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## Pricing at the Market Segment to Drive Cash and Profits

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Recently, a well publicized, Ohio-based, Fortune 100 company documented net profit improvements in the hundreds of percentage points using market level pricing techniques. Price (and cash flow) improvements go directly to the bottom line and experience tells us that segmenting the market, measuring customer value proposition (CVP) and then pricing based upon that value can have a marked effect on even the best run companies.

Market level pricing (as opposed to industry pricing or transaction pricing) begins with a clear definition of specific customer circumstances within your market. Each set of unique circumstances defines a segment. As we study these segments and understand the value each places on your products and services, the key question is: What price level achieves the optimal price/value position relative to customer needs and the competition within each segment?

Before we measure CVP, we need to understand the circumstances of our customers. What drives their costs? What creates pain for them with their customers/suppliers etc. How does our product or service offering affect those factors that drive their business? Take, for example, Acme, a fictitious cleaning supply distributor. The factors that drive value and cost in the healthcare segment of their business are very different than those in the manufacturing segment.

When Acme measures the value provided by keeping operating room surfaces sterile and the value provided by keeping the manufacturer's floor free of grease and oil, they come up with different values driven by different factors.

The hospital measures value in terms of patient outcomes and is concerned about controlling infections and the costs associated with treating those infections and legal fees that result from claims about them.

The manufacturer measures value in efficiency and quality and is interested in reducing accidents and their associated costs which might include increased order lead times, wasted product, and costs related to OSHA claims.

Once the various segments and their circumstances are understood, we can start understanding and measuring value. Value is the "currency" used to set list or published prices for each product or service according to the perceived value within each market segment. In an equation, value can be explained like this:

$$\text{Value} = \text{Perceived Benefits} - \text{Perceived Price}$$

Increasing perceived benefits and reducing perceived price lead to higher value.

Approaches to quantifying perceived benefits vary based upon the tangible vs. intangible nature of those benefits and the awareness of the market segment to the benefits in question. The following are a few techniques to consider in developing a customer value proposition:

- Cost Build-Up** In any circumstance where clear financial information is available about the offering, sum all the costs (or revenue) associated with the product or service application and then do the same for competitive approaches to show a financial advantage. This approach depends on detailed financial information and the accuracy of that information.
- Proxy Analysis** In circumstances where the product or service is unique and there are no appropriate competitive offerings, a proxy can be used to establish value by analogy (e.g., using prices paid for a specialty sterilizing agent used only in nurseries as a proxy for a new operating room sterilizing agent that has no competitors.) Care must be taken in selecting the proxy to ensure that it is an appropriate proxy for the product in question.
- Surveys** In circumstances where surveys are an option, the market can be queried directly about their perceptions. By asking potential customers to rank alternatives and to characterize their value perceptions a value estimate can be developed. This option is only appropriate when the end user is known and can be contacted directly.

Returning for a moment to Acme, they have discovered a significant value proposition associated with the healthcare segment and hospitals' burn units in particular. Burn victims are highly susceptible to infections placing a premium on sterile conditions in burn units. The market segment characteristic; "highly sterile environment required" combined with expertise that Acme offers with their products for use in sterile environments, increases the hospitals' perception of the value of their products and enables Acme to price the combination of the cleaning products and their advice and training at a price which is above that of the same product sold into a manufacturing segment. As a result, they are able to command a price premium in this segment.

While we have been examining a narrow, specific example in Acme, this situation is a pretty typical one. Companies that examine the segment characteristics and the value propositions they drive find pricing opportunities.

Typical improvement opportunities range from 1.5% to as high as 6.5% which goes straight to cash flow and the bottom line, even in an otherwise very well run company. Experience with great companies, especially industry leaders where the prevailing wisdom is that they already command a premium for their products, shows that opportunities abound for this type of advance in profitability. The combination of the

technical nature of the value proposition development and the general lack of awareness of the power of pricing also make this an area where companies tend to be able to make sustainable progress in the segments they serve.