

Do you have a long-term pricing strategy?

Actively pricing products across their life cycle is increasingly important, particularly in innovation-intensive industries. Failing to do so may forego potential profits or even destroy value.

October 2010 | by Walter L. Baker, Michael V. Marn, and Craig C. Zawada

In the late 1990s, the world's three major independent producers of hard-disk drives invested about \$6.5 billion in research and development in the course of just four years. During the next decade, the bytes that can be stored per unit of a drive's surface area increased a thousandfold—while the price per unit of that surface area dropped 70 percent. The three companies created enormous value for customers. Yet their failure to price products correctly throughout this period of significant innovation contributed to net losses totaling almost \$800 million.

Entire industries can suffer when companies fail to grasp the importance of pricing products or services across the life cycle, particularly in innovation-intensive sectors such as consumer electronics and consumer durables, IT hardware and software, medical devices, and pharmaceuticals. That's especially true today. Companies introduce products more regularly, with life cycles often measured in months, not years. There's external pressure for low prices from customers expecting more for less and internal pressure from the belief that pricing is a make-or-break factor when products launch. And a company may have a number of related products in the marketplace simultaneously, which complicates their life cycle pricing.

Two points are essential to price effectively throughout the life of a product or service. First, companies should actively manage the trade-off between price and volume (or profit and market share) to maximize returns. Most businesses fail to test customer value perceptions and price sensitivity after products launch and have no idea how the critical trade-off between price and volume shifts over time. Second, companies must make pricing decisions in the context of their broader product portfolios because when they have multiple generations of a product in a market, a price move for one can have important implications for others.

With these two principles in mind, companies should consider how they respond to pricing challenges during the three major phases in the life cycle of a product or service: launch, midlife, and late life.

The launch phase

Correctly setting the launch price for a product or service can reset market price expectations and boost the profit trajectory across the remainder of that offering's life cycle. In the launch phase, it's critical to concentrate on three imperatives: setting a launch price that maximizes the long-term capture of value, avoiding "anchor effects" from older products, and working the product portfolio to a company's advantage.

One prerequisite for setting a launch price that maximizes long-term value is conducting scenario-based analyses that incorporate different pricing models, potential responses by customers and competitors, and the implications for earnings. This approach can help companies avoid common mistakes, such as setting the launch price too low or reducing a product's price soon after launch. The careful adjustment of prices for existing products also can minimize the degree to which they drag down prices for new ones. More broadly, businesses should assess new-product pricing in the context of their existing product portfolios. (For a step-by-step example of how to use pricing strategy to manage a product portfolio, see the audio-enhanced interactive exhibit, "Pricing new products in a portfolio.")

Interactive

Pricing new products in a portfolio

With the right pricing strategy, a company can avoid discounting and instead compete at higher average price points based on product benefits.

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Consider the case of a medical-device manufacturer that launched new versions of all major products every 6 to 18 months. Each version—whether it was a significant innovation or a minor improvement—was priced only a few percentage points above the existing one, in an effort to encourage migration and mitigate potential customer backlash. The company would then drop the price of older products precipitously (by 20 to 40 percent) while continuing to sell them for an extended period because of ongoing demand from some customers and the company's desire to provide a lower-cost alternative to the new products.

This approach dragged down the prices of new products because their *incremental* value versus the old ones remained more or less constant. As happens at many companies, the average price for each product line declined every year despite annual R&D investments in the hundreds of millions of dollars. In other words, the company was rapidly innovating itself from a market leader into an average performer. Once the company recognized what was happening, it eliminated "fire sales" on older products, changed the incentives of the sales

force to support the new life cycle–pricing strategy, and carefully launched subsequent products at greater premiums.

The midlife phase

Once a product has launched and gained stable market acceptance, it enters the midlife phase. This phase presents both opportunity and risk: it often occurs when companies earn a majority of a product’s operating profit but also when “me too” products may appear and when price compression is most extreme. Organizations rarely revisit their price–volume trade-offs or value maps at this point, nor do they undertake essential market-based customer research. If they did, they could more effectively fine tuning price–volume trade-offs, anticipate internal and external pricing triggers, and identify and adopt new pricing models that capture more value. In this phase, companies should undertake that fine tuning, anticipate trigger events, monitor market conditions, and consider new pricing models that may change the game.

Companies should change product prices in midlife carefully. Managers need to analyze whether the changes are appropriate (for example, whether lowering prices will raise life cycle profits) and, if so, the most effective timing. One personal-computer company, for example, conducted weekly market price tests, implementing cuts only when unit sales had declined and the tests showed that a lower price would significantly increase unit sales. Managing prices in this way (rather than by steadily reducing them) during the midlife stage has allowed the company to generate tens of millions of dollars in additional operating profit over the lifetime of most of its computer models.

There are many midlife trigger events for pricing: internal (such as the launch of a new model or a change in cost position) and external (price moves and product introductions by competitors or shifts in customer demand, for example). Companies need to monitor the market so they can anticipate such events, or they will face the consequences of failing to take advantage of changes in their rivals’ behavior. Take the case of a medical-device company that, after enjoying a period of product exclusivity, decided to lower prices simply because that had been its standard practice. The company then failed to respond when its two main competitors introduced products similar to its own but at much higher prices. Instead of raising prices to capture a larger margin—or at least maintaining them—the company continued to discount, hurting prices and margins for everyone, without gaining market share.

Finally, strong performers are always searching for ways to capture value, and a new midlife-pricing model can reinvigorate a product. Maintenance services for jet engines, for example, were historically undertaken by engine manufacturers using a standard pricing model of “time and materials” associated with each visit to a service shop. As third-party service providers entered the market at lower prices and began to gain prominence, one engine manufacturer introduced long-term service agreements based on hours of flight operation, which roughly correlates with engine wear and tear. Airlines liked the new model because it made their service costs highly predictable, the manufacturer’s volume and margins grew substantially, and industry price compression slowed.

The late-life phase

Counterintuitively, the late life of a product may be an opportune time to raise rather than lower prices. The reason is that its “all in” costs may have increased or its inherent value for the remaining customers may not have decreased as much as it has for those that moved on.

Indeed, its value may even have increased for some users. All this may translate into a willingness to pay higher prices. Whatever choice a company makes, it must have deep insight into the true cost of serving a market and the customer segments still buying the product. Organizations should be guided by three late-life pricing imperatives: capitalizing on pockets of customers with a high willingness to pay, minimizing competition with next-generation products, and actively working to reduce unfavorable product proliferation.

Certain customers may be fairly price insensitive for an older product because they are more comfortable with it, see more value in it, or regard switching costs as prohibitive. A semiconductor manufacturer that profitably managed the transition from a legacy product to a new one wanted customers to adopt it but recognized that the older product still had strong value for some users. The company actually raised the price of the late-life legacy product after the new one launched. By continuing to sell the older product at significantly higher margins for several more quarters, the company captured at least \$250 million in additional profits. It would have given them up if it had followed its usual practice of reducing prices for legacy products when their successors were launched.

Even if a company's first instinct is to discount older products before or just after the launch of a new one, excessive markdowns may hurt newer offerings by making older products seem like a better value. A way to hasten the exit from older products and to achieve higher margins on their remaining sales is to follow the lead of the semiconductor manufacturer above by raising the price of older products, although companies must guard against the risk that higher prices will create obsolete or expired inventory. Another approach—simply eliminating products—can reduce needless complexity in supply chains, service operations, and customer service.

Finally, many companies, especially those selling to businesses, do not manage product proliferation well: claims such as “we never kill a product” are not uncommon. In addition, few companies carefully evaluate their products' economics over time, especially during the late-life stage. While doing so is troublesome for all companies, it is especially problematic for those using a cost-plus methodology, in which prices are set by applying standard margins to standard product costs.

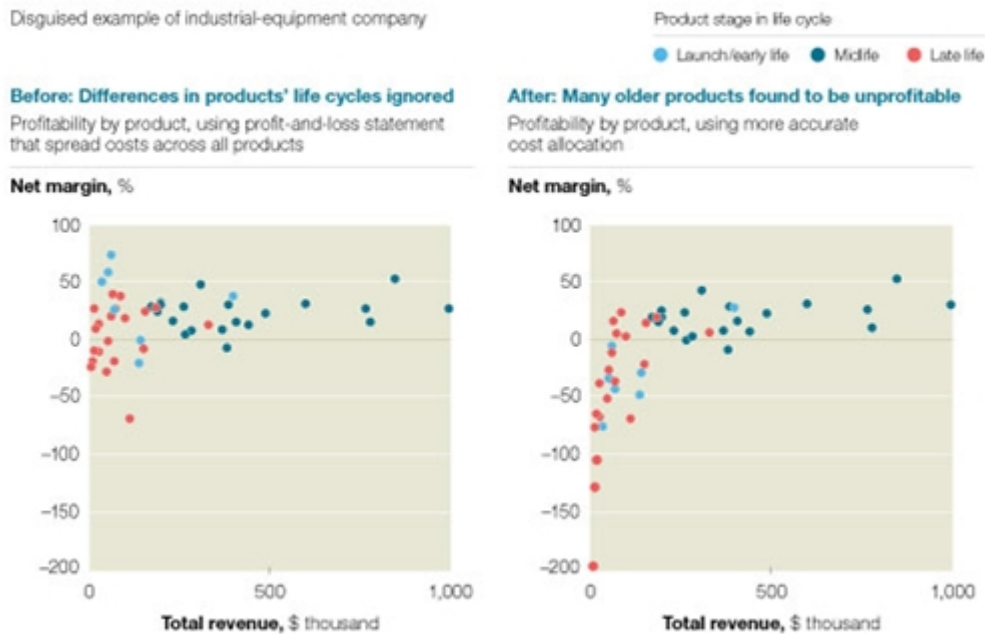
An industrial-equipment manufacturer, for example, ignored life cycle differences and spread its costs across all products—making it appear that it was still making a reasonable margin on older ones. A closer examination of the company's costs in each phase showed that older products cost substantially more to produce than expected and that many were actually unprofitable (exhibit). Once this came to light, the company eliminated some older, unprofitable products and charged more for others so that it was paid appropriately for producing and stocking them.

Exhibit

- Enlarge

Ignoring life cycle differences, one company overestimated the profitability of some of its older products.

Disguised example of industrial-equipment company



Sustaining returns across the life cycle

Companies that capture price advantages across the life cycle of their products have several distinct characteristics. Their perspective on pricing is not myopic: they continually strive to think across life cycle stages, building all their questions and analyses into that framework. Managers regularly scan internally and externally for information about potential trigger events. Their level of energy and activity—the ability to undertake fast, deep customer research or to produce insightful analyses on a multitude of variables—is higher than that of most companies. In short, their capabilities reflect the more dynamic and interdependent pricing environment that prevails when companies manage product life cycles. Businesses can take a number of steps to manage and price their products in this way:

- *Examine life cycle pricing up front.* The pricing of new products at savvy companies is not a reactive, ad hoc process but a core competency undertaken at early stages of product development. Such companies consider alternative price–volume trade-offs and strategies over time and envision how each scenario might play out across different customer segments. The process explicitly incorporates price moves during the life cycle and anticipates internal or external triggers that might prompt the company to shift prices up or down.
- *Maintain a longitudinal view.* Nothing should fall between the cracks when a company manages prices over time and across products in its portfolio. Organizations that capture the price advantage escape the common “launch and forget” pricing pitfall once new products hit the market. Their review processes explicitly monitor life cycle pricing performance, while properly aligned incentives keep employees focused on the opportunity. Much of life cycle pricing inherently involves setting expectations about the way prices and volumes may play out. Sophisticated companies track these assumptions and regularly check performance against them.
- *Find ways to increase life cycle value.* Companies that manage life cycle pricing well are dynamic and adaptive. Often these qualities call for a level of cross-functional

coordination that transcends the pricing function: product development, marketing, competitive intelligence, sales, and operations may all be involved. Beginning with a high-level plan for managing a product to the end of its life cycle, these companies refine their approach by constantly monitoring market conditions, the moves of competitors, internal operational changes, and customer perceptions.

Companies that master pricing do so across the three phases of a product's life cycle—launch, midlife, and late life—and make decisions in the context of adjacent products in their portfolios. In this way, these companies ensure that they reap the full rewards of their innovations by creating price advantages for themselves.

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Artículo on-line:

http://www.mckinsey.com/insights/marketing_sales/do_you_have_a_long-term_pricing_strategy