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Value-Based Pricing – A Success Factor in the Competitive Struggle

Tatyana Netseva-Porcheva

Abstract: Over the past decade, the view that the main purpose of market-oriented organizations is not to satisfy the consumer, but to create values has dominated. Exactly the values, their creation, retention and increase, are the main sources of competitive advantage of the company. The purpose of the present report is to present the price formation, based on product value, as a source of competitive advantage. In connection with the so-defined objective, the value and the product price for the customer are derived as key factors for success of the company in the competitive struggle; the role of the value of the product in the marketing and pricing is revealed; and theory clarifies the two basic approaches for determining the price of the product on the basis of value - customer value modeling (CVM) and economic value modeling (EVM), their nature, scope of application, advantages and disadvantages.

Keywords: value to customer, value-based pricing, customer value modeling, economic value modeling, competitiveness.

1. INTRODUCTION

Over the past decade the view that the main purpose of market-oriented organizations is not to satisfy the consumer, but to create values has dominated. Exactly the values, their creation, retention and increase, are the main sources of competitive advantage of the company.

Today, marketing is considered as a process by which companies create value for their clients and form stable relationships with them in order to obtain final value for customers (Kotler & Armstrong 2008).

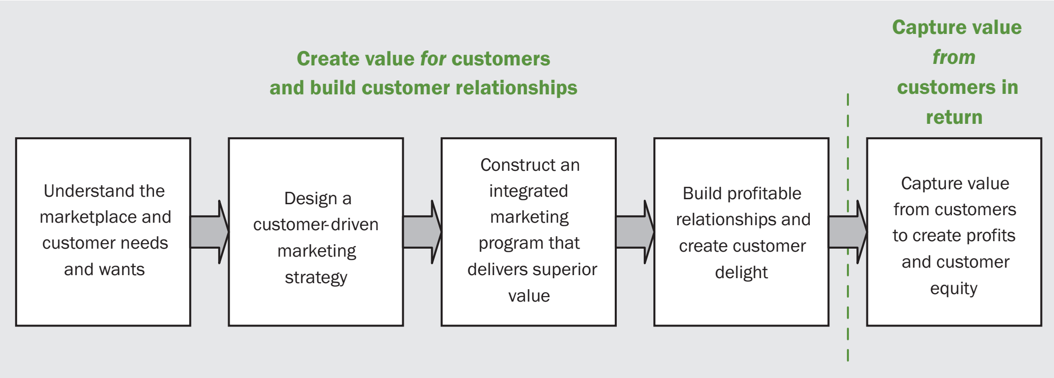
Figure 1 shows a simplified model of the marketing process.

As it is seen from the model, during the first four stages of the marketing process, the company aims to create value of the customers. During the fifth stage, the company receives value from its customers in the form of current and future sales, profits and gained customer capital. The creation of exclusive custom values, increases competitiveness of the company product, as it creates a high degree of satisfaction among customers and motivates them to make regular purchases and buy in larger quantities from the company's product. This enables the company not only to ensure the customer lifetime value, but ensures as well bigger share for their products and services in the client's portfolio of purchases. In combination, this leads to a growth of the company's profits in the long term and increase of its market value.

Creating value for the customer is achieved by: development of product that meets the desires and needs of customers, development of a communications program that transfers the value of this product to the customers, choice of a program for distribution, with which the product is made available to the customers and development of a pricing program that on the one side, creates an incentive for customers to buy the product, on the other side - is an incentive for the company to sell this product (Figure 2).

With creating value for its clients through the first three elements of the marketing mix, the company incurs expenditures. The price is the only element of the marketing mix, through which the company earns revenue and thus retains some of created values to finance its efforts on creating future values. Every mistake in the management of the prices and their determination directly affects the competitiveness of the product and the financial performance of the company (Figure 3).

FIGURE 1
A simple model of the marketing process



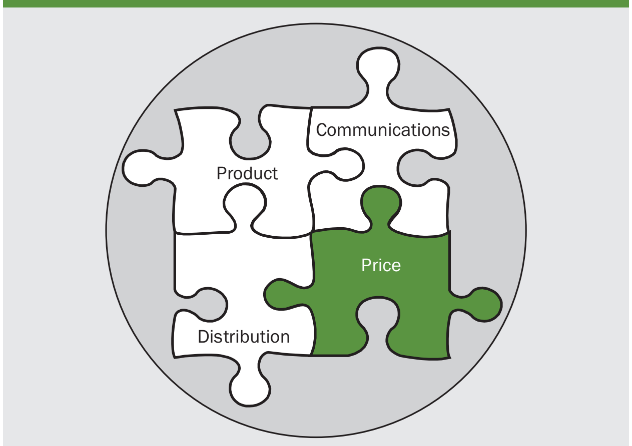
SOURCE: Kotler P., Armstrong G., Principles of Marketing, 12e, Pearson, 2008, p. 5.

Although most of contemporary authors do acknowledge the necessity of reporting the value of the product in the price formation, there is still a deficit in complex theoretical and practical works in the field of researching the value of the product in the pricing, marketing and its competitiveness.

Study of Monitor Group in 2008 (ValueScan Survey, Monitor Group, Cambridge, MA, 2008), involving more than 200 companies from the consumers and the business markets, has found that the companies that develop and use effective price strategies, based on the value, achieve 31% higher operating profit than the companies that use the price to capture greater market share or their target profit.

Examination of the value and the product price, as a source of competitive advantage, the deficit of complex scientific researches for the role of the value in the price formation and in the marketing, as well as the results of the above mentioned study made by Monitor Group in 2008, requires clarification of the theory and methodology of the pricing based on value, attempted to be made in this report.

FIGURE 2 The four policies of the marketing mix



2. ROLE OF THE VALUE IN THE PRICE FORMATION

In order to be competitive in the market, the pricing strategy of the company should be the following:

- *Value-oriented* - the company should define customer-differentiated prices. The company should reflect the price changes during the time and the differences or changes in the value of the product.
- *Proactive* - the company should anticipate destructive events, such as customer bargaining, competitive threats, technology changes and etc., trough development in advance of strategies, with which to neutralize these destructive events.
- *Source of the profit* - the company should evaluate its success in the price management, by comparing the profit of the investments what were done, not by comparing its revenues with those generated by its competitors.

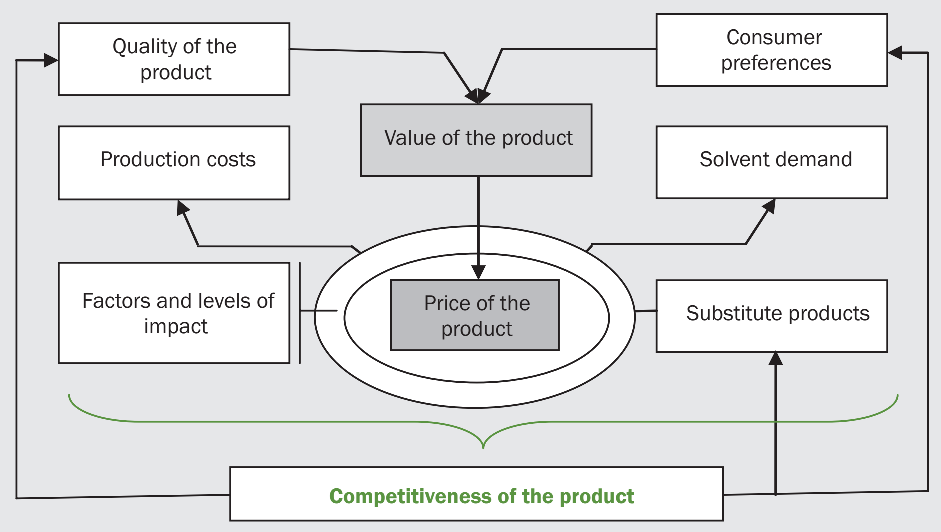
These three principles are leading in making decisions at various levels of the so-called strategic price pyramid (Figure 4). Each prior level of the pyramid serves as a basis and a prerequisite for upgrading.

The basis of the strategic price pyramid is to create value.

The term value is one of the most used in business circles and the academic publications. However, most of the definitions of value are incorrect (not displayed on the background of a specific marketing task) and uncertain (mean different things in different contexts). This makes difficulties in the measuring, analyzing and finding ways to create additional value.

Figure 1 shows that the value is the ”input” and the ”output” of the marketing process. As mentioned above, during the first stages of the marketing process, the company aims to create value for customers; at the final stage the company receives value from its

FIGURE 3 Factors for competitiveness of the product



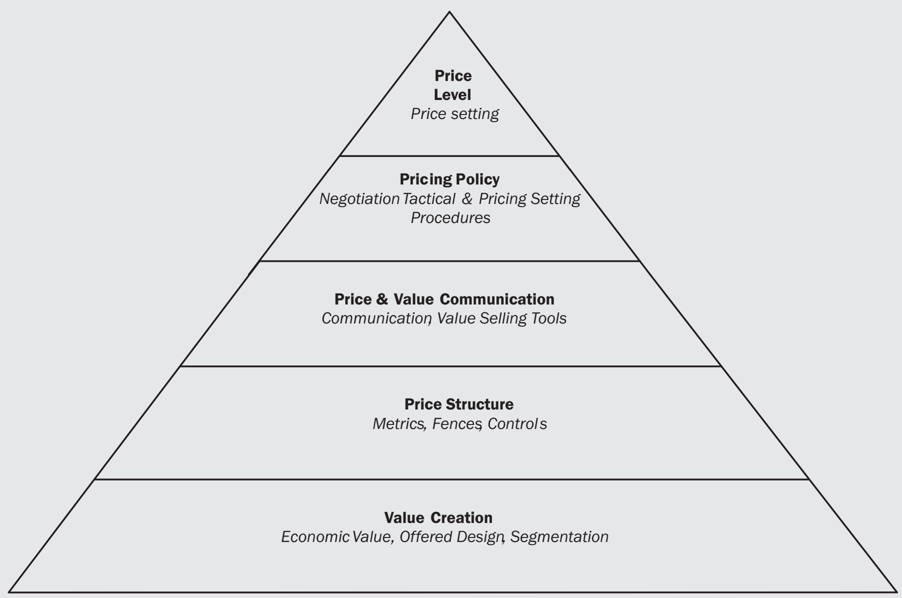
SOURCE: Чурсин А.А., Иванов А.С., Эффективная ценовая политика как фактор успеха в конкурентной борьбе, Евразийский международный научно-аналитический журнал, Проблемы современной экономики, N 1(29)

customers. In connection with this an important moment in defining the value is to specify the object of value: the client or the company. Definitions which do not specify the object of consideration of the value, have no practical implementation, and even confuse the managers.

Value to customer most common is the overall satisfaction that the client gets from the acquisition and the usage of the company product. The customer value is this what many authors (Lipsits 2005, Nagle, Hogan and Zale 2011 and others) mean when they are using the term "value of the product." Further in this statement we will understand the product value as the value of the product for the customer and the two concepts will be used as synonyms.

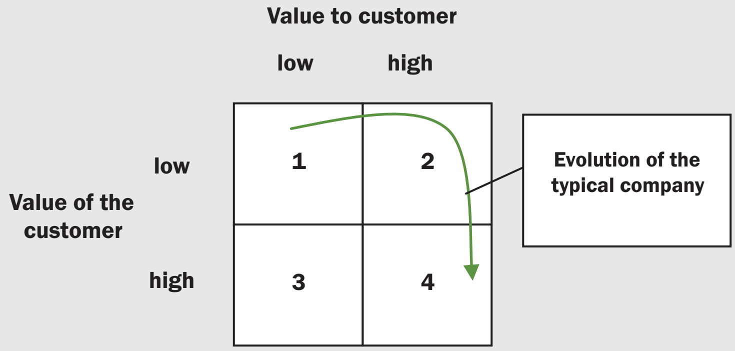
Value of the customer is the one that the company derives over the time from its clients. Source of value for the company are its customers - those who are already customers and those who will be customers in the future. The company aims not so much to earn profit from selling products to the customers. The aim is to accumulate customer capital, to "possess" for the

FIGURE 4
Strategic price pyramid



SOURCE: Hogan, J. & Nagle, T., What is Strategic Pricing? Monitor Group, SPG Insights, summer 2005, p. 2

FIGURE 5: Grid of the value



SOURCE: Soman D., N-Marandi S., Managing Customer Value – One Stage at a Time, Part 2 Value, p. 34

lifetime its customers, to receive their lifetime customer value, and to occupy a large share in their total purchases.

The grid presents the possible combinations between value to customer and value of the customer (Figure 5). The four quadrants of the grid represent the four stages of evolution of the company. If the company chooses the right model for price formation, it will reach the point of complete "happiness" (fourth quadrant), which creates high value to the customers, derives maximum value from them and it is most competitive.

The marketing managers are facing an interesting challenge when it comes to price formation. They are expected to determine a price that corresponds to the value of the product for the customer, but also to maximize the profit of the company. The profound understanding of this how to create a value and what the value of the company product is for the consumers, is the key that unlocks the possibility for the managers to use the pricing as a competitive tool for taking profitable business decisions.

3. APPROACHES FOR DETERMINING THE PRICE ON THE BASIS OF "VALUE TO CUSTOMER"

There are two alternative, fundamentally different approaches to using "value to customer" in determining the price, which leads to various pricing decisions:

- Customer value modeling (CVM approach) - the value is considered as accepted by the consumer benefits that he/she receives for a price. In this case the "cost-benefit" is determining for the competitiveness of the product.
- Economic value modeling (EVM approach) - the value is considered as the global economy (economic savings or profits) and the satisfaction which the user gets as a result of purchasing and using of the company's product, rather than the best available alternative products. In this case the value of the product is the basis for price formation.

3.1. Customer value modeling

The CVM approach is based on the subjective assessments of the consumers for the characteristics and

FIGURE 6 Procedure for modeling of the value of the product

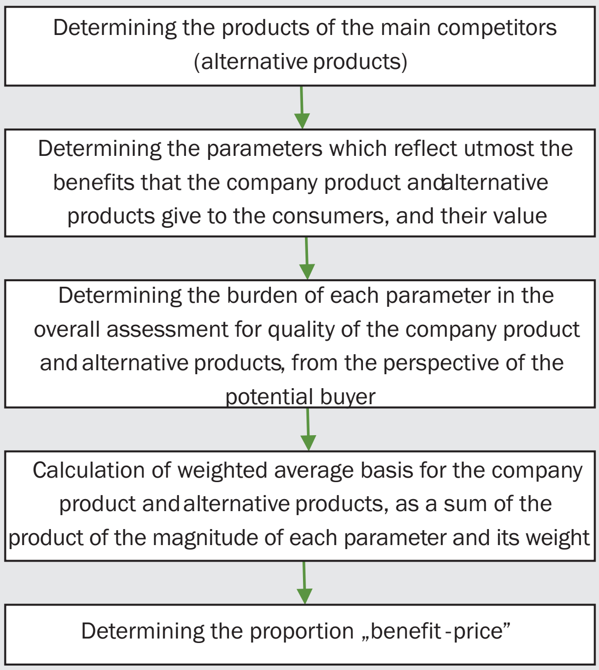
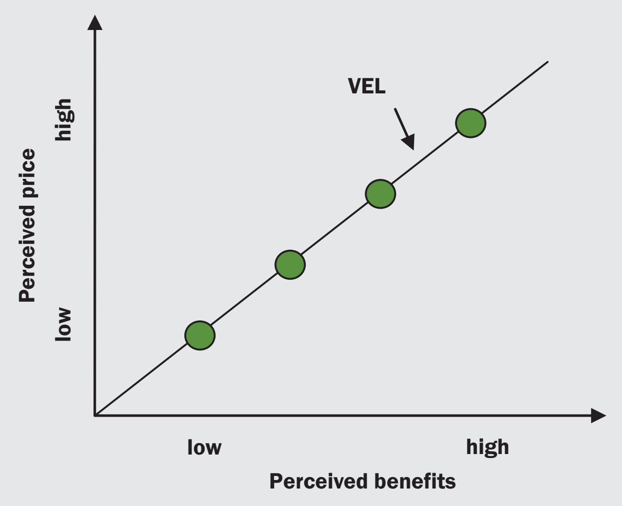


FIGURE 7 Value map: stable market shares



SOURCE: Adapted on Marn, M., E. Roegner, Zawada, C. The Price Advantage, John Wiley & Sons, Inc., 2004, p. 45

the price of the product. The basis of this approach is the understanding that the consumers buy products that have higher benefit at reasonable prices, that the majority of product characteristics have no quantitative character what is difficult to be expressed in money, and consequently per unit price. This avoiding of turning the characteristics of the assessments into cash value, makes the CVM approach suitable mainly for products with high psychological value for the end users.

The implementation of CVM approach consists of five stages presented in Figure 6.

The data obtained as a result of the application the described in Fig. 6. Procedure for average dependence ”benefit-price” of the company and similar products are put on the so called map of the value of consumer (customer value mapping).

The map of the value is the basic tool that companies use, in order to position themselves in competitive markets. Horizontally is applied the amount of the weighted average earnings, and on the ordinate - the price of the company's and the similar products. Once the data for the company and its competitors are inflicted on the map, it is displayed in a different way called *line of equivalent value (value equivalence line) (VEL), a line of fair value (fair-value line) or line of indifference (indifference line).*

The points on the VEL show fair balance between the benefits and the cost of the product (Figure 7).

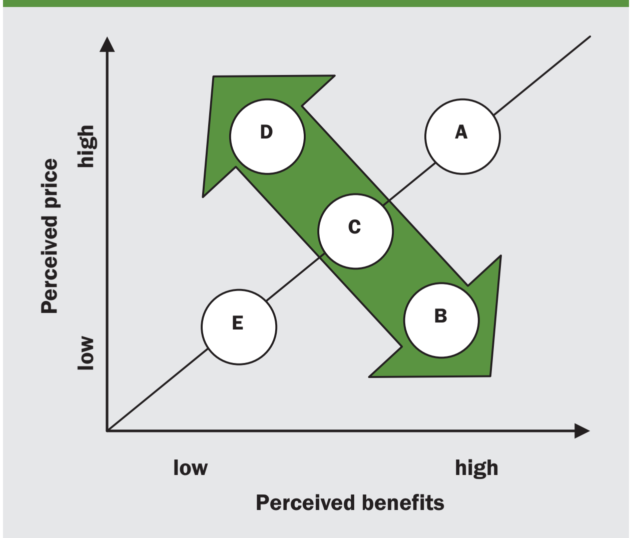
The following main options are available to map the points of the value on the map of the value.

If the market is stable (the market share of competitors does not change) and the perceived costs and benefits are measured accurately, then all products of competing companies are located along the diagonal – the VEL. For any desired level of the price or advantage, exists a logically correct choice of the product. In such markets, the consumers receive exactly the product, for what they pay. If buyers want to obtain products with higher value, they will have to pay more, if they want lower prices, they must be willing to divest themselves of certain benefits.

If the VEL is the place where the perceived benefits and the price are equivalent, the space above it is ”low-value area” where the perceived value exceeds the consumer perception of product quality, and the space below the VEL, suggests higher value of the product rather than price.

If market shares shall be redistributed among the competitors, then the correctly done map of the value will look like that of Figure 8, where some firms are located outside the line VEL.

FIGURE 8 Value map: companies off the VEL – changing market shares



SOURCE: Marn, M., E. Roegner, Zawada, C. The Price Advantage, John Wiley & Sons, Inc., 2004, p. 46

The company B is located below the VEL at advantage in terms of the value of the product and price situation, making it the most competitive in the market. Consumers wishing to buy a cheaper product will choose between products of the company C and E. Since the company B offers a product with better quality characteristics for the same price, its products will be preferred. Users who need a product that provides more benefits, will choose between the products of companies A and B. The product of the company B will be preferred by the buyers, because the perceived benefits are similar, and its price is lower.

The company D is located above the VEL and it is at disadvantaged situation, compared to the other firms. The company E is offering a product with the same benefits as D, but at a much lower price, but company A – offers more benefits for the same price. If this card of the value is accurate, it is logical that company D will start to lose its market share.

With regard to the market shares of companies A and E - they would rather remain stable.

The main advantage of the CVM approach is that it is easier to understand and use this approach, because in it the characteristics of the product are not converted in monetary valuation.

The CVM approach has the following disadvantages:

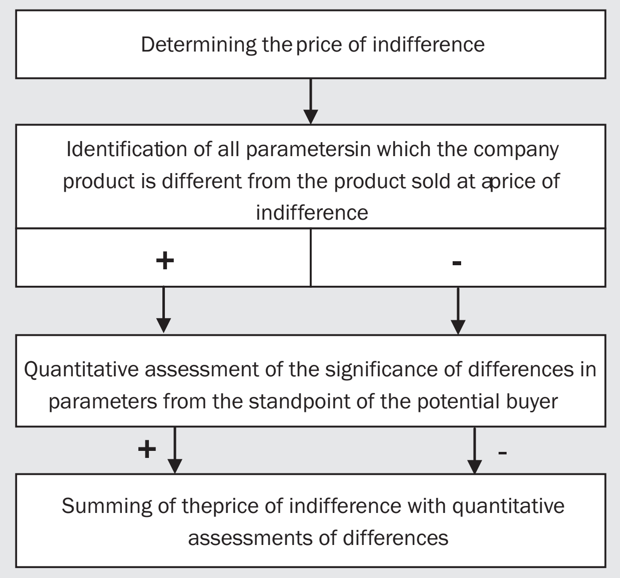
1. Consumers do not pay for the average score of the various benefits and the *value* they receive from them. This is because the users are transferring in their thoughts into monetized benefit and in this way they decide how much higher price to pay for the extra value they receive from more expensive products. If the value of the product is higher than the fixed price, they buy it.
2. The CVM approach does not distinguish between the total value, associated with the characteristics of the company's product, similar to those of major competitors, and the differentiated value, related to the characteristics of the company product, in which it differs from the product of the competition.
3. The CVM approach ignores the difference between objective and perceived value of the product. The consequences of this omission of the pricing and marketing are significant because consumers are willing to pay for perceived value of their product, not economic. Therefore, using marketing communications, marketers should strive to come closer to perceived objective value of the product by customers.

The disadvantages of the CVM approach are avoided in EVM approach.

3.2. Modeling of the economic value

The EVM approach considers as important not the value of the product to the customer at all, but the so-

FIGURE 9 Procedure for determination of the economic value of the product



SOURCE: Липсиц, И.В., Ценообразование – управление ценообразованием в организации: Учебник, Издательство Экономистъ, Москва, 2005, p. 204

called *exchange value, or economic value of the product for the customer (economic value)*. The economic value of the product is determined by the alternatives that the user has to satisfy the same need.

The determination of the total economic value of the product includes a four stage process presented in Figure 9.

The total economic value of the product is calculated as the sum of the price of the best available alternative for the consumer product (*reference value*) and the value that the consumer gets from the differences (positive and negative effects) between the company and the best alternative product (*differentiation value*).

$$\text{Total Economic Value} = \text{Reference Value} + \text{Positive Differentiation Value} - \text{Negative Differentiation Value} \quad (1)$$

In the economic literature to indicate the price of the best available alternative for the consumer product (price analogue) are used the notions: reference price, indifference and etc.

Although that the determination of the best available for the user, alternative competitive product and collection of accurate data for the reference prices, seems relatively simple, sometimes it hinders the marketing specialists. The most frequent difficulties are limited to: lack of specific competing products that consumers consider as suitable available alternatives and lack of information about the prices of competing products under similar conditions. Information about the prices of competing products is easier to be found in the business-to-consumer (B2C) markets, because the retail prices are available for all users. In the business-to-business (B2B) markets, information about competitors' prices can be obtained very difficult and sometimes it might not be true. The reason for the lack of pricing information may be the usage of discount system which is changing the conditions when the contracts are concluded with specific business customers and they become trade secrets for the seller company.

This part of the economic value, what is associated with the differentiation of the company's product from the best available alternative product is called *differentiation value*. The differentiation value has two forms: monetary and emotional.

The monetary value represents the total amount of saved cost or higher revenues, which the consumer receives as a result of the purchase and use of the company's instead of the best available alternative products. The monetary value is more important in the B2B markets. For example, if a company manufactures machine, during the usage of which the current and the capital expenditures are lower than the best alternative available machine from the competitors' machines, then the industrial buyer is willing to pay a higher price for the company's product, because then he/she can produce an end product with lower costs and he/she will be more competitive in the market of the end customers.

The psychological value expresses the many ways with which the company's product creates positive emotions and satisfaction for the consumer, against the best available alternative products. For example, Rolex watches do not create a tangible monetary benefit for their owners, but they have a high psychological value - perceived as successful people with high living standard and lifestyle.

The different characteristics of the monetary and psychological sources of value require different approaches for quantization.

Due to the fact that the monetary sources of the value are quantitative by nature, the monetary value is determined by using quantitative research techniques. First step for the quantification of the sources of monetary value is to understand how the product categories affect the cost and the revenues of the consumers. On the B2C is relatively easy, since the end users usually have a few monetary sources for a particular product category and for the most sources of monetary value there is ready and available data, which is the case, for example, with the price of the fuel and the maintenance costs of the vehicle. It is difficult to determine in quantity the sources of the monetary value in the B2B markets, due to the complexity of the most business operations and the need of full understanding how the product affects the profits of the business buyer. Because of this complexity, the process should be started with a detailed assessment of the business model of the consumer to understand how company product contributes to the ability of the business buyer to create value for its own customers and reduce its operational costs.

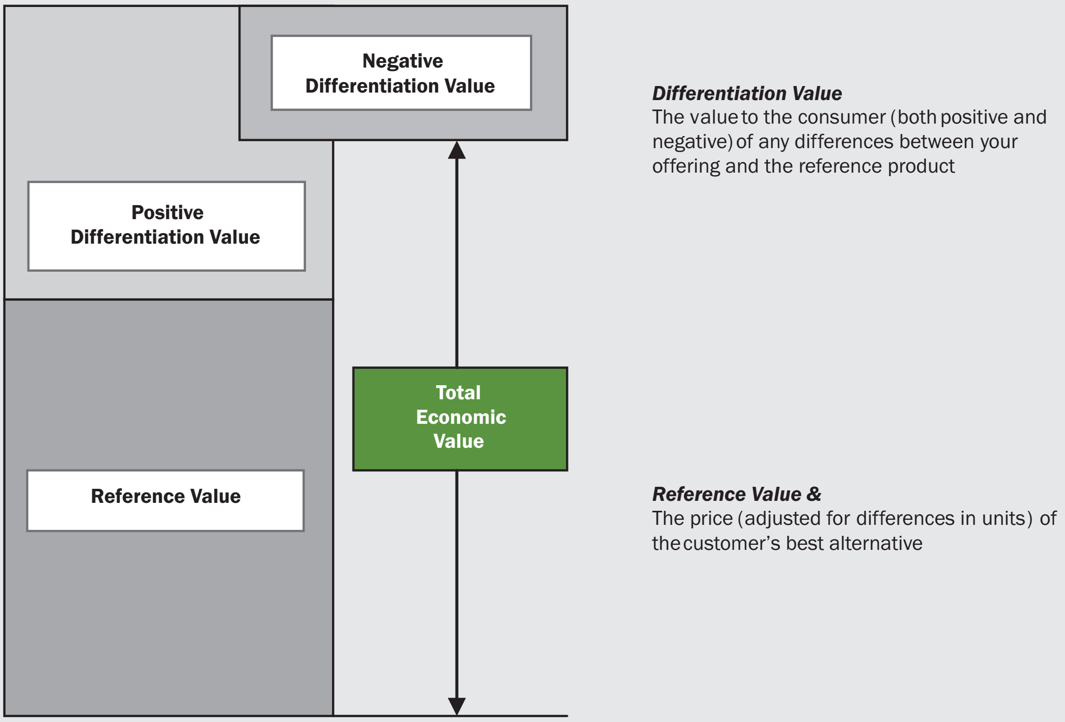
As a difference from the monetary sources of value, the intangible nature of the psychological sources of value, such as satisfaction, safety, security and others, are in its nature not quantifiable. For their determination, is most commonly used a content analysis (conjoint analysis) - a technique that allows to identify the hidden product features, which have value to the consumers. The essence of the conjoint analysis consists of decomposition of the product groups of features and presenting to the consumers a choice between different groups, in order to understand what the most important features are for them.

The differentiated value can have positive and negative elements, as illustrated in Figure 10.

In determining of the economic value of the product for the customer should be followed certain guiding principles that allow avoiding of the possible errors:

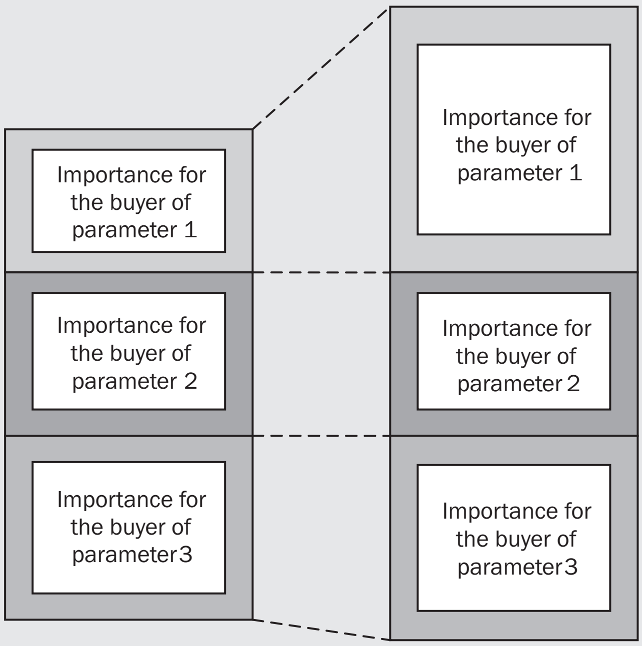
1. To be considered only the value of the *differences* between the company's product and the next best competitive product. The value of all benefits that are common for the company's and alternative product is included in the reference price.
2. The differentiated value to be measured by cost savings *or* as achieved certain level of benefits *or* additional benefits, received for identical costs. Simultaneous recording of one and the other is wrong, as this will lead to double counting and confusion.
3. The scale of the quantitative changes on the level of one or another consumer parameter of the company's product, in comparison with the parameters of the alternative product, is not obligatory to coincide with the scale of the change in the benefits from its usage for a buyer and from then on in the amount of money, which he agrees to pay, to obtain this product (Figure 11).

FIGURE 10 Economic value



SOURCE: Nagle, T., Hogan, J. and Zale, J., The Strategy and Tactics of Pricing of Pricing, A Guide to rowing More Profitable, 5 ed., Person, 2011, p. 20

FIGURE 11 Mismatch of objective scales of change in consumer parameters of the product and their subjective evaluations in comparison with the product analogue



SOURCE: Липсиц, И. В., Ценообразование – управление ценообразованием в организации: Учебник, Издательство Экономистъ, Москва, 2005, p. 206

The total economic value is the maximum price that a "rational buyer", who is fully informed about the market and who is looking for the product with the highest value, would pay. But the consumers are not always rational. It happens often that the buyers, especially the purchasing agents in B2B markets, do not realize the true economic value of the product, what they receive. Therefore, in terms of pricing, it is important to distinguish between objective and perceived value to the customer.

The objective value, or the total economic value is the measure of the benefits that the product provides to the client, regardless of whether the customer recognizes them or not.

The perceived value is the one which the client believes that the product provides to him, those are the so-called perceived benefits. The perceived value is the maximum price that the customer is willing to pay for the product.

The marketing efforts should be directed not only to determine the perceived value, but also to constant search for "roads" for its increasing and its maximum possible approximation to the objective of the perceived value of the product to the customer. For this purpose, it is of great importance for us, the use of marketing communications through which to understand what characteristics are likely important for the consumers, and to focus their attention exactly to them.

Advantages of the EVM approach:

1. The economic value of the product is a logical starting point for determining the price, since this is the monetary value of the benefits that customers will receive in return for the price that they have paid.
2. The economic value of the product is the starting point for development of product pricing strategies, which are value based, not just consistent with this what the customers are willing to pay for the product, or only with the competitors.
3. The economic value of the product is useful in persuading potential customers in the superiority of the company's over competing products and the justification of the price. This is so, because the economic value is calculated based on the actual data for the prices of analogues and compared to the characteristics between the company's and similar products, which seems fair in the eyes of the people.

4. CONCLUSION

In the present report makes an attempt to derive value and price of the product for the customer, as key factors for success of the company in the competitive struggle, to reveal the role of the value of the product pricing and the marketing and to clarify the theoretical aspect of the two main approaches for determining the price of the product based on value - customer value modeling (CVM) and economic value modeling (EVM), their nature, advantages and disadvantages. The future studies in regard to the subject of this report, are generally limited to clarification of the following key questions:

- Value-Based Market Segmentation.
- Price and Value Communication.
- How to approach the perceived value to the objective value of the product for the customer.
- Obtaining value from the customers and creating of customer capital.

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Rezime

Formiranje cena zasnovano na vrednosti - faktor uspeha u konkurentskoj borbi

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Tokom protekle decenije dominantan je bio pogled da glavna svrha tržišno zasnovane organizacije ne predstavlja zadovoljenje kupaca već povećanje vrednosti. Upravo, vrednosti, njihovo stvaranje, zadržavanje i povećanje su glavni izvori konkurentske prednosti kompanije. Svrha ovog rada je da prezentuje formiranje cena zasnovano na vrednosti proizvoda kao izvora konkurentske prednosti. U vezi sa tako određenim ciljevima vrednost i cena proizvoda za kupca proizilazi iz ključnih faktora uspeha kompanije u konkurentskoj borbi; uloga vrednosti proizvoda u marketingu i formiranju cena je prikazana. I teorija objašnjava dva osnovna pristupa za određivanje cene proizvoda po osnovu vrednosti:modeliranje vrednosti za kupca (CVP) i modeliranje ekonomske vrednosti (EVM), objašnjava njihovu prirodu, domet primene, prednosti i mane.

Ključne reči: vrednost za kupca, formiranje cena zasnovano na vrednosti, modeliranje vrednosti za kupca, modeliranje ekonomske vrednosti, konkurentnost

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