The New Math for Pricing

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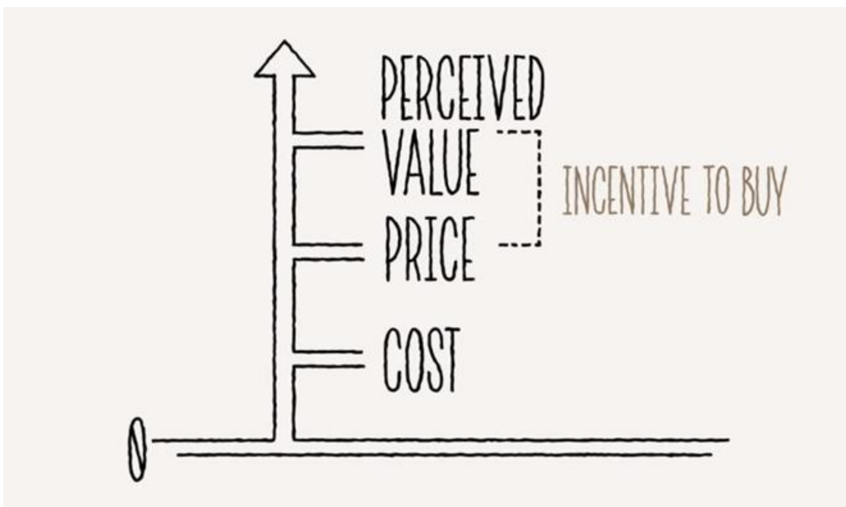
It represents one of the most difficult decisions you will make: What price do I charge for my products? Many people, including myself, have always held that pricing should be based on covering all of your costs with some allowance for profits. However, thanks to Robert Dolan of Harvard Business School, there is a new math for calculating price that goes beyond the financial numbers.

Dolan argues that what matters more is what people perceive as value. Dolan calls this the **Incentive to Buy** and this is where you have leverage. The problem for most of us is that we are focused solely on the Margin Gap (Price vs. Cost); what Dolan calls the Incentive to Sell. It is exceedingly difficult to make money when everyone is focused on margins alone and not the value perceived by customers.



Your goal should be to increase the Incentive to Buy gap; i.e. give your customers better choices, allow them to customize their products, add features not provided by your competition, or give people different grades of products (low, medium and high). This is what enhances value and drives people to buy based on things other than price. Trying to compete based on price is a losing battle in the long run – you are chasing the lowest common denominator.

Take for example plane fares: First Class vs. Coach. By providing some additional value, airlines charge a higher fare that certain people are willing to pay. Higher pricing allows customers to judge quality and perceive value on their terms. Luxury items from perfume to cars often follow this value-based approach to pricing. Bundling is another way of raising perceived value. Offer several related products or services for a lump sum price to raise perceived value.

One place where value-based pricing seems to work is with heavy users. People who are strong buyers of your products are usually interested in other features or complimentary products. Companies should connect with their best customers, finding new ways of presenting their current products based on value.

"Customers do not buy solely on low price. They buy according to customer value, that is, the difference between the benefits a company gives customers and the price it charges. More precisely, customer value equals customer-perceived benefits minus customer-perceived price. So, the higher the perceived benefit and/or the lower the price of a product, the higher the customer value and the greater the likelihood that customers will choose that product." - Setting Value, Not Price
by Ralf Leszinski and Michael V. Marn, McKinsey Quarterly

Your power to influence pricing has dramatic implications on the profitability of your business. Your influence over pricing is best gained through a new math to pricing that is more value-based and less margin-based. Yes, it is true that most people most of the time will look at price as the most important factor, but increasingly the best customers are those who are looking for value. It is not easy to increase perceived value, but if you can differentiate based on value, you can conquer a niche as opposed to going head on against everyone based on price alone. A value-based approach to pricing requires a lot of analytics about how customers view features and functions; how their buying decision was influenced by value.

The bottom line is that if you analyze your pricing by looking at financials, then you are going to have to increase volumes (similar to Wal-Mart) to make more money. In today's hyper-competitive world, this is a perilous journey that will not distinguish your business. You have to address value and not just price if you expect strong profits in the future.

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