

Pricing new products

Companies habitually charge less than they could for new offerings. It's a terrible habit.

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How much should you charge for a new product? Charge too much and it won't sell—a problem that can be fixed relatively easily by reducing the price. Charging too little is far more dangerous: a company not only forgoes significant revenues and profits but also fixes the product's market value position at a low level. And as companies have found time and again, once prices hit the market it is difficult, even impossible, to raise them. In our experience, 80 to 90 percent of all poorly chosen prices are too low.

Companies consistently undercharge for products despite spending millions or even billions of dollars to develop or acquire them. It is true that businesses and private consumers alike are demanding more for less; the prices of personal computers, for example, have been pushed downward despite their higher processor speeds and additional memory. Global competition, increased pricing transparency, and lower barriers to entry in many of the most attractive industries have contributed to the trend. But these are not the only problems. Many companies want to make a quick grab for market share or return on investment, and with high prices both objectives can be harder to achieve.

These concerns encourage companies to take an incremental approach to pricing: they use existing products as their reference point. If a new offering costs 15 percent more to build than the older version does, for instance, they charge about 15 percent more for it. Particularly in consumer markets, they might set the price slightly higher or lower than that of their main competitor.

The incremental approach often underestimates the value of new products for customers. One of the first makers of portable bar code readers, for example, calculated how much more quickly its customers would be able to assemble their own products if they used portable readers. The company then took the price of the older, stationary readers and raised it proportionally, solely to account for the time savings. This strategy also fit in with the company's desire to penetrate the market quickly.

But by using an existing product as the reference point, the company undervalued a revolutionary product. The portable reader not only improved existing processes but also enabled companies to redesign their supply chains. Portability and instant access to information prepared the way for real-time inventory control, vastly improved logistics planning, and just-in-time deliveries, thus eliminating the need for large inventories. Buyers quickly recognized a bargain and flocked to the low-priced product. The company, which couldn't keep up with demand, not only failed to capture the full value of its reader but also set the market's price expectations at a very low level. A single bad decision easily erased \$1 billion or more in potential profits for the industry.

Analyses based on cost differences and process improvements are parts of the puzzle, and so is an understanding of the competitive landscape. But good pricing decisions are based on an expansive rather than an incremental approach. Before zeroing in on a price that promises the greatest long-term profitability, companies must know both the highest and the lowest prices they could charge. Price-benefit analysis should begin early in the development cycle, when the market is first being probed, for it not only shows companies whether price barriers might make products unfeasible but can also guide their development by indicating which attributes customers are most willing to pay for.

Exploring the full range of pricing options

For products that replicate others on the market ("me-too" products) or that offer small improvements (evolutionary products), the room to maneuver is relatively narrow, and incremental approaches may come close to the optimal price (*see* sidebar "Launch position"). Even then, however, a lot of money can be left on the table. Charging just 1 percent less than the optimal price for a product can mean forfeiting about 8 percent of its potential operating profit.¹ And the more novel a product may be, the more important it is for companies to take a broader view of the pricing possibilities.

The highest price

Since incremental approaches tend to focus on the lower end of the price range, companies should start by defining the opposite end of the spectrum. Such a price ceiling, based on a product's benefits, may ultimately prove to be unrealistic: there may not be a sufficient market at that level, it may leave too much room for competitors, or customers may be strong enough to demand a greater share of the value the product creates.² But establishing this ceiling will ensure that each and every potential price point is brought up for discussion.

To establish a price ceiling, a clear understanding of a product's benefits for its customers is essential. The value of some benefits, such as savings on raw materials, can be measured easily. But others, particularly process and relationship benefits such as on-line purchasing options or brand reputation, must be evaluated through market research.

Advanced marketing tools—for instance, conjoint analysis and perceptual mapping³—can assess how much value each benefit offers to customers. But companies must see to it that their research does more than make comparisons with known reference points. Many suppliers rely too heavily on their internal perceptions, which sometimes unintentionally skew their efforts to probe the market. While formulating the research and writing the questions for a market test, a company should therefore ensure that they cover a broad range of possibilities; otherwise the work may serve merely to confirm the benefits claimed by the product's developers or anecdotal information brought back by the sales force.

To take an accurate measure of the benefits a product offers—and thereby find its true price ceiling—market research must be designed to elicit more open-ended feedback than can usually be acquired through multiple-choice questionnaires or trade-off techniques, both of which can limit responses. For example, a controls maker's revolutionary high-pressure steam valve for nuclear power plants significantly increased the reliability and reduced the complexity of their water-management systems. At first, trade-off techniques were used to research the market: the company described the technical benefits of the new valve and tried

to find out how much customers would pay by comparing it with a valve for another application. Most of them felt that a 20 to 25 percent premium was justified.

The company later redid its research to broaden the outlook, this time asking more open-ended questions to establish how much value the valve would deliver to the business systems of its customers. Instead of first asking them to compare the new valve with an existing one, the company now sought to evaluate the cost of planned maintenance shutdowns and the role the new valve could play in reducing their number. Now that the company had a fuller picture of the new benefits—a picture based on its customers' economics—it asked how much customers would be willing to pay for them. This time, the customers gave a figure that was several times the price of the existing valve. The supplier had a more accurate picture of its pricing options.

The floor

Cost-plus pricing is often derided as weak, but it plays an essential role in setting the floor for a company's pricing options. An accurate analysis of costs per unit, plus a margin representing a minimally acceptable return on investment, reveals a new product's lowest reasonable price level. If the market can't bear it, the company must rethink the product's viability.

Although the cost-plus model is well-known, companies often trip up in two areas when they use it to analyze their costs. First, surprisingly, they don't account for all costs that should be allocated to products; there is a tendency, for example, to overlook R&D expenses associated with a product category (including expenses for incomplete projects) and goodwill linked to acquisitions that lead directly to new products. As a necessary part of any development program, these are legitimate items to bring into the cost calculation. Second, overly optimistic market projections can create false estimates of costs, particularly fixed ones.⁴

The range of pricing options is usually smallest for me-too products. Companies using them to play catch-up must therefore be particularly careful to assess their costs correctly and to understand the assumptions underlying these calculations; a small error can permanently prevent products from becoming profitable. If a product's viability relies on cost savings generated by economies of scale, for instance, a false estimate of the size of the market or of a customer segment would be disastrous.

The size of the market

Similar research is needed to gauge the size of the market or market segments for various prices at and below the ceiling. Instinct might suggest that the lower the price, the higher the demand, but that isn't always true. Midrange prices, for instance, might put a product in the dead zone—too cheap for quality-conscious customers and too expensive for bargain hunters.

One company, for example, offered a new data-management system that it claimed could save large companies hundreds of millions of dollars a year. But to penetrate the market quickly, it released the core software with an enterprise license fee of less than \$100,000.⁵ Potential customers wouldn't take the company's claims seriously; if the claims were true, the software should have been priced in the same range as other enterprise-resource-planning (ERP) packages, which cost \$1 million or more.

Estimating the size of a market at various price points clarifies the range of pricing options, suggests which price models to use at any price and volume point, and increases the accuracy of estimates of profitability along the spectrum and of the unit-cost calculations needed to define the price floor.

Setting the release price

After a company has determined the full range of its pricing options and the market's size at various points within that range, it is ready to formulate the release price. Targeting the largest market segment within the range might be tempting, but maximizing volume doesn't necessarily maximize profits (*see* sidebar "Penetration pricing"). In particular, four aspects of new-product pricing may counsel against targeting the largest market, especially if doing so means setting the price low.

Reference price

The release price minus any discounts or other incentives establishes the market's first reference point for the product's true value as judged by its maker. More than any press release, sales pitch, or catalog description, the reference price tells the market what a company really thinks a new product is worth. An excessively low reference price can handicap its long-term profitability—the low price might hasten its penetration of the market, but the resulting lower margins forgo the future profits a higher price would have captured once a customer base had been established. A low reference price is particularly damaging if it conflicts with the value position the company is trying to establish or if market demand has been underestimated.

Competitors' reactions

Especially for evolutionary products, a low price that noticeably shifts market share will probably trigger a destructive price war: competitors usually can't react immediately by improving the benefits of their own products, so they often cut prices instead.⁶ A higher reference price, by contrast, suggests that a company is targeting profits rather than market share and might therefore generate few if any immediate reactions from competitors.

Life cycle strategy

If an early-adopter segment is willing to pay a premium for a product, the company that makes it may wish to consider a high release price to capture the extra value, with planned reductions down the road to attract latecomers. Along with capturing more revenue over the life of a product, this strategy can also help companies match demand to production capacity for a new product.

Cannibalization

Companies must also carefully consider how new wares will affect their current ones. If an older product remains viable, a company might try to manage the cannibalization problem by giving its new product a higher release price targeting a smaller segment of customers. By contrast, if a product line is being retired, a lower release price for a new offering may be appropriate to shift customers to it as quickly as possible.

Going to market

Presenting a price to the market requires both astute communication with it and patience. It can be especially hard to explain the value and benefits of revolutionary products to often-skeptical buyers, but whatever conditions a new product may face, a faulty pricing strategy shouldn't be allowed to undermine its value message.

A product's fortunes during the first six months to a year after it hits the market have a critical influence on its value position. Especially during this period, companies must keep firm control of their pricing operations, all the way down to individual transactions. For instance, discounting, which could be routine for continuing product lines, might sabotage a new product's reference price.

If managers must push a product quickly, however, they can do so without sacrificing its reference price or the market's perception of its value. One common technique is to offer consumers free samples or to give the product to small groups of customers with a high profile or significant market influence. Another is to offer it to customers for a free-trial period. Both approaches speed up the market penetration of the product without cutting the reference price. Standard discounts or rebates are usually a mistake, however, since they do cut it and also provoke doubts about the product's benefits.

The answers to questions about the price of new products can't wait for the end of the development cycle; the questions are an intricate part of the process of developing them, and the answers are needed to assess their ultimate profitability. At present, companies routinely overlook the higher reaches of their pricing potential. Basing release prices on credible market research and cost analysis can give managers the confidence to ride out the initial turbulence that usually surrounds new products and to claim their true value.

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