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Pricing is not only about price

How retailers can improve their price image

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Executive summary

Consumer shopping behavior has become increasingly polarized. Consumers will hunt assiduously for bargains on everyday items, but they're willing to splurge on a few luxury items. This trend is squeezing mid-tier retailers, which need to adapt their pricing strategies to survive competitive encroachment from above and below. But here's the catch: Pricing is not just about pricing. Customers don't evaluate pricing in isolation; factors such as promotions, assortment, services, and store environment strongly influence pricing perceptions.

Unfortunately, most companies are not good at tracking customer perceptions, and don't have an effective strategy to influence them. They manage their actual prices without adequately factoring in nonmonetary costs and other elements of value that customers are consciously and subconsciously considering all the time.

This approach is no longer adequate. Companies need a new strategic model, one that expands the pricing strategy beyond the traditional pricing function to include several other partners within the enterprise. Based on our experiences with clients, a retailer that adopts a cross-functional and actionable "price+value" strategy can improve near-term earnings by as much as 4 percent and put the company on a much firmer competitive footing.

The polarization of purchasing

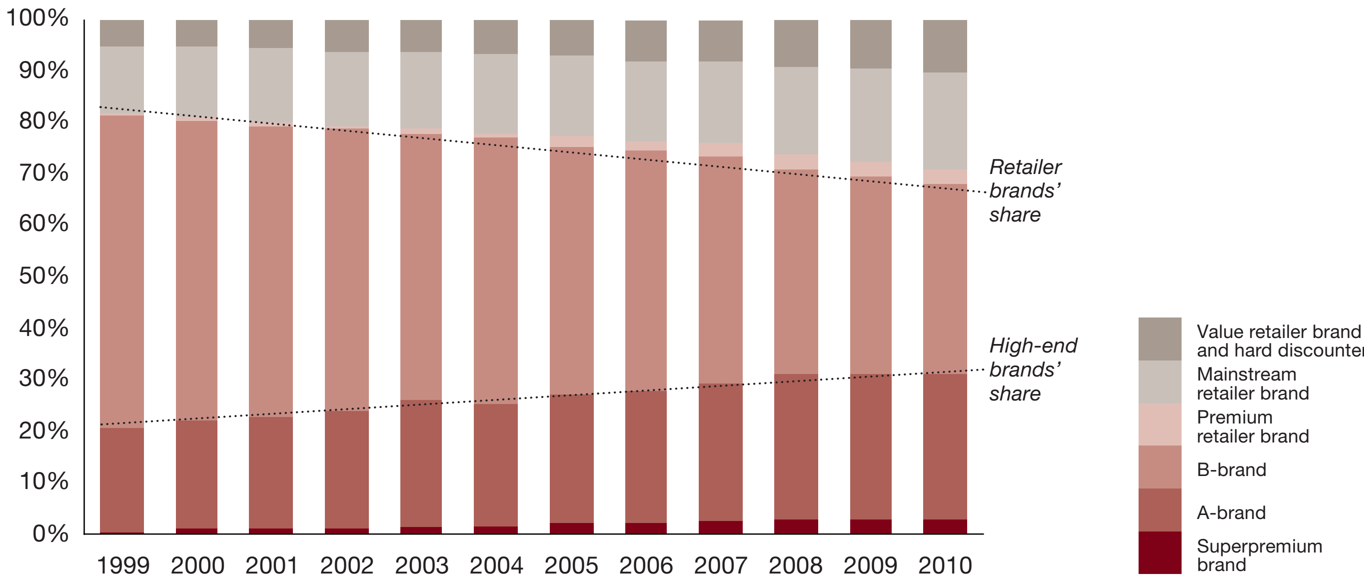
Talk to retail executives anywhere and they are likely to tell you that consumers are more price conscious than ever. This shouldn't be surprising. Many European countries are perched precariously at the edge of recession. And although the U.S. economy is seeing respectable growth — while certainly modest — retail customers are sticking to the shopping behaviors they adopted during the Great Recession.

One notable aspect of this retail environment is how polarized consumer behavior has become. Many low-end retailers with everyday low prices (EDLP) continue to see decent business. Especially for basic goods, consumers are motivated to pay as little as possible. But they will still occasionally turn to high-end retailers to treat themselves to a few luxury items. In this dynamic the middle market is getting squeezed (*see Exhibit 1, next page*).

Many retailers are responding by increasing promotions and lowering prices. But this can do more harm than good. Often, competitors simply follow suit in an attempt to maintain market share, and customers start to cherry-pick deals. The result is that market share numbers fluctuate week by week but don't change much over time. This kind of stalemate reduces retailers' margins and damages their bottom lines. For example, Kmart adopted EDLP to woo price-sensitive customers away from competitors, but ended up reducing its margins, alienating its existing clientele, and hastening its bankruptcy a year later, in 2002.

Kmart failed, in part, because management assumed that by changing the company's pricing and promotion policies it could immediately change customers' perception of the store. In other words, management failed to realize that pricing is not all about pricing. Whether a retailer is trying to cater to price-conscious consumers or repair a broken price image, we don't believe its goal can be accomplished through a series of pricing campaigns; instead, it requires a specific retail capability that we call "price+value" management. This approach is an enterprise-wide effort that involves many functions (not just the pricing team) in coordinating pricing actions and messaging. In our experience, retailers that develop a price+value management capability can increase near-term earnings by as much as 4 percent and put the company on a much firmer competitive footing.

Exhibit 1
Market shares of brands/retailer brands in global food retail sales, 1999–2010



Source: Euromonitor; PLMA; Rabobank, 2010

A framework for "price+value" management

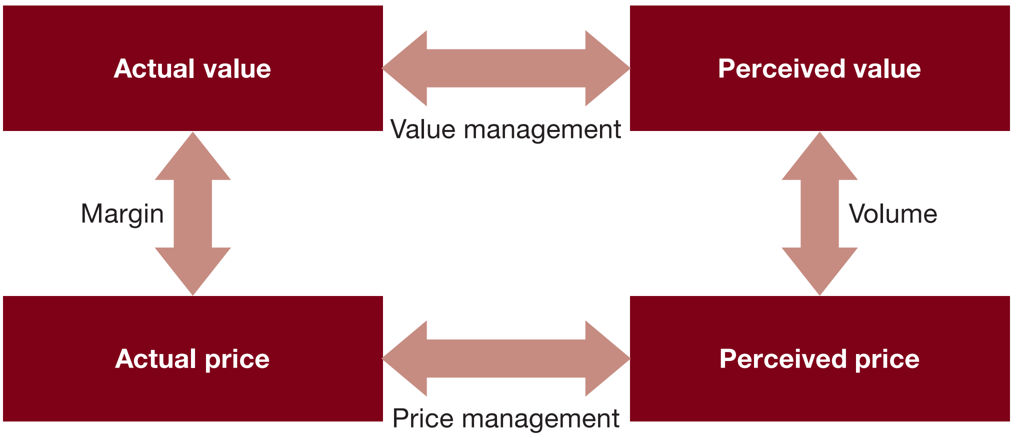
Because customers don't evaluate prices in isolation, good pricing is not all about the actual price. Retailers need to identify and analyze the many factors that affect customer perceptions of both price and value, and use this deeper understanding to manage the two simultaneously and create a better price image (*see Exhibit 2, next page*).

Consumers are driven by perceptions more than reality. In fact, consumers' conscious and subconscious perceptions about price can drive purchasing behavior that doesn't always seem to make sense. For example, a study found that a US$10 discount on a $500 camera would fail to persuade many camera shoppers to visit a store across town. Shoppers would, however, cross town for a $10 discount on a $20 DVD. In both cases, the savings was $10, but consumers felt they were a getting a better value on the DVD, so they were more motivated to make the purchase at the store with the lower price.

Context also matters. For example, when consumers in another study were given a choice to purchase a Bestron vacuum cleaner for €58 or an AEG vacuum cleaner for €188, they judged the AEG machine to be too expensive. But when they were also given the choice of a Miele vacuum cleaner for €349, the AEG product's price suddenly seemed reasonable. This is a simplistic example, of course. In the real world, understanding consumers' points of reference and context for their decisions is more difficult. But the fact is that companies can price their items "correctly" compared to competitors and still suffer a worse price image among consumers depending on the context.

To a consumer, price includes the actual price of the product as well as various nonmonetary "costs," such as the risk that the product will be out of stock when the customer gets to the store, the time it takes to get in and out of the store, the uncertainty about new brands and products, the possibility that the store will be closed or the parking lot full, and the effort to learn about or understand products. These nonmonetary costs are why, for instance, most people buy the same grocery store brands over and over. By buying the same brand, the consumer avoids all the cognitive processing involved in evaluating other choices. Even

Exhibit 2
Price+value management framework



Source: Strategy&

if the current brand is more expensive, the equation is simple: The current price wins over the cheaper price plus the hassle.

Value, meanwhile, encapsulates all the benefits customers gain when shopping in a certain store. These benefits might include superior product quality, a pleasant store environment, excellent customer service, a wide range of choices, brand exclusivity, and the satisfaction of bargain hunting. All of these can and should be managed by retailers. For instance, about 20 percent of Costco's stock is limited-quantity items kept in stores for as little as a week. This strategy attaches a scarcity value to items that can motivate consumers to make an immediate purchase.

These examples illustrate that reality and perceptions of price and value are intertwined, yet few retailers are good at managing perceptions. Even if they track their price image, companies rarely have a solid framework to manage the differences between actual price and value and perceived price and value.

Influencing customer perceptions

If consumers don’t evaluate prices in isolation, neither should retailers. Astute price+value management includes all elements of the retail value proposition when making pricing decisions: pricing, promotions, assortment, services, store environment, and brand communications.

Pricing: This includes price levels, price points, and price cues. It turns out that consumers actually have a poor knowledge of individual product prices (40 percent of the time they’re off by more than 20 percent on individual items). Retailers need to identify the items whose price is most visible and important to customers, and the ones whose price elasticity is highest. They also need to understand which points of reference customers are using to judge prices: A competitor’s comparable product? Other products on the store’s shelves? The price they paid last time?

Promotions: This includes both frequency and type of promotions, as well as the depth of discounting. One might assume that frequent promotions and discounting always lead to higher sales and a better pricing image. But this is not so. People might not remember exact prices, but they often remember that an item was marked down 50 percent the last time they purchased it. If today’s markdown is 25 percent, the deal is perceived as less good, and price perception falls. A more scientific approach to promotion analysis can provide insights into the true net effect of promotions. In our experience, after quantifying effects such as pantry loading and product cannibalization, only about half of promotions have a positive result.

Assortment: This is the breadth of choices at various price points. Interestingly, consumers’ price perceptions of various retailers are often driven more by differences in the retailers’ assortments than by differences in like-for-like pricing and promotions. So even if a company’s prices are identical to those of a competitor, that competitor will enjoy a much better price perception if it has a wider assortment of products at the low end. Customers have a sense they’re “getting a lot for little money.” This effect is biggest in more frequently shopped categories such as groceries and health and beauty.

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Services: This includes information and interactions between employees and customers. Service levels can improve price perception by reducing "costs" related to time in the store, and the risk of disappointment. For instance, salespeople at Coach and Brighton focus on the immediate after-sales moment when customers might feel doubt about their purchase by saying, "That really looks good on you." Price-matching guarantees are another great example of how services can influence price perception. Customers are less likely to engage in comparative shopping when a retailer promises to match any competitor's price on the same item, boosting the retailer's price image.

Store environment: This includes social factors such as crowding and staffing levels; design factors such as aisle width, cleanliness, and efficient layout to get in and out of the store quickly; and ambient factors such as music, lighting, colors, and signs. For instance, Trader Joe's has handwritten product information on shelving for a personal touch that conveys a familiar, "mom and pop" authenticity. Walgreens widened its aisles and lowered its shelves — effectively reducing the assortment in its stores — in order to improve the store environment.

Brand communications: This includes brand advertising, online presence, public relations, and mass communications. For instance, consumers in the U.K. perceived incorrectly that Waitrose, an upscale U.K.-based grocery chain, was more expensive than competitors. In response, the company launched a campaign — "1000s of ways to great value" — that catapulted Waitrose to the top of supermarket satisfaction surveys.

Common pitfalls

Instead of managing all elements of the retail value proposition, companies often focus on price, and so they naturally assign the task of price+value management to the head of the pricing group. This often leads to disappointing results. For instance, we recently worked with a retailer that put pricing rules at the heart of its pricing strategy. It matched and sometimes beat the prices of its main competitor, a low-priced player with an excellent price image. And it even backed up this pricing strategy with an intense promotional campaign.

All the conditions to improve pricing image seemed to be in place, and yet the effort failed. Why? It turned out that the retailer's assortment and price ladder, not the individual product prices or promotions, was the critical issue. Its chief competitor offered a much wider range of choices at lower price points, resulting in an average ticket size that was 20 percent lower. By adding items at lower price points, our client quickly improved its price image and attracted a new group of price-sensitive customers.

This tendency to try to manage price and value perceptions solely within the pricing function is not the only pitfall for retailers. Sometimes the scope of the price+value initiative is too narrowly defined. It's not uncommon for a retailer to focus on creating and sustaining a price differential with a particular rival on a particular product but ignore the rest of the competitive playing field.

In some cases, a retailer simply has its facts wrong, mistakenly believing that a competitor will or won't tolerate being undercut on pricing, or that a steeper discount will improve its pricing image. Retailers are also plagued by misconceptions about what consumers know (or don't know) about prices. Separating facts from feelings is a key requirement for successful price+value management.

Building an effective organizational capability

To avoid pricing pitfalls, organizations need a comprehensive framework to manage price and value perceptions across functions and subfunctions (*see Exhibit 3, next page*). Not only does a cohesive approach align the organization around an overarching price+value strategy, but it also allows the retailer to coordinate cross-functional efforts to support individual price+value initiatives.

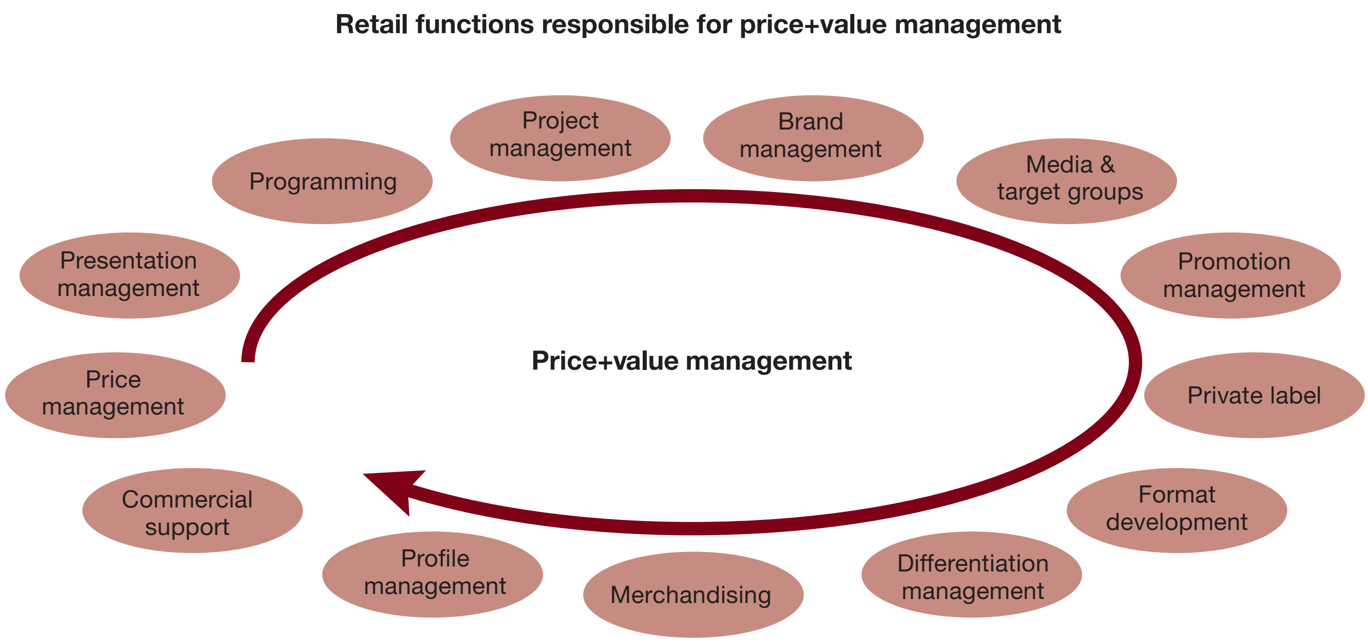
To this end, Strategy& has developed a proven model for managing price and value perceptions. The fundamental feature of this model is that it's cross-functional and actionable. All functions within the organization must align on each price+value claim, take specific coordinated actions, and support the overall price+value strategy (*see Exhibit 4, page 14*). For example, if the price+value claim is "our prices are surprisingly low," then all functions — pricing, promotions, assortment, services, store environment, and brand communications — need to buttress this claim in a coordinated way. In this example, the pricing function should institute EDLP on selected items, the assortment function must ensure that enough lower-priced items are on the shelves, the services function could offer a price guarantee, and the store environment might highlight EDLP items with shelf signs.

To enable this model, a company must put certain capabilities in place. It must define people's roles and responsibilities, make decision support tools available, and implement necessary processes. For example, the approach must be fact-based. Powerful analytical tools and econometrics make category dynamics and consumer behavior more transparent. The company also needs to understand elasticity of demand and have the processes in place to gather factual insights into competitors' responses to pricing actions. Some retailers say IT challenges prevent them from taking this more fact-based approach. But they need not wait for a new technology to gather more data and solve all their IT problems. Advanced analytics applied to current data can yield actionable insights.

In our experience, new price+value management initiatives can easily be self-funding in less than a year. By enhancing the effectiveness of promotions, a retailer can improve cash margins on promotions by 3 to 5 percent; by improving the timing of markdowns, it can increase cash margins on markdowns by 5 to 15 percent; and by optimizing regular prices to improve profit margins and influence consumer decision making, it can grow cash margins on regular sales by 2 to 4 percent.

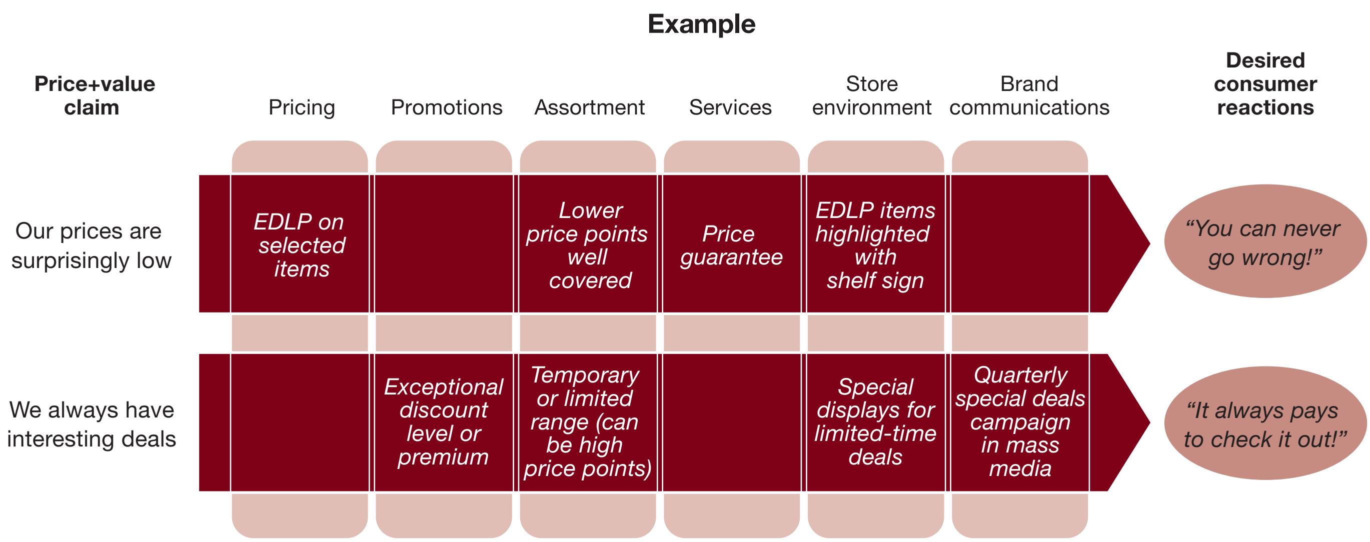
Exhibit 3

"Price+value" management cuts across all retail functions



Source: Strategy&

Exhibit 4
All retail functions have to contribute to a common price+value claim



Source: Strategy&

A path forward

Understanding the complex calculus behind a consumer's decision to purchase an item has never been easy. But getting a handle on what motivates that customer's decision making is more important than ever. Economies are shaky, competition is intense, and consumers are playing the field more than they used to. Retailers in the midrange are, in particular, getting squeezed by the trend among consumers to hunt for bargains on the basics and then splurge on a few luxury items.

The old approach to pricing is no longer adequate to create an attractive price image. Retailers need a pricing strategy that manages price+value perceptions on a constant basis and does so across functions so that every part of the organization actively supports price+value initiatives. Retailers are bound to find these organizational changes a challenge, but the rewards will be significant in terms of customer loyalty and profit margins.

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