Choosing the wrong pricing strategy essay

[Business](), [Branding]()

Choosing the Wrong Pricing Strategy Can Be a Costly Mistake:(http://knowledge. wharton. upenn. edu/article. cfm? articleid= 792) Choosing the Wrong Pricing Strategy Can Be a Costly Mistake Published : June 04, 2003 inPrices have been at the center of human interaction ever since traders in ancient Mesopotamia — our modern-day Iraq — began keeping records.

Who doesn't love to guess what something costs – or argue about what something ought to cost? So it should come as no surprise that companies spend a lot of time figuring out how to price their products and services. But two professors in Wharton's marketing department, Jagmohan S. Raju and Z. John Zhang, say firms do not always go about pricing the right way. Raju and Zhang say devising appropriate pricing strategies is more critical than ever in a world of hyper-competition. Pricing strategies also take on added importance at a time when central bankers and economists are concerned about the possibility of deflation – a broad, general decline in prices. This is a single/personal use copy ofFor multiple copies, custom reprints, e-prints, posters or plaques, please contact PARS International:

com P. (212) 221-9595 x407. According to Raju and Zhang, research suggests that pricing strategies can have a huge influence on company profits. They cite a study of more than 2, 400 companies by McKinsey in 1992 showing the impact that various decisions would have on the bottom line: a 1% reduction in fixed costs improves profitability by 2.

3%; a 1% increase in volume will result in a 3. % increase in profit; a 1% reduction in variable costs will prompt a 7. 8% rise in profit; but a 1% hike in pricing can boost profitability by 11%. “ In recent years, business people have paid attention to many things that can influence their companies’ success,” Zhang says.

“ They’ve looked at organizational behavior, downsizing, benchmarking and reengineering, and companies have done a lot to cut costs. But they haven’t spent as much time thinking about the best possible pricing strategies. I think the picture painted by McKinsey is still pretty much true today.

There’s a lot of room for profit improvement through better pricing strategies. ” In the past, Zhang says, many companies “ would set a price, stick to it and hope for the best. But that isn’t the best way to set prices. One reason companies took that approach is because pricing is difficult. You have to know what you’re doing and you have to take direct responsibility for your decisions. A lot of managers want to have a say in their companies’ pricing strategies but they don’t want to take the responsibility if things go wrong. Raju stresses that pricing must be systematic and strategic: A seat-of-the-pants attitude can hurt the bottom line.

“ One of the misconceptions about pricing is that it’s a decision that can be made after everything else has been done to develop a product,” says Raju. “ But, actually, pricing needs to be an integral part of the plan for taking a product to market from the very beginning. It cannot be an ad hoc approach.

” Among other things, companies must carefully identify the customers they are targeting and understand how much those customers are willing to pay for a product or service. Firms also must recognize that pricing is a key tool to differentiate a product or service from those of the competition, since prices emit signals about product quality and exclusivity. In addition, it is important to take into account the distributors who will bring the product to market; if they themselves do not make enough profit, sales will suffer. What's more, firms must realize that a pricing strategy should be long-term in nature, in that it should pave the way to take more products to market in the future.

All materials copyright of the Wharton School of the University of Pennsylvania. Page 1 of 3 Choosing the Wrong Pricing Strategy Can Be a Costly Mistake: (http://knowledge.

wharton. upenn. edu/article. cfm? articleid= 792) " When you consider pricing decisions, your overall goal is to look ahead to stay a step ahead of the competition," says Raju. " You have to lay out the scenarios: If I do this, the competition will react a certain way. If the competition doesn't react that way, then you have to have another plan ready. You cannot afford to fall behind your competition. " Pricing can be thought of in any number of ways.

One approach is a simple " cost-plus" strategy: You figure out what it costs to produce an item and tack on a nice profit margin. Another approach is to conduct research to determine what customers are willing to pay for your product ($200 for a tiny bottle of perfume, for example) and set the price accordingly. Another method is competition-based pricing, whereby a company figures out what its competitors are charging, then adjusts its prices up or down. " All of these approaches make some sense, but none alone is sufficient," says Zhang. " With pricing strategies, the whole really is greater than the sum of its parts.

A classic example of how developing the right pricing strategy can spell the difference between profit mediocrity and profit stardom occurred at Ford Motor in the 1990s. For years, Ford, like other auto makers, tried to hold prices as low as possible on entry-level cars, such as Escorts. Low prices represented an attempt to attract young buyers, with the hope that as they grew older and needed bigger vehicles they would remain loyal to the brand and trade up.

The problem was that, while Ford sold a lot of inexpensive cars, their profit margins on these models were ho-hum or nonexistent. To earn profits, Ford relied on the higher margins on bigger cars, like the Explorer or Crown Victoria. But because the prices on the larger cars were relatively high, Ford sold fewer of them than it would have liked to. In 1995, Zhang says, Ford made an important decision. It lowered the prices of its high-end vehicles a little bit – enough to stimulate demand but not enough to cut too deeply into its margins. This adjustment was one of the key reasons that Ford earned $7.

2 billion in 1999 – the most annual profit ever for any auto marker. What is noteworthy is that from 1995 to 1999, Ford's U. S. market share fell from 25. 7% to 23.

8%, according to BusinessWeek. But the decline did not spell disaster. Although Ford sold 420, 000 fewer low-margin cars because of its new pricing strategy, it boosted sales of high-margin vehicles by 600, 000. " Ford cannibalized its low-end cars a bit, but it was worth it," Zhang notes. Pharmaceutical companies are also learning to do a smart job of pricing when they face intense competition from generics, according to Zhang. They do not always respond by matching generic prices. Instead, they try to out-smart generics through branding.

Spending money to market brand-name supremacy has worked for some drug companies for decades. " If you have been using Bayer aspirin for a long time and it works every time for you, there's no reason for you to change, even though the brand-name version of aspirin costs much more than a private-label product," says Zhang. " The risk of switching from brand-name aspirin to a generic may be zero.

But try to tell that to those satisfied customers. Good luck! " Zhang offers another example of effective pricing strategies – companies that offer cellular telephone service. Their pricing plans are quite sophisticated, so much so that few customers can make sense of them. " That is done for many good reasons. Certainly it does not hurt that the consumer cannot compare rates as a result," he explains. Zhang says the cell phone calling business would be in danger of becoming a commodity business in a hurry, just like regular long-distance calls, if cellular companies were to take a knee jerk approach with
 their pricing strategies.

“ A sophisticated and well-thought-out pricing structure can help to prevent the industry from being commoditized. ” Raju and Zhang, who teach a new Wharton Executive Education course titled “ Pricing Strategies: Measuring, Capturing and Retaining Value,” say that a deflationary environment – of the kind economists fear may occur in the months ahead – would be difficult for true commodity industries, such as oil and grains, as well as companies whose products tend to be seen by consumers as commodities. Regardless of the economic environment at any given moment, a firm’s pricing strategy should always be comprehensive. “ You have to analyze the pricing environment in which you are operating, determine how much pricing discretion you have and determine the value your product or services has for customers,” says Zhang.

“ Then you can develop a pricing structure that will be ideally suited to the marketplace to enable you to capture as much value as possible. The point is that even in a deflationary environment, your firm does not necessarily have to lower its prices. Even if you do have to, [that does not] necessarily mean lowering your prices for all of your products in all of your markets to all of your customers for every one of their transactions. To identify your pricing opportunities and to make confident pricing decisions, you have to learn the pricing basics in a systematic way.

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