



Smart Pricing: **STRATEGIES FOR BUSINESS SUCCESS**

INTERVIEW WITH
PROFESSOR HERMANN SIMON ▶

In this interview, the world's leading expert on pricing strategy, Professor Hermann Simon joins us to discuss smart pricing strategies for business success.

Professor Hermann Simon is Honorary Chairman of Simon-Kucher & Partners. He is an expert in strategy, marketing and pricing, and has an extensive range of global clients. An ongoing online survey (in German language countries) votes him the most influential living management thinker. Professor Simon has authored numerous books and writes articles for international newspapers and business magazines.

Q: What is your key message? What would you like listeners to take away from this interview?

Prof. Simon: I would like to point the attention to the fact that there is a huge discrepancy between the importance of price and the effort to determine prices.

Managers should better understand the effect of prices, think more deeply about them, and use more resources to set prices. If I succeed to convince readers to observe these tenets I have achieved my goal.

Q: What is the most important thing we need to understand about pricing?

Prof. Simon: In my long career, I have been asked this question hundreds of times. I always have one answer: Value or, more specifically, perceived value-to-customer. In this regard, we can learn from the Romans, who were very smart already 2000 years ago. They had the same Latin word for "price" and "value": "pretium". This is the core equation of pricing, $\text{price} = \text{value} = \text{pretium}$! Value and price must always be balanced. Accepting and understanding this simple equation can mean an enormous improvement for people who make price decisions. ▶

“Value and price must always be balanced.”

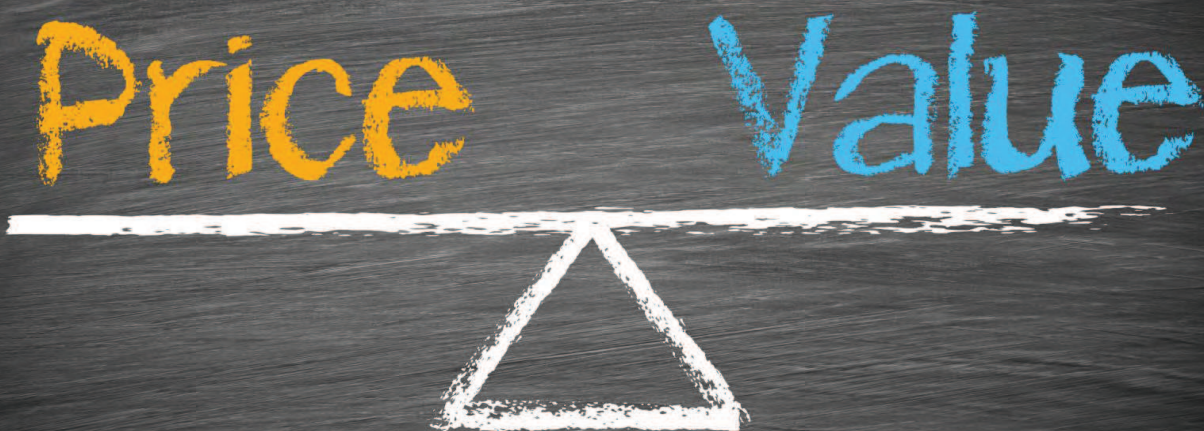


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Q: What is the biggest mistake companies make when it comes to pricing?

Prof. Simon: There is not one big mistake; rather there are several. Probably the most widespread mistake is cost-plus-pricing. In its extreme form it is unidimensional, which means that only costs are used to set prices. This is done by applying a standard mark-up to the costs. The biggest mistake is to use full costs, which include variable and fixed costs. This approach means that you increase your price when demand goes down, and vice versa. If you use variable costs for the mark-up the mistake is less serious, but you still neglect value-to-customer.

Another frequent mistake in pricing is to strictly follow the competition. We recently had the case of a large retailer who set 600 prices according to a competitor's prices. They virtually

delegated their pricing function to the competition. For commodities, there may not be a lot of latitude in this regard, but for most products strictly following the competition is a mistake. Again, it neglects value-to-customer.

Q: What key factors should we consider when pricing services and products?

Prof. Simon: After what I said it should be clear that the starting base should be value-to-customer. Only the value perceived by the customer determines the customer's willingness-to-pay. This willingness-to-pay should be your first criterion when setting prices.

Of course, costs have to be taken into account. But for the price decision only the variable costs are relevant because fixed costs are not influenced by price and volume. One general decision rule is that a factor that is not influenced by a parameter should not be considered when setting this parameter, in our case price.

There is basically no difference in setting prices for services or products, but of course practices differ from industry sector to industry sector. Evaluating and understanding the value-to-customer of a service is often even more difficult than of a product.

Q: Could you give us some tips on how we can best optimise our price?

Prof. Simon: Any simple answer to this question is wrong. The only general statement I can make is that





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you have to understand how the customer perceives the value of your offer. Creating value is a challenge for innovation and product design, while communicating value is a challenge for advertising and distribution. Capturing the value is the task of the price decision and implementation. However, it all starts with a better understanding of the value. Ultimately you have to quantify this value; price is a number and you must express the value as a number.

Q: Are there any “rules of thumb” when it comes to pricing and pricing strategies?

Prof. Simon: I tend to be very careful with simple rules of thumb. However, one rule is rather generally valid. Once you understand and have established the value you should share this value with your customer.

If the value of your product is 20% higher than the value of competitive products you should not charge 20% more, as this would mean that the customer does not get any added value. Instead, you should split the premium value with your customer, e.g. by charging only 10% more. This way you have an advantage in getting paid 10% more than the competition, and the customer has an advantage because by paying 10% more he gets 20% more value than by buying an inferior product.

There are also some rules for new products, namely skimming and penetration strategies. If you are new to a market and have little brand reputation you probably need a low introductory price to make your product known. We call this a penetration strategy. If, on the other hand, you are a leading brand like ►

Apple you can start with a high price and gradually reduce the price (as happened with the iPhone); this is a skimming strategy.

Q: I come from a FMCG (Fast Moving Consumer Goods) background. When we analysed price discounts, we found we never succeeded in increasing volume to the level where we recovered the cost of the discount. We always lost money. What is your experience with price discounting?

Prof. Simon: I fully concur with your experience. I remember the case of a very large supermarket retailer. They ran a promotion in which they skipped the value-added tax (19% in Germany). Everything was 19% cheaper. I asked the CEO how much more traffic they had generated and he said 30-40%. I then made the simple calculation that they would have to double revenue to make the same profit. If you assume that they had a margin of roughly 25-30%, they sacrificed about half of that margin. To recuperate that they would have to double their revenue. The CEO thought the promotion was a big success when in reality it was a massive failure. The same thing happens with many promotion and discount activities.

Q: How can we best communicate value?

Prof. Simon: The best way to communicate value is of course to create a product which has a great value and communicates the value by itself. In reality, this is a dream that does not come true too often. Value communication differs across product types.

In the case of a cosmetic or luxury product, a large part of the value is created through advertising and image building. In the case of industrial products, the value is mostly created through clear-cut economic advantages, e.g. cost savings or higher productivity.

“Profit is the cost of survival.”

Ultimately this question leads to the customer: What does the customer appreciate most, and how can we address these most important needs? In the case of a pharmaceutical e.g., do patients or doctors pay more attention to quick results or the absence of side effects? Do they want quick effects or long-term improvement? To effectively communicate value, you must connect the customers' needs and the performance features of the product or service.

Q: What benefits can we expect from shifting our focus from market share to profit? ►

Prof. Simon: Profit is the cost of survival. In a strategic sense, this is for me the only relevant definition of profit. At the same time, this tells us that a pure market share orientation can be dangerous.

Market share may be a good guideline in the early stages of a product life cycle. But long-term market share maximization at the expense of profitability is likely to end in disaster. We have seen it in airlines, in retail, in electronics. A company has to observe several goals, but profit should be the *conditio qua non*.

General Motors is probably the most prominent example of the danger of a market share orientation. Around 2005 General Motors had a share of about 22% in the US market. They were aiming at a market share of 29% and cut prices across the board. Volume did increase

temporarily but the losses exploded. Ultimately market share actually went down and they ended in bankruptcy in 2010.

Q: What steps can we take to transition a company from a market share focus to profit focused strategy?

Prof. Simon: If a market share orientation is deeply rooted in a company's culture a reorientation will take time. It usually requires a change in the incentive system, especially for the salesforce. And I would say that in almost all cases it requires an exchange of key personnel.

Behind the market share orientation lies a drive to kill the competition. This has to be eradicated. Many of the concepts of competitive strategies popular in the second half of 20th century misguided ►



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entire manager generations. The most prominent example is the so-called PIMS project. PIMS stands for profit impact of market share. The main result of this project was that higher market share leads to higher profitability. However, this was a correlation, not a causal relationship.

We have to re-educate a generation of managers to be truly profit oriented, not market share driven. This is a very demanding task.

Q: You advocate a profit oriented incentive plan for sales teams rather than one based on revenue or sales targets. Can you explain?

Prof. Simon: If you want to pursue a profit-oriented strategy you need incentives that support this strategy. Incentives based on revenue or sales targets do not lead to profit-optimal prices.

This means you can only use them if you do not give pricing authority to your salesforce. But this is quite unusual. In all B2B markets the salesforce needs some pricing authority, and they will employ this authority to maximize their benefit. They will sell as much as possible to create the biggest revenue if you have a sales incentive. However, we know that the biggest revenue comes with a price which is below the profit-optimal price. Thus, you will not optimize your profit. The incentive and objective systems have to be aligned across the corporation and for the different hierarchical levels. It's that simple.

Q: Could you share an example of a company you worked with, where smart pricing resulted in significant improvements in profit.

Prof. Simon: Würth is the global leader in assembly products, with more than 70,000 employees and presences in practically all countries of the world, also in Australia. About half of the workforce belongs to the salesforce, about 35,000 salespeople. These salespeople have pricing authority; all prices are negotiated and they can give discounts up to a certain level.

We introduced an entirely new discount incentive. On a screen, the salesperson sees immediately how his or her commission will change if they give a higher discount. Within about two months the average discount went down from 16% to 14%. This is 2 percentage points of pure margin since there were no volume losses. With a revenue of roughly €12 billion in 2016 this difference of 2 percentage points translates into a substantial amount of additional profit.

Another case concerns a large software company for which we did a project. I asked the CEO whether we should include a certain person who was in charge of the complex price lists in the project team. The CEO said: "No, this person has a simple administrative function". Talking to the sales director in the US I asked how much discount they can give. He said: "Up to a certain percentage we can decide here in the US. If it goes beyond a certain percentage to special discounts we ▶



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have to ask headquarters in Europe.” When I asked for the name of the person they had to ask he mentioned the person the CEO had excluded from the project team. 80% of the US business were on special discounts, all decided by Mr. X. Nobody was aware of this role because Mr. X had been doing this for the past 20 years. We then changed the organizational responsibilities. This had a major impact on profitability. I think Mr. X was the person with the strongest influence on profit, but nobody was aware of this.

Q: In what ways has the internet impacted pricing considerations?

Prof. Simon: The internet has an extremely strong impact on pricing. The first and most obvious effect is the dramatic increase in price transparency. At a fingertip you can compare prices across many competitors, across countries and for the whole world. This changes the

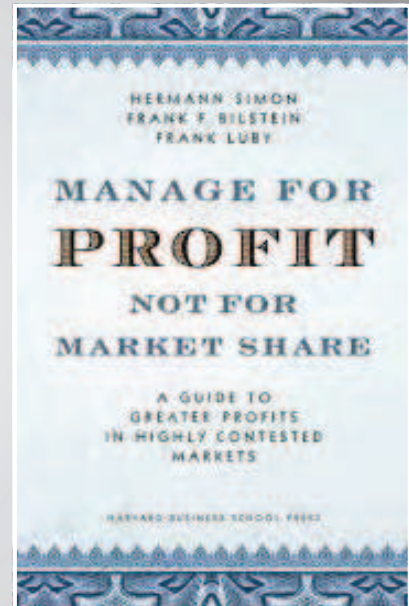
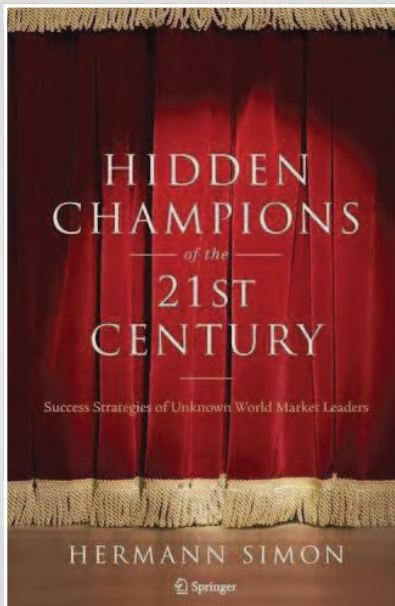
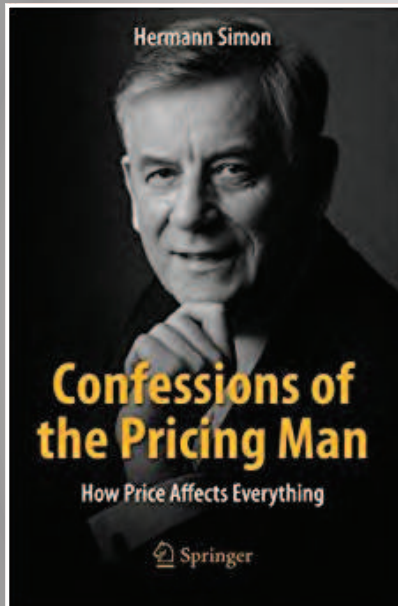
price response. It's in favour of low-price offers and disadvantages high-price offers.

A maybe even more important, longer-term effect is the increase in value transparency. This has highly asymmetric effects. If somebody gets bad customer feedback, price as a competitive weapon becomes ineffective. If a hotel gets bad evaluations customers will not book it even if it offers a lower price. On the other hand, if someone gets excellent feedback they can afford to charge higher prices or to increase their prices. Understanding these complex consequences of the internet is important for online pricing.

Q: What are some interesting innovations in pricing that you have seen in the last few years?

Prof. Simon: If we look back at the last 150 years, there have been very few pricing innovations. Paying in installments was introduced in the late 19th century, price bundling was first used by the film industry around 1915, car rental started around 1910. Non-linear pricing has been around for a long time in terms of quantity discounts, but was only fully understood in a systematic way in the 1980s. Innovations were few and occurred only every few decades.

This has radically changed with the introduction of the internet which has brought a massive wave of innovations: flatrates, freemium, pay-per-use, customer-driven pricing, and dynamic pricing are examples. ►



The decisions have become more complex. On the one hand, these new methods offer great potential for profit improvement. On the other hand, they carry risks as we try to exploit the customers' willingness-to-pay more systematically and go all the way to the margin; if we go too far we may fall off the cliff. The new pricing methods require a much deeper understanding, better data, and speed. In dynamic pricing e.g. speed is everything.

Q: What's one final piece of advice you would like to leave readers?

Prof. Simon: Always remember the core equation: $\text{pretium} = \text{value} = \text{price}$. This equation brings great challenges: understanding, creating, communicating value. Ultimately you have to quantify the value. If you don't do this you are flying through the fog.

Q: Where can people go to find out more about you and your services?

Prof. Simon: We supply a lot of literature. My most recent book is "Confessions of the Pricing Man". We are just preparing a standard textbook which will have the title "Price Management" and will be published later this year by SpringerNature. With 600 pages, it's the most comprehensive and most up-to-date work on price management. Especially for new products, I recommend "Monetizing Innovation" by Madhavan Ramanujam and Georg Tacke.

Of course, I invite you to visit our homepage simon-kucher.com. Our company is the global leader in price consulting and certainly the thought leader. We have an office in Sydney, as well as offices throughout Europe, the Middle East, Asia Pacific and the Americas. ■



**Professor
Hermann Simon**

Prof. Dr. Dr. h.c. mult. Hermann Simon is Honorary Chairman of **Simon-Kucher & Partners**. He is an expert in strategy, marketing and pricing. He has an extensive global range of clients. In the German language area he was voted the most influential living management thinker.

Before committing himself entirely to management consulting, Simon was a professor of business administration and marketing at the Universities of Mainz (1989-1995) and Bielefeld (1979-1989). He was also a visiting professor at Harvard Business School, Stanford, London Business School, INSEAD, Keio University in Tokyo and the Massachusetts Institute of Technology. From 1995 to 2009 he was CEO of Simon-Kucher & Partners. His Hirsch-Index is 51.

Professor Simon has published over 35 books in 26 languages, including the worldwide bestsellers *Hidden Champions* (Boston 1996, cover story of *BusinessWeek* in 2004) and *Power Pricing* (New York 1997), as well as *Manage for Profit, Not for Market Share* (Boston 2006). His book *Hidden Champions of the 21st Century, Success Strategies of Unknown World Market Leaders* (New York 2009) investigates the strategies of little known market leaders. His book *Confessions of the Pricing Man* was published by Springer, New York in October

2015. *Price Management*, the US version of his leading German textbook, will be published in 2017.

Simon was and is a member of the editorial boards of numerous business journals, including the International Journal of Research in Marketing, Management Science, Recherche et Applications en Marketing, Décisions Marketing, European Management Journal as well as several German journals. For several decades he regularly wrote columns for the German business monthly Manager Magazin. As a board member of numerous foundations and corporations, Professor Simon has gained substantial experience in corporate governance. From 1984 to 1986 he was the president of the European Marketing Academy (EMAC). Simon is co-founder of the first Special Purpose Acquisition Company (SPAC) listed on the German Stock Exchange in Frankfurt, which acquired Exceet Group S.E. in July 2011.

A native of Germany, he studied economics and business administration at the universities of Bonn and Cologne. He received his diploma (1973) and his doctorate (1976) from the University of Bonn. Simon has received numerous international awards and holds honorary doctorates from IEDC Business School of Bled (Slovenia), from the University of Siegen (Germany) and from Kozminski University Warsaw (Poland). He is a honorary professor at the University of International Business and Economics in Beijing.

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