Harvard Business Review

PRICING

A Quick Guide to Value-Based Pricing

by Utpal M. Dholakia

AUGUST 09, 2016

In my 15-plus years of working with companies & teaching courses on pricing strategies to MBA students, I have found value-based pricing (also known as “value pricing”) to be the most commonly discussed concept that’s also the most misunderstood one. It creates more confusion among marketers, even many pricing experts, than any other pricing concept. What is more, these misconceptions often lead companies to shy away from using it, instead settling for cost-based or other pricing methods that leave money on the table.

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What is Value-Based Pricing?

I like to use this definition: “Value-based pricing is the method of setting a price by which a company calculates and tries to earn the differentiated worth of its product for a particular customer segment when compared to its competitor.”

To understand how value-based pricing works, let’s take the example of Brand A that is about to launch a new LED television. It wants to figure out the price for its new 65-inch LED TV, the biggest screen size in the marketplace at the time. The company’s closest competitor, Brand B, recently introduced a 60-inch TV for $799. Both TVs have other features that are similar — both have built-in WiFi, the same level of definition, same number of HDMI inputs, same refresh rate, and so on.

Now let’s apply value-based pricing by considering each part of the definition carefully:

1) Focus on a single segment. The first thing to know about value-based pricing is that it always references one specific segment. (For B2B products, it can be a single customer). Brand A’s focus is only on big-screen TV buyers, not all TV buyers. Marketers can’t use value-based pricing unless they have a specific segment. If they have multiple segments, they must determine a suitable value-based price for each one.

2) Compare with next best alternative. This pricing method only works when the target segment has a specific competitor’s product they can buy instead. Value-based pricers always ask the question: “What would this segment buy if my product wasn’t available?” This “next best alternative” for the target is the essential point of comparison for calculating the value-based price. For products that are truly new, without peers, the value-based pricing methodology won’t work well.

3) Understand differentiated worth. The next task is to figure out which product features are unique, that is, differentiated, from the competitor’s offering. In our case, the only differentiated feature of Brand A is its larger screen size.

4) Place a dollar amount on the differentiation. The last, and arguably the most difficult, step in calculating value-based price is to estimate the dollar value of the differentiated features. For us, this boils down to: “How much will big-screen TV shoppers pay for an extra 5 inches of screen size?” and then add that amount (let’s say it is $150) to $799, Brand B’s price. The value-based price of Brand A’s TV is $949. To accomplish this step, marketers typically use research methods like conjoint analysis or qualitative customer interviewing.

One final point about value-based pricing is this. Just because the differentiated worth is $150 doesn’t mean the company will get it all. In many situations (buying or renting a house for example), there will be a negotiation process, and the marketer may have to share the differentiated worth with the customer.

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Dispelling Key Misconceptions About Value-Based Pricing

Value-based pricing is used in virtually every industry, to price everything from TVs and drugs, to oil rigs and airplanes. Despite its popularity, marketers have significant misconceptions about the approach. Here are three of the most common ones.

Misconception 1: Value-based pricing requires the company to evaluate consumers' willingness-to-pay for each and every product feature. Some marketers wrongly believe that when a company uses value-based pricing, it has to assess how much the customer values every single product feature, assign a dollar amount to each one, and then add them all up to calculate the product's final price. Even the simplest products have dozens of features. Imagine the difficulty of pulling this off for an oil rig or even a TV. This misconception turns many marketers off at the outset.

In reality, feature common with the next best alternative is captured by its price. In our TV example, the fact that both TVs have 3 HDMI inputs, built-in Wifi, and 4K Ultra HD is included in Brand B's $799. We do not have to calculate each feature's value separately. The only thing Brand A has to do is find the feature differences and assess customers' valuation of these differentiated features. This is a lot easier to do.

Misconception 2: Even if competitors are not smart with pricing, using value-based pricing will lead to success. This is likely the most dangerous misperception about value-based pricing because it can create false, high expectations. Many marketers think that value-based pricing is a panacea. If they use it, they will make lots of money under any circumstances. Not true! The success of value-based pricing depends on how smartly competitors have priced their products. If they have set untenably low prices, value-based pricing can't save you.

Just imagine what would happen if Brand B foolishly chose to sell its TV at $399 instead of $799. Brand A would still be only able to charge the $150 extra for its larger screen size, not any more. It would end up with a low price, and perhaps even lose money *because of Brand B*. Competitors have to practice "intelligent pricing" if value-based pricing is to work successfully.

Misconception 3: The brand's value is part of the value-based pricing calculation. With value-based pricing, the marketer's goal is to put a dollar amount on its differentiated features. The method's focus is on features that add value to the customer *and* that can be converted into dollars and cents. Features such as "longer-lasting by X%," "faster by Y hours," "less likely to break down by Z%," all work nicely because they can be easily converted into money.

But it's much harder to deal with a brand's value this way. This is why brand value is left out of the equation with value-based pricing. And it is one reason why the method is more popular in B2B settings that give less weight to the brand value.

Value-based pricing is an effective method to price products. On the one hand, it's a lot easier in practice than it appears to be in theory. The marketer needs to identify and assess its products'

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differentiated features only (except the brand's value), not every feature. And when competitors have priced their products foolishly, value-based pricing won't help. With a stronger grasp of how this method works, marketers will be able to make smarter pricing decisions, and employ value-based pricing to increase profits.

Utpal M. Dholakia is the George R. Brown Professor of Marketing at Rice University's Jesse H. Jones Graduate School of Business.

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