

Pricing as a Strategic Capability



Companies that know how to set the right prices for their products and services understand that pricing isn't simply a matter of good tactics. By investing in specific areas of organizational capital, they've made it a strategic weapon that competitors can only envy.

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For too long, most people who run companies have made a variety of unwarranted but detrimental assumptions about pricing. Changing prices, for example, has been looked upon as an easy, quick and reversible process, and new technologies have only reinforced this way of thinking. Similarly, extracting value from a product by pricing it correctly has been seen as relatively uncomplicated; the hard part is creating the valuable product in the first place. But these dismissive attitudes toward pricing miss the mark. As any executive of a company with thousands of products and hundreds of customers will tell you, price changes are not easy: Start tinkering in an ad hoc way and you end up with irrational prices and angry customers. And as any manager of an innovative organization will explain, it's awfully difficult to set a price for a radically new product in an untested market. Set the wrong price in that case and you squander an opportunity that a competitor is sure to seize.

The problem with typical assumptions is that they reduce pricing decisions to mere tactics, and tactics aren't enough. If pricing isn't a strategic capability — a contributor to a company's ability to devise and implement its strategy — it's probably a strategic liability. Pricing is complex,

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and it's only growing more so as new tools and techniques become available. In order to be able to set the right price at the right time, any time, companies need to invest in resources, infrastructure and processes. These investments allow a company to create a pricing strategy by building the capabilities it needs to routinely set prices for all its goods and services that fit with its positioning, with its customers, with its suppliers and with evolving market conditions.

For many companies, pricing capabilities are increasingly critical to their ability to implement their strategies. We interviewed one CEO in the computer business, in fact, who called pricing *the* essential capability for survival in that industry and has made investments in his organization that show that his comment isn't just an idle remark.

In the course of working with dozens of companies in the past couple of years, we have spoken with several other executives who have a similar outlook.¹ Their focus is on developing organization-wide capabilities by investing in three areas: human capital, systems capital and social capital. These investments — which are required, indeed, to develop a strategic capability in any area — are like the three legs of a stool: If one is missing, the whole thing topples over. A well-built capability, on the other hand, can serve as the foundation for superior pricing decisions for years to come. Once a company has made the necessary investments and given them time to bear fruit, its pricing processes will be difficult to imitate and thus a source of sustainable competitive advantage.²

We'll explore a few companies that have built a strategic pricing capability and explain how specific investments can pay off, but not before offering a few cautionary tales involving companies that, in effect, priced themselves out of the market — permanently.

Swimming Against the Tide

A pricing capability isn't just a "nice to have," something to think about "when we have the resources" in some far-off time that never quite comes. It's often a matter of survival for companies of every shape, size and age. That's because the cost of not having a fully developed pricing capability goes well beyond the losses associated with poor pricing decisions. After all, a bad decision or two can be rectified. The true cost must be reckoned by looking at the way an organization's strategy is hampered, sometimes disastrously, by an inability to price effectively.

Consider the case of Polaroid. This proud and venerable company was one of the first to develop digital-imaging technology, but its executives chose not to bring this breakthrough to market. Why? Given what they knew about pricing, they didn't think they could make money from the technology. Polaroid had long relied on a razors-and-blades approach to business: It sold cameras for relatively little and made money on the film. The company couldn't fit digital technologies into that box, so it gave up on digital

initiatives and lost its advantage in those technologies to competitors such as Kodak and Fuji. There's little doubt that Polaroid's inability to figure out how to extract value from digital cameras contributed to its slide into bankruptcy. The larger point, however, is that a company that had always been driven by a culture of innovation was stopped in its tracks when its pricing capability could no longer support its strategy.

Smaller companies and startups can also struggle their way into oblivion for lack of a pricing capability. Sun Country Airlines did just that. Founded in 1983, the company strove to establish itself as a cheaper alternative to Northwest Airlines for frozen Minnesotans in search of sunny vacation spots. Ultimately, this challenger's failure to develop a pricing capability hurt its chances of maintaining a viable operation. Before the business suspended operations in December 2001, Sun Country's CEO complained that the company did not have enough expertise to be able to price routes more profitably. It was stuck either operating by simple pricing rules (for example, it might drop the prices on a particular route by an identical amount in response to a decline in demand) or following rules of competitors whose goals, costs and needs were different from Sun Country's. Northwest, meanwhile, had the staff, the computer networks and the organizational glue to outmaneuver Sun Country on pricing every step of the way. And while it's true that Northwest had a considerable head start in this arena because of its size and experience, Sun Country could possibly have avoided some of its troubles by investing more in pricing capital earlier in its history. Such investments might have allowed the airline to maintain its niche as a more affordable choice for vacation travelers. (As evidence that size isn't everything, consider the success of easyJet in Europe. This startup hasn't ignored the need to develop pricing capabilities and has been extremely successful as a discount airline on the continent.)

Sun Country's experience mirrors that of many startup businesses, which often have better technologies and ideas but weaker pricing capabilities than incumbents. New entrants frequently set prices that are too low to capture a fair share of the value they've created. They also have a difficult time segmenting the market; that is, setting prices for different customer groups according to what they value and will pay for. Unfortunately, entrepreneurs often put the need to develop pricing expertise toward the bottom of their to-do lists. Startup founders have a lot to worry about, no question, but they limit their attention to pricing at their business's peril.

The Price Is Right

In terms of pricing, a company like Sun Country is the equivalent of a novice darts player — someone picking them up for the first time, on a bet, after a few beers. He may get lucky and even hit the bull's-eye on one throw, but the overall effect will

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be scattershot and the wall will suffer more than a few nicks. A company with a pricing capability, on the other hand, is like an accomplished player — someone who enters competitions and wins them. The seasoned player might not put any shots in the bull's-eye, but virtually every dart will score points, and they will all cluster around the center.

Companies with a pricing capability will also cluster around optimal prices and will rarely go so wrong that they end up outside the board. They understand that the optimal price frequently is not the one that wrings the most out of their customers (who will get tired of getting squeezed and find relief from another supplier at the first possible opportunity). A division of Roche, the medical-products company based in Switzerland, provides a good example of a business that has, over time, evolved to become an accomplished darts player.

Through acquisition of smaller companies, Roche grew a couple of years ago to become one of the top suppliers of diagnostic medical equipment in the world. But the acquisitions presented huge headaches in terms of pricing, as Ron Andrews — the new vice president for marketing of the division for centralized and molecular diagnostics — realized immediately upon taking over his duties.

The diagnostics business has two components: selling reagents, or tests, that aid the detection of heart disease, diabetes, hepatitis and other maladies; and selling the equipment needed to read the tests. When Roche had finished acquiring smaller companies to build the division, Andrews found that approaches to pricing were all over the map. There was no standard way of thinking about list prices, discount structures, bundling, or contract lengths. There was no collective agreement on whether machines should be given away (money would be made on sales of the tests) or sold to recoup expenses (the machines were becoming increasingly expensive to produce as technology improved). Some sales departments were used to having the freedom to negotiate prices; others adhered to set prices and schedules. In addition, the division faced the standard industry pressures on the bottom line, as buying groups and testing labs came together to seek lower prices by ordering in bulk, and as insurance companies and regulatory bodies sought to keep testing costs down.

Andrews reacted to these problems by taking the long view. He did adjust a few prices at the outset, but he understood that the situation wasn't one for him to fix overnight by changing all the company's prices. He knew that the division needed to build a long-term solution, a pricing capability rather than a set of new prices. As a result, he invested resources in three areas. He expanded human capital by hiring people with pricing expertise and creating an internal center of learning — Roche Marketing University — to build pricing knowledge throughout the organization. He increased the division's systems capital by investing in a new software system that drew together information from throughout Roche to control and support its prices. And he generated more social capital by bringing together people from sales, marketing, finance and other groups to reduce conflict and build consensus on pricing.

Internal estimates of the value of investments in the software systems alone are a 10% increase in profitability in the first year and a three- to five-year advantage before competitors will be able to catch up. The investments in pricing capability helped the division leverage its higher-value products to improve the profitability of items that had become commodities; they also led to improved customer relationships and a better understanding of costs. And, in a market growing at 2% or less, the division has enjoyed double-digit revenue growth. Most important of all, perhaps, is the fact that the pricing capability is now being integrated into their strategic processes, fundamentally altering the way they explore technological breakthroughs in areas such as molecular genetic research.

The development of a pricing capability is having a similar effect on strategy at Owens & Minor, a leading distributor of medical supplies. The company developed what it called "activity-based pricing" a few years ago and that approach has been instrumental in the evolution of its strategy. Owens & Minor is now a provider of value-added logistics, materials management and information services. In particular, the company's pricing capabilities have allowed it to capture value from new services, which form the backbone of its current strategy.

The Three Capitals of Pricing

The key to the story is that Roche developed three forms of

pricing capital simultaneously. Investments in these three areas form a unit that exceeds the sum of its parts. A competitor can hire your pricing director, but if it doesn't have systems in place or social capital, the director won't be able to act effectively. Another competitor can invest heavily in systems, but without people who have a broad view of pricing, the software is likely to be underused or misused. Finally, social capital takes time to build; it can't be bought or lured from a competitor. To get a better sense of how investments in these three capitals can contribute to pricing capability, let's look at each in turn.

Human Capital An effective pricing process can't be run on automatic pilot: It requires well-trained people who understand the company in all its complexities — its strategy, range of products or services, customers, suppliers and competitors. Companies can meet this requirement by training existing employees and by hiring business school graduates or seasoned executives who bring pricing expertise with them.

Roche has used its internal university to increase knowledge about pricing among its employees. We also saw the benefits of training at a large U.S. industrial company that manufactures parts used to maintain machinery. (We spent two years studying pricing processes at this company, which sells more than 8,000 parts in three product lines to some 1,400 customers. We agreed to keep its name confidential as a condition of the research.) Managers at the company were sent to take courses aimed at increasing their theoretical knowledge about pricing. In addition, task-specific tools and programs were developed. For example, one sales manager put together a package that would help people in the field recognize whether they had negotiated a good deal. The package provided information about the company's net profit before taxes, fixed and variable costs, and freight expenses; reps could plug in the terms of a deal to see what kind of profit it would generate. This tool helped the salespeople, who lacked the expertise to do complex financial analysis on their own, get a better understanding of how to align prices with profitability.

The hiring lever is always an important way to add human capital. As more business schools and executive education programs add pricing to the curriculum, it is becoming easier to find people with a sophisticated understanding of the subject. Companies sometimes fall down in this area, however, because the hiring managers themselves don't know enough about pricing to spot talent when they see it. Internal training may be needed to raise the level of understanding within an organization so that effective hiring decisions can be made.

The importance of human capital in a knowledge-driven economy is harped upon so often that it's easy to tune out after a while. Maybe we have to turn up the volume a little. Thanks to

the Internet, pricing has become a lot more complicated. Companies that don't have people who deeply understand dynamic pricing, auction theory, bundling, game theory, and so on, are going to be involved in a daily game of catch-up with rivals who have invested in human capital.³ It's a wearying, frustrating game that's bound to end in defeat.

Systems Capital Companies can have any number of dedicated and savvy people involved with pricing decisions, but those people won't be fully effective if the organization is systems poor.⁴ AT&T failed to capture the customer value and cost savings it hoped to gain by bundling products and services, for example, in part because it lacked the systems to do so. Sears also suffered several years ago because it lacked the computer infrastructure it needed to easily set different prices from one store to another. Thus it had limited flexibility to respond to competitors' actions market by market and was consistently behind the curve on pricing.

On the other hand, many companies have made major investments in software and hardware systems in recent years in order to collect, share and analyze data. Leaders in the direct marketing industry such as HSN (Home Shopping Network) have long relied on superior systems that allow them to react to information about customers in real time, and large grocery store chains have used sophisticated price-sensitivity tools and category-management systems to improve profitability dramatically. Some are now innovating with electronic pricing systems on store shelves, a change that will allow managers to change the prices of thousands of goods much more efficiently and cheaply.

At the industrial manufacturing company, senior management developed systems capital and human capital hand-in-glove. The tool that helped sales reps understand the profitability of their deals is one example. The company also invested in a new system to get more accurate information about customer purchase history. The system kept track of the exact prices paid by customers, including special discounts and the reasons those discounts were offered. Another system allowed salespeople to call up a part number and get information about the product's uses, comparable products offered by competitors, and engineering details. Among other advantages, these systems enabled sales reps to quote prices to the customer almost immediately instead of having to go back to the office to calculate the deal; in turn, the deals themselves could be reached much more quickly.

The bottom line: Superior systems and better-trained people can form a virtuous circle in which technology and human capital reinforce each other to become optimally effective. Of course, that sounds great, but we don't want to minimize either the challenges or the opportunities. Most companies know, or should

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know, that they'll be left in the dust if they don't invest in the systems they need to take control of the vast body of data available to them. At the same time, if pricing is left out of strategy, managers may not understand how any one particular system will pay off at the end of the day. Systems capital, like its human and social counterparts, cannot be considered in isolation. When it is, companies tend to end up with expensive, underused hardware and software and a lot of static information.

Social Capital Developing human capital and appropriate systems are two important steps in the direction of effective pricing. But companies will still lack the strategic capability — the ability to set the right price at the right time — if they have not invested in social capital, the internal glue that coordinates and holds together the many participants in the pricing process.⁵

A senior manager in the manufacturing company found this out the hard way. He complained to us once that, despite hiring some of the best M.B.A.s available and making use of new systems, pricing at the company did not improve during his first two years with the organization. During that time, he had been unable to convince the company's divisions to implement his pricing ideas; in short, he lacked the social capital to sell the pricing ideas internally. The manager eventually changed the composition of his pricing team. He replaced people he had hired with managers from the various divisions in the company. He brought everyone involved with pricing to a number of off-site meetings. Although he noticed a drop in the technical sophistication of the team's pricing recommendations, he saw an overall improvement in the company's ability to price effectively as a result of the focus on social capital.

Social capital extends beyond the company's doors to encompass its customers. In fact, anticipating and managing customers' responses to price changes may be the most difficult element of pricing capability to develop. Too often, companies concentrate on the technical issues involved with implementing the change and neglect to sell their customers on the reasons behind it.

Procter & Gamble, for example, spent heavily to change internal processes and routines that would allow it to implement a strategy of everyday low prices. As it pushed ahead with its new pricing strategy, however, the company failed to anticipate the

retailer anger that followed the change. The CEO of Stop & Shop said that Procter & Gamble was "acting like a dictator" and warned that "We will do everything in our power to undermine their plan." Wholesalers were also upset. SuperValu added a special surcharge to P&G products, and many wholesalers discontinued or stopped merchandising P&G brands. One senior P&G manager later commented, "I had never in my 30 years in this business seen our customer base as angry." The company has tried to make amends, but the damage is nowhere near completely repaired.⁶

To avoid the P&G scenario, companies must develop teams that can anticipate customer reactions by involving lead users, conducting market research and analyzing reactions to previous price changes. Managers may not be able to completely stave off emotional responses to price changes, but they can invest in social capital to prevent a total meltdown of customer relationships.

Of the three capitals, social capital is unique in that it can't be bought. Competitors can hire pricing experts and buy software systems, but social connections take time to develop and must be carefully nurtured. This form of capital is, in fact, the hardest to build. The success of the senior manager at the manufacturing company we studied came after much time and was not easily won. And note that investments in social capital tend to differ from those in people and systems. They can involve money — paying for an off-site meeting, for example — but they often require more in the way of managerial time, as executives adjust an organization's structure to build effective relationships. That investment of time is crucial, however, because the power of systems and the talents of individuals will go to waste if managers fail to integrate them.

Competing for Resources

We don't want to imply that the investment decisions involved in building a strategic pricing capability are simple. The very idea that pricing is a capability is challenging and new, and it won't be easy to put the development of pricing capabilities on par with other, more traditional strategic capabilities. And make no mistake: Building a pricing capability requires commitment. You can't wade in up to your knees (by investing in one capital) or even up to your chest (two capitals) and, in effect, reach the treasure on the seabed. Either dive in and grasp

for the full benefits of a pricing capability, or stay on the beach.

We also want, however, to avoid painting a scenario of "invest or die." Companies always have to balance investments aimed at creating new value with those that could be used to extract more value from existing products or services. CEOs have to consider the possibility that investments in pricing capital may not generate the returns that investments in areas like product development or R&D or new plant construction can produce.

When a company chooses not to invest in pricing capabilities, it should be careful to adopt pricing tactics that are consistent with a lack of those capabilities. Many companies make the mistake of following rivals into forms of pricing that are much more costly for them than for their competitors. For example, if a competitor has streamlined its price-adjustment process so that it can change prices at low cost, matching every price change will put you at a disadvantage if your processes are more cumbersome and thus more costly. In such cases, you shouldn't plan to be a price leader but to follow as well as possible. Similarly, if a competitor has the capability to price bundled goods and you don't, it would be a mistake to attempt bundling. (A large medical-products supplier we worked with learned this lesson at its own considerable expense.) To put it another way, companies that don't have a well-developed pricing capability have to understand that they will not extract as large a share of the value they create as competitors who have invested in pricing capabilities.

Feeding the Tree's Roots

A company's products and services, to indulge in another metaphor, are just the fruit of the tree; its roots are the core capabilities and competencies that organizations develop. A strategic pricing capability is an important contributor to the tree's long-term health. Although only the prices themselves are visible to onlookers, the capability underlying the prices is ultimately what makes them right for the market or either too high (driving away customers who perceive them as unfair) or too low (opening up opportunities for competitors). Most CEOs will never set a single price. They can, however, give their managers the ability to win price wars, maintain price leadership and hold a competitive edge in pricing. The key is understanding how different forms of capital — human, systems and social — blend in a way that competitors will find difficult to imitate, and then making the necessary investments to create a formidable new strategic capability.

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