieve the same profit margin across different product lines.*

Some financial strategies support a drive for uniformity, and companies try to achieve identical profit margins for disparate product lines. The iron law of pricing is that different customers will assign different values to identical products. For any single product, profit is optimized when the price reflects the customer's willingness to pay. This willingness to pay is a reflection of his or her perception of value of that product, and the profit margin in another product line is completely irrelevant.

The Wall Street Journal reported on March 27 of this year how the industrial behemoth Parker had a uniform 35% gross profit objective across its 800,000 products. They were stuck in a "profit-margin rut." A new CEO in 2002 determined to change this. The change was championed in the face of determined opposition from the division managers. "There was so much pushback," according to the Journal, "the CEO eventually assembled a list of the 50 most commonly given reasons why the new pricing scheme would fail. If a manager came up with an argument not already on the list, then Mr. Washkewicz agreed to hear it out. Otherwise, he told them, get on board." The company credits the new pricing program with adding $200 million to their bottom line, improving return-on-invested capital from 7% to 21% and its shares have gained nearly 88%.

Mistake #4: *Companies fail to segment their customers.*

Customer segments are differentiated by the customers' different requirements for your product. The value proposition for any product or service is different in different market segments, and the price strategy must reflect that difference. Your price realization strategy should include options that tailor your product, packaging, delivery options, marketing message and your pricing structure to particular customer segments, in order to capture the additional value created for these segments.

One Atenga client developed an innovative software product. They priced the desktop version at $79.00 per seat, a figure that "felt right" for the executive team. Sales stagnated. Atenga research showed that there were two distinct market segments: consumers and professionals. The $79.00 price was too high for the consumers who were interested in purchasing the product, and too low for the professionals. It communicated "not a serious tool" for the professionals who were interested in its value proposition. As a result of this research, the company decided to focus on the professional marketplace, and raised the price to $129.00. Sales soared

Mistake #5: *Companies hold prices at the same level for too long, ignoring changes in costs, competitive environment and in customers' preferences.*

While we don't advocate changing prices every day, the fact is that most companies fear the uproar of a price change and put it off as long as possible. Savvy companies accustom their customers and their sales forces to frequent price changes. The process of keeping customers informed of price changes can, in reality, be a component of good customer service. Marketplaces change radically in a short period of time. It is important to recognize that the value proposition of your products changes along with changes in the marketplace, and you must adjust your pricing to reflect these changes.

One Atenga customer sells services to the biopharmaceutical marketplace. Over the past few years, demands for its services have increased dramatically, and the entire industry has run into limitations in the number of trained personnel to do the work, and restricted capacity in terms of the required facilities and equipment. The company has held prices constant for the past seven years, even in the face of rising costs for capable staff. Atenga research found that customers believed the company was the best "value for money" in the industry, and they could raise prices about 12% without impacting sales. The additional 12%, however, more than doubled the company's profits in the second quarter after it was initiated.

Mistake #6: *Companies often incentivize their salespeople on revenue generated, rather than on profits.*

Volume-based sales incentives create a drain on profits when salespeople are compensated to push volume at the lowest possible price. This mistake is especially costly when salespeople have the authority to negotiate discounts. They will almost always leave money on the table by: (1) selling lower priced products, and (2) dropping prices to "clinch the deal." When their "job" is to get the deal, regardless of profitability, salespeople will do exactly that. And, as a result, your profitability will diminish. Companies need to redefine the salesperson's "job" as *maximizing* profitability, and incentivize profitability, while also providing the salespeople the necessary "tools" to do so. These tools include information on profitability on each of the products your company sells, strict control of the awarding of discounts.

One Atenga client was persuaded by its sales staff to reduce the price of its keynote component from $2400 to $1800. The staff believed – and persuaded management - that lowering the price would drive proportionately higher sales volumes. The result was catastrophic. Sales volume over the following year declined almost 40%, as customers and channel partners perceived that the lower price signaled a lower quality. That lower-quality perception prevented the company from reversing the price increase, and it was not until a new product was designed – 18 months later -- and released that the company began to recapture its former price point, and sales volume.

Mistake #7: *Companies change prices without forecasting competitors' reactions.*

Any change in your prices will cause a reaction by your competitors. Smart companies know enough about their competitors to forecast their reactions, and prepare for them. This avoids costly price wars that can destroy the profitability of an entire industry. Savvy companies understand that any significant lowering of your price – which may drive increases in volume – will provoke a reaction from your competitors.

One Atenga client dominates its marketplace for a specific type of internet web services. As they prepared to move into a new market for the services, smaller competitors were already selling into it with a different form factor. Atenga research showed that the new form factor would be preferred by the entire market – including the client's existing customers. The new entrants were financially weak, however and a low price point by the client would put pressure on the competitors that they would not be able to stand. At the end of the Atenga engagement, the client purchased one of the competitors, and went on to dominate the market in the new form factor, as well.

Mistake #8:

Companies spend insufficient resources managing their pricing practices..

There are three basic variables in a company's profit calculation: cost, sales volume and price. Most management teams are comfortable working on cost reduction initiatives, and they have some level of confidence in growing their sales volume. But good price setting practices is seen as a "black art." Consequently, many companies resort to simplistic price procedures, while the same companies use highly sophisticated procedures and technologies to track and control their costs in minute detail and in real time. Likewise, companies believe they know what effect marketing campaigns and "the number of feet on the street" have on sales volume. Managers feel comfortable with these two hard data sets. Therefore, they spend nearly all their time on the issues of sales volume growth and cost control, overlooking the vital role of pricing strategy. They erroneously believe that pricing is not important, or that hard data and rigorous methods are not available to enable them to control pricing. In fact pricing is of outmost importance, and a key element of the marketing mix. Good pricing strategies use hard data generated by modern methods such as Value Attribute Positioning, Conjoint Analysis or Van Westendorp's Price Sensitivity Meter, to generate accurate hard data on the perceived value of a product or service, thereby enabling mangers to maximize their profits by optimizing their prices.

One Atenga client managed prices by reviewing the prices of their competitors and making adjustments to their own accordingly. The primary data input to the pricing decision was the stories customers and salespeople told them about how competitors were offering lower prices. Atenga research showed that a significant segment of the customers desired a particular set of services along with the product, and that if our client, as opposed to its competition, offered those services, they would be willing to pay significantly higher prices, as their overall costs would decline. Setting price levels and strategies based on competitive information was missing important profit opportunities.

Mistake #9: *Companies fail to establish internal procedures to optimize prices.*

In some companies, the hastily-called "price meeting" has become a regular occurrence—a last-minute meeting to set the final price for a new product or service, or a semi-regular review of the company's price list. The attendees are often unprepared, and research is limited to a few salespeople's anecdotes, perhaps a competitor's last year's price list, and a financial officer's careful calculation of the product's cost structure across a variety of assumptions.

A more disciplined approach to price optimization requires data, analysis and discipline. These are the same ingredients that drove the cost-cutting success of the 1980's and 1990's, when companies systematically studied, reviewed and re-engineered their processes to eliminate redundancy and to reduce costs and cycle times. Price optimization requires, and deserves, the same level of attention and support.

Price optimization data comes from focused research. The research comes from surveys constructed and conducted by professionals who know what to ask for and how to extract the information that is important to the pricing project. They have experience structuring the questions, questionnaires and data to uncover the most important points, inconsistencies, and above all, the values perceived by the interviewees.

Mistake #10: *Companies spend most of their time serving their least profitable customers.*

Most companies do not even know who their most profitable customers are. While 80% of a company's profits generally come from 20% of its customers, a careful review of the data often will show surprises, since a company's largest customers are often only marginally profitable. Failure to identify and focus on their most profitable customers leaves companies undefended against wilier competitors. Such failure also deprives the company of the loyalty that more attention and better service would provide. It can also mean that the company cannot actively seek out more profitable customers because they identified or profiled them. These companies base their decisions on anecdotes, stories, whispers and hearsay rather than hard data about customers and competitors.

Mistake #11 (Bonus entry) *Companies rely on salespeople and other customer-facing staff for intelligence about the value perceptions of their customers.* Such people are an uncertain source, because their information gathering methodology is often haphazard, and the information obtained thereby can be purely anecdotal. Such information is neither precise nor quantifiable. A customer will rarely tell the "complete truth" to a salesperson, so any information the customer may volunteer will be biased in many ways. Salespeople can readily identify those anecdotes that advance their interests (e.g., lower prices means higher revenues, regardless of profitability), and those that operate against them. Savvy companies employ trained professionals to collect and analyze the data to identify and evaluate the value perceptions of their marketplace. Large companies have entire departments doing this fulltime; smaller companies may outsource it to a specialist like Atenga.

Conclusion: The optimization of pricing strategy is as important as the management of costs and the growth of sales volume. Since most companies have never done it, rigorous price optimization has emerged as an important source of competitive advantage and increased profitability. The iron law of pricing states that different customers will ascribe different values to your products and services. Savvy companies do the research to identify the various market segments they serve, and they re-engineer their marketing, packaging, and service operations to excel at meeting their needs. They use that research to align their prices with the value perceptions of their customers. In this way they win customer loyalty, lower costs of sales, and above all, enhanced profits.

Value Optimized Pricing (VOP) is the business process that ties price levels and price strategies to the value perceptions of the customers. Far superior to pricing based on costs, competitors and "gut feel," VOP enables a company to discover and document the customer's perceptions of the company, its competitors, its products and services, its value propositions and its policies and practices. The span of VOP is the entire business experience your customers have with your company, for the entire package constitutes the basis

Six Steps to Higher Profits™ using Value Optimized Pricing

Atenga uses a consistent, disciplined data model and process to provide the information and analytics to enable companies to discover and leverage the value perceptions of their customers. Through the application of its trademark Six Steps process, the company provides the information and prescriptives to set and realize optimum price levels. Atenga customers report:

- Triple profit margins (audio manufacturer)
- 50% increase in profit margins (biopharmaceutical services company)
- Sound pricing for new product, including corporate acquisition to enter new market (web services company)
- Successful entry into new market segment with 63% higher prices
- Release of new service offering to complement established computer network hardware business
- Confirmation of business strategy as part of due diligence for new investors in household products manufacturer

The Six Steps are:

1. **Benchmark**

   We benchmark your company's resources, capabilities, pricing strategies and processes. We compare your company's sales, marketing and pricing practices and performance against the best practices of leading companies. We assess whether optimizing pricing will improve your business performance and determine the likely results. The Assessment delivers a list of improvement areas.

2. **Internal Research**

   The perceptions of your key staff underlie most of the important decisions your company makes. Their views of the price drivers, values, attributes, strengths, weaknesses, competitors, and value perceptions of your customers drive your product development, marketing, sales and pricing decisions. We document and correlate these internal perceptions; we give you a window onto your company's consistency and ability to succeed in the marketplace. We also create an information base that can be compared with external perceptions in Step 4.

3. **External Research**

   Your marketplace consists of customers, prospects, lost-business contacts, former customers, competitors and (possibly) channel partners. We build a custom questionnaire that elicits information about each groups perception of value, an its drivers. We use a variety of methods such as personal interviews, focus groups, conjoint analysis and web-panels to gather data on how the company is perceived in the marketplace.

4. **Analysis**

   We compare the perceptions of internal and external groups to see how they differ and what impact that will have on your sales and marketing effectiveness. We document how the market segments differ in their valuation of the price drivers, their preference in terms of messaging, packaging, delivery, options, bundles, and usage patterns. We relate these preferences to valuation and pricing.

   Using data from our research, and proprietary data models and statistical analysis, we are able to determine, with a high degree of accuracy, the perceived value of a service, product or a product line. We call this the Perception Audit™.

   The Perception Audit™ provides the hard data to support important decisions about product, positioning, place and price. It is composed of two important components: a Perception Profile™ and a Perception Gap Analysis™.

The Perception Profile combines the internal and external data to document how your company is perceived in the marketplace. Far superior to the anecdotes and hearsay that most companies use, the Profile is scientifically designed to provide hard, quantifiable, actionable data that will serve as a sound basis for marketing, sales processes, and price realization strategies. It tells you how well your marketing is working and tells how to improve the efficiency and effectiveness of your marketing, service policies, and price realization strategies.

The Perception Gap Analysis details how various market segments compare in their perceptions. It highlights important differences between internal and external perceptions, customers' and non-customers' perceptions, various market segments' differences by role, geography, sales territory or other meaningful factors.

The Perception Audit also tells you how well the entire enterprise is coordinated. It tells you whether its sales, marketing and product development teams are all focusing on the same issues in the same way. If a company is not coordinated well, you can substantially alter your marketing processes to enhance the way it presents itself and how it sells it products – all the while setting and meeting your customers' expectations and perceptions – thus further increasing its business prospects and improving business results.

5. **Price Strategy**

The Strategy is a comprehensive document that summarizes and leverages the research and analysis. Not only does it provide a recommendation on price setting and price realization, it also includes other prescriptives we have made during the process. This may include staff or reseller support, information and training, marketing and product enhancements, policy changes, internal process or product or service enhancements.

6. **Price Training for Sales**

Training the company's sales force is critical to the successful implementation of the new price. When the sales staff understands the perceived value of a product or service, they can better defend the price -- and thus discounting is reduced or eliminated.