SECOND EDITION

THE STRATEGY AND TACTICS OF PRICING

A Guide To Profitable Decision Making

Thomas T. Nagle / Reed K. Holden

Second Edition

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PRENTICE HALL
Englewood Cliffs, New Jersey 07632

Library of Congress Cataloging-in-Publication Data

Nagle, Thomas T.
The strategy and tactics of pricing : a guide to profitable decision making / Thomas T. Nagle, Reed K. Holden. -- 2nd ed.
p. cm.
Includes bibliographical references and index.
ISBN 0-13-669376-8 -- ISBN 0-13-669060-2 (pbk.)
1. Pricing. 2. Marketing--Decision making. I. Holden, Reed K. II. Title.
HF5416.5.N34 1994
658.8'16--dc20 94-15812
CIP

Acquisitions editor Sandra Steiner
Production editor Maureen Wilson
Cover designer Tweet Design
Buyer Patrice Fraccio
Editorial Assistant Cathi Profitko

A Paramount Communications Company
Englewood Cliffs, NJ 07632

Printed in the United States of America

10 9

ISBN 0-13-669060-2

Prentice-Hall International (UK) Limited, *London*
Prentice-Hall of Australia Pty. Limited, *Sydney*
Prentice-Hall Canada Inc., *Toronto*
Prentice-Hall Hispanoamericana, S.A., *Mexico*
Prentice-Hall of India Private Limited, *New Delhi*
Prentice-Hall of Japan, Inc., *Tokyo*
Simon & Schuster Asia Pte. Ltd., *Singapore*
Editora Prentice Hall do Brasil, Ltda., *Rio de Janeiro*

PREFACE

"Pricing is the moment of truth—all of marketing comes to focus in the pricing decision."[1]

When Raymond Corey wrote these words at the Harvard Business School in the early 1960s, marketing was just coming into its own as the driving force of a business. Unfortunately, few marketing practitioners actually took Corey's words to heart. Enjoying their new prestige and power to influence corporate strategy, they were reluctant to let financial considerations constrain their "strategic" thinking. Instead, they focused on achieving market share and customer satisfaction, believing that high profitability would somehow naturally follow. Marketing academics also slighted pricing, offering little research and few courses on the subject. Whenever the subject of pricing problems did arise, professors assured their students that all could be solved indirectly by redoubling efforts to differentiate the products and services.

These attitudes toward pricing changed radically when marketers encountered the challenges of the 1980s. Companies with leading brand names saw brand loyalty and their power over distribution erode from years of price "promotion" to defend market share. Even large companies often found profits unattainable, as smaller firms targeted and lured away their most profitable customers (a practice labeled "cream skimming" by the victims). Then, successful corporate raiders showed that they could increase cash flow and profits, often by raising prices and cutting marketing expenditures. In response, the survivors "restructured" their businesses by applying rigorous financial criteria to all their expenditures, including marketing and sales.

Marketers were challenged to show that their efforts to differentiate products and increase market share could ultimately pay off at the bottom line. To do so, successful marketing executives began incorporating pricing as an integral part of their jobs; leading business schools began making it an integral part of their marketing curricula. Both efforts required information which our seminars and the first edition of this text were designed to satisfy. In the seven years since the first edition, not only has interest in pricing grown but so has our knowledge of the subject. First, research on pricing by marketers, economists, and cost accountants has increased in both quality and quantity, thus expanding our understanding and providing more effective tools for making pricing decisions. Moreover, the intervening years have taught us that it is often better to aim for practical improvement than to cling to the impractical "ideal." These insights are reflected in this new edition.

Since the first edition, the nature of pricing problems has undergone considerable change. In the early 1980s, the most common pricing errors could be traced to cost-based formulas. From Wang Computer to Sears Roebuck, managements tried in vain to solve problems of excessive fixed costs simply by raising their gross margins. The result, of course, was decreasingly competitive products. Today, all but the most naive companies have abandoned purely cost-driven pricing. For many, however, the transition to more market-driven pricing has done little for profitability. Unleashing sales and marketing managers from financial constraints has led to ad hoc price negotiations. Price lists have lost their credibility; customers have become tougher negotiators; the prices charged have lost their connection to value received. Consequently, many companies have lost control of their pricing and, therefore, of their ability to formulate pricing strategies.

The second edition of this text offers specific help to companies struggling with these problems. The completely new chapter on competition (Chapter 5) shows how to manage, rather than simply react to, a difficult competitive environment. The new chapter on customer negotiation (Chapter 8) shows sales representatives and managers how to reestablish a connection between the value they offer and the prices they charge. The chapter on financial analysis (Chapter 3) now explains how to analyze "reactive" price changes to defend sales. And the chapter on strategy (Chapter 6) provides a behavioral segmentation for pricing that reflects different purchase behaviors that effective pricing strategies must accommodate.

As in the first edition, the primary objective of this edition is to develop a practical and readable manager's guide to pricing, not a textbook. Our references are not necessarily to the seminal articles on the subject, but to those that are most managerially relevant and accessible. For reviews of the academic pricing literature, we recommend the texts by Kent Monroe[2] and Hermann Simon.[3] Professors will be happy to learn that an expanded Instructor's Manual for this edition includes substantially more classroom exercises, minicases, and examination questions. We expect that the combination of clear writing and current, relevant examples will continue to make this the most popular text in the classroom.

Notes

1. E. Raymond Corey, *Industrial Marketing: Cases and Concepts* (Englewood Cliffs, N.J.: Prentice Hall, 1962).
2. Kent Monroe, *Pricing: Making Profitable Decisions*, 2nd ed. (New York: McGraw-Hill, 1990).
3. Hermann Simon, *Price Management* (Amsterdam: Elsevier Science Publishers, 1989).

ACKNOWLEDGMENTS

We cannot practically enumerate all those people to whom we owe a debt of gratitude but collectively they have contributed substantially to the content of this work. We wish to renew our thanks to all who contributed to the first edition and whose specific contributions were acknowledged there. The success of that edition not only created the demand for a second edition, but also gave us access to client companies and managers from whom we have learned much more about pricing strategy and implementation than would have been possible from purely academic research. Many thanks to our students and seminar participants at Boston University, the University of Chicago Center for Continuing Studies, Management Center Europe, the Singapore Institute of Management, the RAYMA Management Institute, and at numerous companies. Their probing questions and challenging problems continue to keep our work interesting and relevant.

We gratefully acknowledge the advice of numerous experts in marketing, pricing, and business management whose published and unpublished insights we have incorporated into this text. While we could never enumerate them all, we wish to acknowledge our special debt to Kevin Clancy, Richard Harmer, Jay Klopmeker, Milind Lele, Mike Marn, and Gerald Smith. Our research assistants conducted extensive literature reviews and wrote drafts incorporating those reviews with material from the first edition and with notes from our seminars and consulting. Of special note are the contributions of Jim Muth (Chapter 5 on Competition), Cathy Grafton (Chapter 9 on Price Segmentation), and David Kreidberg (Chapter 7 on Life Cycle Pricing and Chapter 8 on Customer Negotiation). We also wish to acknowledge those contributors to the book whose precise contributions are cited in the text: Gerald Smith (Chapters 3 and 12), John Martin (Chapter 13), Craig Harkins and Donna Hamlin (Chapter 13), and Neil E. Graham and William E. Kovacic (Chapter 14).

Much of the success of the first edition, and the promise of the second, comes from the exceptional clarity and style of the writing. All too often the excitement, if not the content, of marketing gets lost in the written word. To the extent that we have avoided this pitfall, some of the credit goes to others. Rena Henderson and Barbara Haller extensively edited drafts of the new chapters, in which our literary sins were most numerous and appalling. Their exceptional abilities to criticize constructively were greatly appreciated. In addition, we had the good fortune to work with very thorough and exceptionally patient editors at Prentice Hall. The copy editor, Terry Seng, and the production editor, Kristin E. Dackow, took the time to understand what we were doing, thus enabling them to correct errors and confusions of content as well as of style. Sandra Steiner, marketing editor at Prentice Hall, deserves credit for convincing us to complete a second edition and getting us what we needed to do so.

Finally, Tom Nagle thanks his wife, Leslie, for her tolerance and patience while he neglected their life together to finally complete this second edition. Reed Holden thanks his wife, Annie; his children, Rebecca and Mark; his parents, Carl and Dottie Holden; and close friends, Ray and Ramona Nichols, for their unwavering support and encouragement during the final stages of the writing and development of the book.

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THE HARVEST OF YOUR PROFIT POTENTIAL

Marketing consists of four coequal elements—(1) the product, (2) its promotion, (3) its distribution, and (4) its pricing. The first three elements—product, promotion, and distribution—are a firm's attempt to *create* value in the marketplace. The last element—pricing—differs essentially from the other three: It is the firm's attempt to *capture* some of that value in the profits it earns. If effective product development, promotion, and distribution sow the seeds of business success, effective pricing is the harvest. Although effective pricing can never compensate for poor execution of the first three elements, ineffective pricing can surely prevent those efforts from resulting in financial success. Regrettably, that is a common occurrence.

WHY PRICING IS OFTEN INEFFECTIVE

Philips leads the world in consumer electronics innovation; Citicorp has achieved a commanding share of the credit card business; a handful of airlines dominates the airports of America. Yet, in every case, smaller, less visibly successful competitors in the same industries are substantially and consistently more profitable.[1] Why do these large companies and many others that clearly create great value for their customers fail to capture that value in their earnings? The reason, we believe, is their failure to integrate their value-creating activities with their pricing decisions.

Consequently, whatever profitability they do achieve is less by design than as a byproduct.

The difference between successful and unsuccessful pricers lies in how they approach the process. To achieve superior, sustainable profitability, pricing must become an integral part of strategy, not merely an afterthought. Strategic pricers do not ask, "What prices do we need to cover our costs and earn a profit?" Rather, they ask, "What costs can we afford to incur, given the prices achievable in the market, and still earn a profit?" Strategic pricers do not ask, "What price is this customer willing to pay?" but "What is our product worth to this customer and how can we better communicate that value, thus justifying the price?" When value doesn't justify price to some customers, strategic pricers don't surreptitiously discount. Instead, they consider how they can segment the market with different products or distribution channels to serve these customers without undermining the perceived value to other customers. And strategic pricers never ask, "What prices do we need to meet our sales or market-share objectives?" Instead, they ask, "What level of sales or market share can we most profitably achieve?"

Strategic pricing often requires more than just a change in attitude; it requires a change in when, how, and who makes pricing decisions. For example, strategic pricing requires anticipating price levels before beginning product development. The only way to ensure profitable pricing is to reject those ideas early for which adequate value cannot be captured to justify the cost. Strategic pricing also requires that management take responsibility for establishing a coherent set of pricing policies and procedures, consistent with its strategic goals for the company. Abdicating responsibility for pricing to the sales force or to the distribution channel is abdicating responsibility for the strategic direction of the business. Perhaps most important, strategic pricing requires a new relationship between marketing and finance.

Strategic pricing is actually the interface between marketing and finance. It involves finding a balance between the customers' desire to obtain good value and the firm's need to cover costs and earn profits. Unfortunately, pricing at most companies is characterized more by conflict than by balance between these objectives. If pricing is to reflect value to the customer, specific prices must be set by those best able to anticipate that value—presumably marketing and sales managers. But their efforts will not generate sustainable profits unless constrained by appropriate financial objectives. Rather than attempting to "cover costs," finance must learn how costs change with changes in sales and use that knowledge to develop appropriate incentives for marketing and sales to achieve their objectives profitably.

With their respective roles appropriately defined, marketing and finance can work together toward a common goal—to achieve profitability through strategic pricing.

Before marketing and finance can attain this goal, however, they must discard the flawed thinking about pricing that leads them into conflict and that drives them to make unprofitable decisions. Let's look at these flawed paradigms and destroy them once and for all.

The cost-plus delusion

Cost-plus pricing is, historically, the most common pricing procedure because it carries an aura of financial prudence. Financial prudence according to this view, is achieved by pricing every product or service to yield a fair return over all costs, fully and fairly allocated. In theory, it is a simple guide to profitability; in practice, it is a blueprint for mediocre financial performance.

The problem with cost-driven pricing is fundamental. In most industries it is impossible to determine a product's unit cost before determining its price. Why? Because unit costs change with volume. This cost change occurs because a significant portion of costs are "fixed" and must somehow be "allocated" to determine the full unit cost. Unfortunately, since these allocations depend on volume, which changes with changes in price, unit cost is a moving target.

To "solve" the problem of determining unit cost, cost-based pricers are forced to make the absurd assumption that they can set price without affecting volume. The failure to account for the effects of price on volume, and of volume on costs, leads managers directly into pricing decisions that undermine profits. One particularly tragic example, for the company and its customers, was Wang Laboratory's experience in pricing the world's first word processor. Introduced in 1976, the product was an instant success, enabling Wang to grow rapidly and dominate the market. By the mid-1980s, however, personal computers with word processing software were becoming credible competitors. As competition increased and growth slowed, the company's cost-driven pricing philosophy began killing its market advantage. Unit costs were repeatedly recalculated and prices raised to reflect the rising overhead allocation. As a result, sales declined even further. Before long, even Wang's most loyal customers began making the switch to cheaper alternatives.

A price increase to "cover" higher fixed costs reduces sales further and causes unit cost to rise even higher. The result is often that price increases actually reduce profits. On the other hand, if a price cut causes sales to increase, fixed costs are spread over more units, making unit costs decline. The result is often increased profit. Instead of pricing *reactively* to cover costs and profit objectives, managers need to price *proactively*. They need to acknowledge that pricing affects sales volume, and that volume affects costs.