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The Knowledge – July 2012

Pricing Outside-In: Capture Your Customers' Willingness to Pay

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Does your pricing reflect the value of your product, or only the cost? At a time when most companies are acutely aware of the need to deliver added value, they frequently overlook their pricing strategy. Many companies set their prices inside-out, using a cost-plus approach without realising that they leave significant amounts of money on the table. Dr Göran Skugge of PriceGain describes in this article how you can improve your bottom line by pricing outside-in where the customers' preferences and willingness to pay drive prices.

Pricing outside-in

Pricing outside-in vs. inside-out

Understanding your customers' willingness to pay and dynamically adjusting your prices in the market is a necessity for survival in industries such as travel, transportation, and hospitality. Sophisticated airlines and hotels forecast future demand based on historical observations and dynamically adjust their rates to maximise revenues and profits. This is an outside-in approach to prices where the end-customers' preferences and willingness to pay drive the pricing.

However, most industries don't have this focus on finding the optimal prices. Instead, the most common approach to pricing is inside-out i.e. cost-plus with a market price component. Companies calculate their costs and add a margin to arrive at a price that is then adjusted based on knowledge about the competitors' prices. The problem with this approach is that it does not incorporate any information about how your customers value your offering compared to the competition. What needs does my product or service fulfil and how much is it worth to the customer? How much more are they willing to pay for my product compared to a cheap import? How much cheaper than the premium brand service must my service be in order to maximise profits? If you don't have the answers to these questions, it is very likely that your prices are wrong, with significant foregone profits.

Capturing value using outside-in pricing

Pricing outside-in (also called Value Pricing) sets prices not just to recover costs but also to capture the value of the offering to the customer. Consequently, when we price outside-in, we need to start with the end-customer, understand his/her preferences, how our products or services fulfil these, and what this is worth to him/her in light of competing offerings. With this information, we set a price that is, at most, equal to this perceived value (and more than the cost of supplying this offering).

As your customer base typically consists of customers with varying preferences and characteristics in multiple segments, understanding the value of your offering requires you to calculate the relationship between price and demand for your offerings, given the prices of the competition. This is the most challenging part of pricing outside-in. One approach to this that has been used with great success in varying industries is price optimisation using conjoint analysis.

Conjoint analysis is a statistical technique that reveals the relative importance of different product attributes through trade-offs. Typically, a representative set of respondents from the target customer segment is invited to participate in a survey. In the survey, the participants are asked to choose a product from a shelf of products with associated prices. The available products and their prices are varied systematically between the choice situations. Statistical techniques are then used to analyse the choices made by all participants and to establish the relationship between demand for each product and the prices of all products in the survey.

With this information, the next step in pricing outside-in is to optimise the prices. In order to do this we need to understand the relationship between prices to the end-customers and our own contribution margin, i.e., model the distribution channel. With this model and the relationships between price and demand for all competing offerings, we can then find the prices that maximise contribution or maximise market share. It will also be possible to find answers to questions such as "What does it cost us in foregone profits if we want to increase our market share to x%?" or "How much market share will we lose if we want to maximise profits?"

The most advanced outside-in companies have implemented the optimisation model described above in a decision support tool that is used in the pricing process. The outcomes of previous price actions as well as price moves by the competition are tracked and the tool is used to find the best answer to the competitors' price changes. Companies that use this approach to pricing have seen profit improvements in the order of 20%. The price performance in these companies is continuously measured and evaluated at senior management meetings to ensure that a minimum amount of money is left on the table.

Implications for managers

Shifting from pricing inside-out to outside-in changes the way the company views pricing. Today, pricing is often seen as an administrative task and not an area for business development and a source of improved profits. Businesses need to put pricing higher on the corporate agenda and, where appropriate, appoint a full time resource responsible for pricing.

Further reading

Baker RJ. *Pricing on Purpose - Creating and Capturing Value*. New Jersey: John Wiley and Sons, Inc.; 2006

Nagle TT, Hogan JE, Zale J. *The Strategy and Tactics of Pricing - A Guide to Growing More Profitably*, Fifth edition. New Jersey: Prentice Hall; 2011

Biography

Dr Göran Skugge is Senior Partner at PriceGain, the pricing and revenue management consultancy where he leads the Price Optimisation practice. During his career of over 20 years as a revenue management and pricing consultant, he has led pricing projects in a variety of industries both in B2B and B2C including airlines, media, passenger rail, manufacturing, finance, and retail. Dr Skugge's engagements cover all aspects of pricing, from introducing companies to the concepts to developing and implementing pricing strategies and designing state-of-the-art pricing and revenue management systems.