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RIEKHOF ON PRICING No 48

Creating Pricing Categories for Your Products

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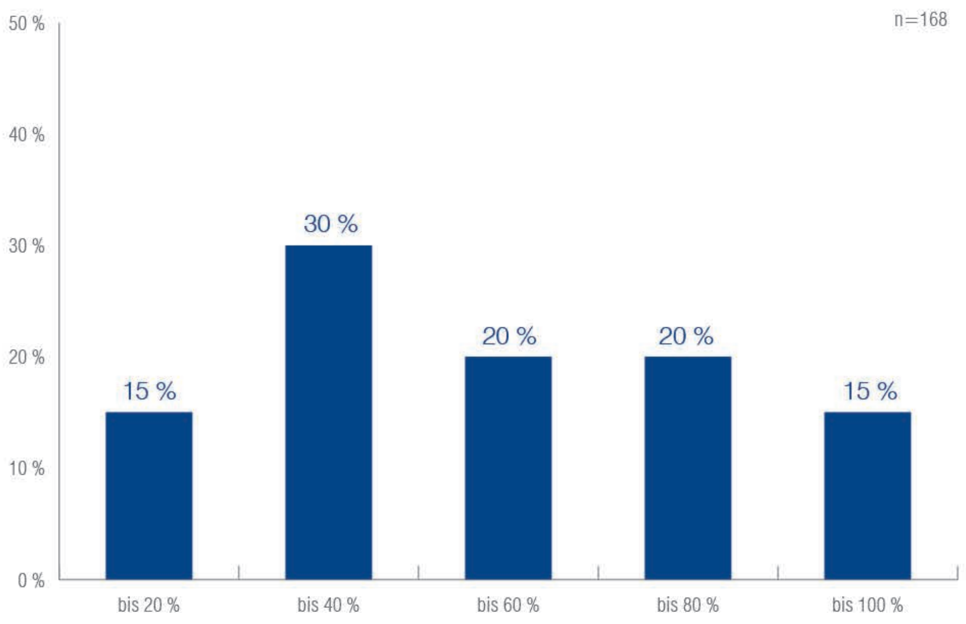
How differentiated are your company's guidelines for the strategic pricing of products and product groups? Does your company even have a strategic pricing structure in place for your product range?

How you can create such a structure, such pricing categories, along with some options and practical examples, is the subject of today's Pricing Newsletter.

What are Category Models in Strategic Pricing?

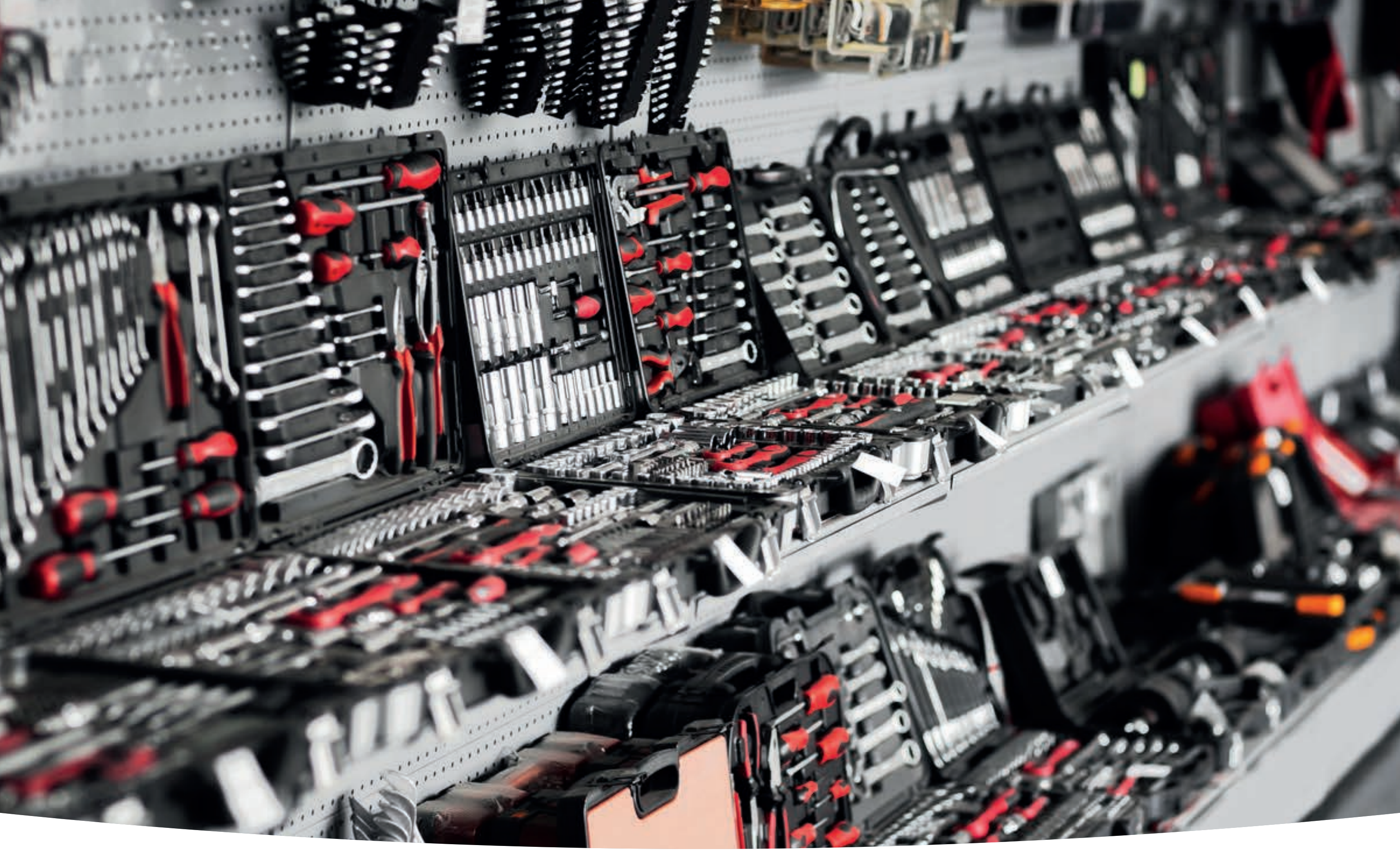
When it comes to pricing strategy, not all of a company's products should be treated in the same way. Some products can demand comparatively higher prices or cost calculations, while others face greater pressure in their markets or offer no real enhanced value over comparable products offered by the competition. Our empirical studies have repeatedly reported on how companies rate the price elasticity of their product range. Here are the findings of our study in which we asked about the percentage of particularly price-sensitive products:

Fig. 1: What percentage of your products would you describe as very price sensitive?



Source: Riekhof/Wille 2018, Pricing-Prozesse in der unternehmerischen Praxis. Eine empirische Studie der PFH Göttingen.

It goes without saying that not all elements of a product range are equally price sensitive. We can see here that it is relatively rare for the percentage of price-sensitive product range components to exceed 60% or 80%.



How can companies with highly complex product ranges comprising, say, 20,000 or more individual products effectively map the differences in (perceived or indeed measured) price sensitivity? In our pricing projects, we work with a category model that I would like to present in this newsletter.

The LSDC Model as a Basis for Pricing Categories for the Product Range of a DIY Store

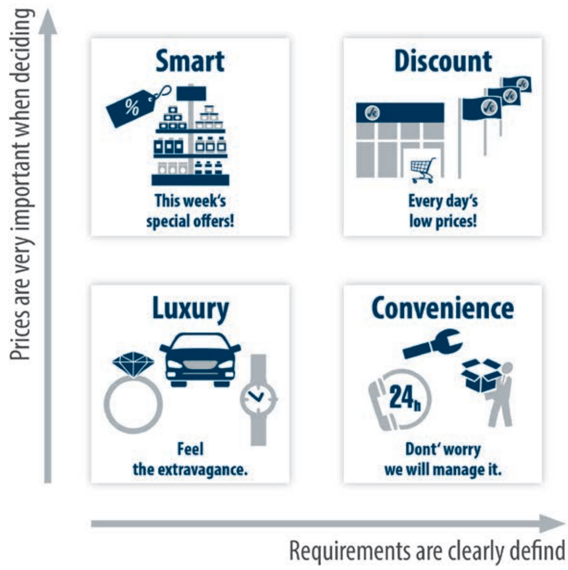
The project described in the following for a German DIY chain dates back a few years, but the approach taken proved to be highly effective. The point of reference was our LSDC model, according to which customers tend to respond to discount pricing, smart pricing, convenience pricing or luxury pricing depending on the situation.

In applying this model, we assigned all 50,000 products in the DIY store range to one of these four categories and defined an additional mandatory characteristic in the article master data.

For each segment of the product range, this made it possible to evaluate

- how the products are distributed across these four categories
- what the key management parameters for these four categories are (number of units, average prices per product group, product variations or depth of the range, delivery capability, stock rotation, handling costs, resulting contribution margins).

Fig. 2: Professor Riekhof's LSDC shopping type model



Differentiated Parameters and Key Indicators for the LSDC Categories

It goes without saying that the key management indicators for each of these categories differ substantially:

- In the **discount segment**, important criteria include a high stock rotation rate, good delivery capability, relatively low contribution margins, lower price ranges and high numbers of units sold.
- High unit sales are also a priority in the **smart segment**, along with attractive discounts and limited-time product promotions.
- In the **convenience segment**, we expect significantly higher contribution margins, but also higher range complexity.
- The cost calculation as well as the targeted price classes will be highest in the **luxury or innovation segment**, with products that feature unique characteristics dominating.

In the meantime, we apply an even more differentiated model in our pricing projects that enable us to establish more detailed guidelines for strategic pricing. In this category model, we distinguish according to industry and business model between the following categories for product pricing strategy:

1 Pricing for Basic Items/Commodities

These products tend to be standard items and largely interchangeable commodities subject to considerable price pressure. For a full range of products, they are, however, indispensable. In terms of pricing, they are characterized by low prices, tight cost calculations and a limited product portfolio.

2 Pricing for NOS (Never out of Stock) Products

The basic items are closely followed by the NOS products. This category is mainly found in fashion/textiles retailing, where good supply readiness and availability can cause major problems, especially in the case of seasonal top sellers. The NOS product category is designed to ensure that for part of the product range more exact forecasts are made, where necessary supply quotas are agreed and minimum stocks are defined. For pricing, this means the goal should be to ensure at least a reasonable profit margin – while keeping processes lean.

3 Pricing for Recommended Items

This category makes up the core of the product range. The sales force should be trained to market these aggressively, with special sales incentives provided for where appropriate. Bricks-and-mortar retailers should give special prominence to these items, as they are the most important drivers of planned revenue growth.

4 Pricing for the Extended Product Line

These products are add-ons for specific applications and are usually not given such a hard sell. In this category, the pricing strategy potential is greater than for recommended items.

5 Pricing for Market Introduction Products

Two opposing pricing strategy options present themselves for product innovations introduced to the market: low prices aimed at quickly establishing a market share, or high prices in order to maximize profits. It is important to look at these products separately for a specified time period so as to be able to define differentiated targets (e.g. high growth).

6 Pricing for USP Products (where applicable also patented products)

One strategically very important category are those products that offer a real USP, or unique selling proposition, for example because they are based on patents or generally have an important innovation value that is recognized in the market. This category is likely to give rise to preemptive internal discussions along the lines of "does the product really have a unique position"? A company's regular customers are probably best positioned to answer this question. For products in this category, the logical pricing strategy benchmark is sustained sales growth coupled with very high margins.

7 Pricing for Hidden Products

In the case of highly complex product ranges in particular, some customers have had products in use over a very long time. These are no longer to be actively sold or marketed, therefore they no longer appear in official price lists or product overviews. Companies will generally tend to plan for declining volumes for such products; however, as a rule they will be priced up at a higher-than-average rate. In our experience, some customers are unwilling to switch to another product even if prices are raised on a regular basis. This would seem to imply either considerable switching costs for the customer or a certain organizational inertia.

8 Pricing for Limited Editions

Limited editions are not typical in all industries. We find them in the automotive, luxury watches and handbag sectors, but also for consumer goods such as vodka, cookies or chocolate.

The intention behind limited editions is not always to enforce higher prices; sometimes the overriding goal is to generate public awareness. It makes sense to consider these products in a separate category so as to assess their respective contribution to revenue and earnings.

9 Pricing for Final Editions

Some products no longer correspond to the state of the art. This may be because their product characteristics render them uncompetitive, or because they are based on obsolete technology. A company may therefore choose to phase them out over a certain period and have to decide whether a lower price tag could help boost sales and clear remaining stock.

In our experience, price reductions do not tend to be reflected in higher quantities sold. Consumers who are seriously interested in final editions are less likely to be price sensitive. Porsche, among others, has some interesting examples for final editions.

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10 Pricing for SMUs (Special Make Ups)

Where (brand) products are offered offline as well as online, retailers can be expected to market them online at aggressively calculated prices, especially in the case of bestsellers. By keeping handling processes very lean and cost calculations tight, some retailers see an opportunity here to rank in the first places in price search engines with these products, thus creating the impression that no one buys at the "normal price" anymore, but only the online version at 30% below the RRP. Some manufacturers even very successfully attempt to create an artificial product differentiation by producing so-called SMUs (special make ups) for leading retailers. This involves making only minimal changes to the products, possibly altering the packaging, but above all selling them under a different product number, making comparability and product searches in online price comparison portals more difficult.

11 Pricing for Long Tail Products

Our empirical studies have shown that slow-moving long tail products are often offered using the same pricing strategy. In our experience, this makes little sense: If you have found a niche product, you will generally have a strong interest in purchasing that product, even if it is priced much higher than similar products.

In other words: The **long tail products** category lends itself to a distinctly high pricing strategy. In many of our pricing projects, companies have realized price increases of up to 30% in this category without any decline in volume.

12 Pricing for Customized Products

In some industries, it is technically possible and also common practice to customize product offerings to take account of individual customer requirements. Automakers such as Bentley or Porsche have established bespoke divisions specializing in these processes. It goes without saying that a high pricing strategy is the obvious choice here for such special customer requests. Bentley, for instance, offers special paint finishes that are listed as an optional extra with € 26,000.

On the other hand, some customers insist that (especially technical) products be tailored to their specific requirements. With one commercial vehicle manufacturer, we observed during our projects that a very high ratio of customized solutions led to a high level of complexity and a great number of variants. This may well be desirable. However, if these special requests result in below-average contribution margins or even lead to negative earnings, then the pricing model needs to be reviewed.

13 Pricing for Validated Products

In the field of chemical and pharmaceutical products in particular, it is not unusual for products from a supplier to be used in production processes that have been validated within the scope of quality management. Substituting these products is only possible with considerable cost and effort, creating a dependency that constitutes a near-monopoly or possibly duopoly if two suppliers share the volumes.

It may be tempting to exploit this monopoly with a high pricing strategy. Something that may well prove successful if the strategy is deployed modestly. However, it also harbors the risk of driving annoyed customers to seek alternative sources of supply. Ultimately, any profits earned here are at the expense of the long-term customer relationship – in such cases we speak of **"bad profits"**.

An Initial Conclusion: What are the Benefits of Category Models in Pricing?

In our estimation, such pricing categorizations are still relatively rare in practice. This approach has been introduced in a DIY store group and a biotech company, with each individual product being assigned to a unique category in the product master data. This makes it possible to

- take these categories into account in planning for all strategic business segments
- define differentiated volume and profit targets for these categories
- utilize these categories for business management
- conduct corresponding profit analyses.

Consistent strategic pricing relies on such category-related differentiation, at least where the product range is characterized by a certain complexity

> "Many managers are not aware that a pricing architecture and pricing roles for their product portfolio reduce complexity and facilitate the execution of pricing strategies."

Prof. Dr. Hans-Christian Riekhof

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