

Value-based Pricing in Austrian Medium-sized Companies

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Abstract

This article deals with the topic of value-based pricing and its role in medium-sized Austrian companies. The topic is interesting, as pricing is known to be the variable with the most influence on financial success or failure in this highly competitive business environment. The effects of choosing an adequate pricing strategy can, or most certainly will have a distinct impact on competitiveness and contribute to a company's long - term success.

In recent years, growing importance has been placed on term value as the fundamental determination affecting customer satisfaction and has been increasingly considered in the discipline of pricing. Customer value pricing does not rely heavily on costs incurred, competitors' prices or the product's historical price. It rather reveals the fact, that each customer evaluates products or services differently and attaches either more or less importance or value to them, which results in different degrees of willingness to pay. But still this method is a prerequisite for the other methods (cost and competitive focus) as well and therefore it can be seen as the only integrated pricing approach.

In order to learn the details of the Austrian pricing situation in medium – sized B2B companies a quantitative study with 180 respondents was compiled. The study's aim was to find out how firms using the value-based approach differ from those, using conventional pricing methods in terms of profitability, customer relationship, customer satisfaction and so forth.

The export rate of Austrian-based companies is in general higher than 50%; value-based pricing (and the integrated approach) is even more important in an interconnected world than in the local market.

Keywords

Value-based pricing, pricing methods, pricing strategy, pricing approach, integrated price process.

Introduction

Nowadays companies' long-term success is mostly dependent on the right approach to determining pricing strategy. The companies' failure or significant development also relies mostly on prices, because price has the highest impact on profitability. Furthermore, the right strategy and the integration of the pricing process in the entire company influences the stable position of the company in the global market. Moreover, a clearly structured and integrated price process affects the competition in the market and a company's competitiveness. Various scientific litera-

ture articles as well as researches show that, when considering all pricing methods, value-based pricing is the most successful and reliable approach for the long-term success of a company. (Baker, 2011; Hinterhuber, 2008; Michael & Pfaffli, 2009; Monroe, 2003)

There are several reasons, however, why companies do not implement value-based approaches. On one hand it is enormously difficult to identify the value that customers perceive, because of the different perspective of every individual. On the other hand there are easier ways to set a price, e.g. cost plus pricing strategy and measuring competi-

tors' prices. Yet only the value-based pricing approach integrates all important elements (cost and competitive situation and value for the customer). (Hinterhuber, 2003; Brennan, Canning & Mc Dowell, 2011)

Three key questions will be explored in this article:

- To what extent is the value-based pricing approach in Austrian medium-sized companies established and employed as a prominent practice?
- What are the main obstacles that hinder the implementation of the value-based pricing approach in medium-sized companies in Austria?
- Why does it make sense to apply the value-based approach in medium-sized companies in the long run?

The article is organized as follows: First of all the theoretical basis of the topic is described in order to foster better understanding of the value-based method, which is a relatively new theme in the scientific literature. Secondly, the practical side of the topic is explored, properly addressing the actual business situation in Austria. The method used for research is quantitative, and focuses on the description of comparisons and interpretations as well as the analysis of the outcomes.

1. Theoretical background

In order to better understand the ideas developed in this article, the authors explain the theoretical aspects through representing several traditional approaches regarding price setting in literature on one hand, and on the other the cost-based and competition-oriented approaches. The value-based pricing approach is more complex and complicated, which is why the description is divided into five parts: definition of value, value-based pricing as a driver for sustainable company value through customer satisfaction, a model for implementation of value-based pricing, advantages of the value-based pricing approach and obstacles for implementation of value-based pricing.

A brief description of the traditional methods to pricing will show its usual application use and understanding of the companies and the perception of customers in the current business environment. Pricing approaches include a certain scope of actions, which are defined as between the price floor (where no profits are possible below this price) and the price ceiling (where there is no de-

mand above this price). In reference to the above mentioned possible range of prices, several conventional methods for pricing exist. Value-based pricing can be seen as the integration of different price methods, because cost-based pricing and competitive pricing are the basis for value-based pricing with this method.

1.1. Cost-based approaches to pricing

Price calculations based on the expenses for the production of a given product constitute the so-called cost-based approaches to pricing. There are different approaches that will be briefly examined:

1.1.1. Cost-plus

This approach is mostly applied in less competitive or non-competitive fields of business. These methods are estimated to be the least risky strategy as the main focus lies in the coverage of the average total costs plus calculated profit. (Shy, 2008)

Formula: $target\ selling\ price = Variable\ Costs + (Fix\ Costs / sales\ volume) + markup\ markup = (desired\ ROI\ (\%) * total\ amount\ invested) / sales\ volume$

1.1.2. Target costing

Unlike the above mentioned method target costing is applied in highly competitive markets where market price is determined according to the features of the offering to which a desired profit is added. (Clifton, Bird, Albano & Townsend, 2004)

Formula: $target\ cost = market\ price - target\ profit$

1.1.3. Break-even

Break-even pricing is another conventional pricing method which displays the interrelationship between total costs and total revenue with dependence on sales volumes. The main goal of this pricing method is a desired return on the invest capital which should be achieved.

Formula: $target\ return\ price = unit\ cost + [(target\ return * invested\ capital)/unit\ sales]$

One of the advantages of the conventional cost-based pricing methods is that it is relatively simple to calculate a price, because this is a quite rational and mathematical approach. Furthermore, in some fields of business it can ensure relative price stability and minimize the destructive price influence of the competition. (Capon & Hulbert, 2012).

Inevitably the conventional cost-based pricing methods have some limitations as well. For example these approaches do not take into consideration any noneconomic elements related to the excess of the use value over the cash value of a product – an indicator of great importance to the client. (Macdivitt & Wilkonson, 2012)

In both chapters the cost-base pricing approach and competition-oriented pricing, only the main methods are shown; it would expand the frame of this article to discuss all methods in both categories.

1.2. Competition oriented pricing

The price calculations of the competition-oriented pricing method are based on the prices of competing companies in the market. This method enjoys great popularity in markets where customers are extremely sensitive to prices.

1.2.1. Going-rate pricing

This is the customer's perception of the price of a company which is assessed by the customer regarding different factors such as performance plus features, brand reputation, etc., and after a certain evaluation the client chooses a particular product on the market. This approach saves time and costs and is easy to apply. (Macdivitt & Wilkonson, 2012)

1.2.2. Competitive bidding (reversed auction)

A reverse auction is a type of auction in which the roles of buyer and seller are reversed. A buyer presents a contract for bidding (by either using specialized software or through an online marketplace). Multiple sellers are then able to make bids on the contract. As the auction progresses, the price decreases as sellers compete to underbid their competitors while still meeting all of the specifications of the original contract. (Pandey, 2007)

The limitations of the competitor-based method can be seen due to the fact that just being better than one's competitors (differentiation) does not automatically mean that the company will deliver value to its customers.

The method of value-based pricing will be introduced in detail in the following sections, because the authors strongly believe that this is the only pricing concept that allows medium-sized companies to sustain their success in a global market.

1.3. Value-based pricing approach

The value-based pricing approach is considered to be the method with the highest profit potential, regarding long-term relationship orientation and the created use value of a given product rather than just good quality.

1.3.1. Definition of the value

With regard to all the descriptions in the scientific literature of this term, the basic definition of value represents all the benefits that the customer receives when purchasing a product or service and their features. The main problem of the value lies in its intangible nature and unconscious acceptance. Therefore a company must consider the efforts needed for discovering the customer's perceptions of the received benefits. (Meehan, Simonetto, Montan, & Goodin, 2011).

Another way of calculating the value is by comparing benefits to costs (total costs or investments). Furthermore, value-based pricing should be considered both from the viewpoint of the company itself and its competitors (Anderson, Kumar, & Narus, 2007):

$$(Value_f - Price_f) > (Value_a - Price_a)$$

1.3.2. Building a value proposition and a model for implementation of value-based pricing

Building value proposition must firstly be considered by composing a differentiation list of features and elements of the products or services provided, and their distinctions must be perceived from the customer's perspective, and from that of the company. Secondly, it is necessary to compare the value-based offerings and the differences between other next best alternatives on the market also regarding their prices. After these two steps have been completed, the value should be expressed financially and this approach should be implemented throughout the whole company. (Anderson, Kumar, & Narus, 2007).

Implementation steps include at the outset, the identification of customer needs, which should be conducted through direct contact with the company's regular clients, applying "active listening" and asking the right questions of the right people. During the second step prices should be assigned to the defined value offerings. The third step represents the development of different pricing options for the customer, i.e. the company has to provide the best solution, which has to match the

customer's specific requirements. In addition, the company must find the right approach to present the offer in order to facilitate negotiations so that good results can be achieved. Moreover, after the purchasing phase ended, the customer's satisfaction should be determined and new improvements should be continually applied. (Baker, 2011).

Based on these arguments value-based pricing also creates long-term success of a company – as a driver for sustainable company value through customer satisfaction. Recent studies (Matzler & Stahl, 2000; Rappaport, 1998) show that customer satisfaction is the core driver for company's success in the market; success is defined in the study of Rappaport as ROI, while Matzler and Stahl defines long-term success as related to cash flow.

1.3.3. Advantages of the value-based pricing method

The main advantage of the value-based pricing method compared to other pricing methods is that this approach addresses customer's needs, whereas the others focus mostly on competition and cost-cutting. Another advantage, as previously mentioned, is the focus on the long-term relationship between the customer and the company, which results in higher profitability for the company. Moreover, this long-term relationship requires profound knowledge of the customer that will result in providing the right solutions and offers in accordance with their needs. (Baker, 2009).

1.3.4. Obstacles to the implementation of the value-based pricing method

The survey conducted represents the main impediments for companies regarding the implementation of the value-based approach. Two key points are stated: adapting the corporate structure to value-based pricing and the high expenses for implementing the method. Furthermore, a very serious roadblock happened to be the beginning of the process and more precisely the assessment of value. What is more a problem frequently occurs in connection with the conforming of the value to the customer, which seems to be related to the differentiation of the product/service and to the high competitiveness of the market. Thus the customer's attention is difficult to assess. Moreover, many other difficulties could occur, as for example the lack of sales force or the lack of senior management's support for applying such a method in a company structure.

1.3.5. Integrated approach

The only integrated approach in price management is seen as the value - added price approach. Hinterhuber (2003) recommends using the value-based method, the cost + and the competition method in order to define the price strategy. For efficient price management it is necessary to gain insights into the following points:

- company's cost analysis,
- competitor analysis (understanding trends, strategies and product offerings),
- value analysis of the customer.

Taking only the cost situation of a company into consideration excludes the competition situation and customer needs. In addition, focusing only on differentiation does not mean that *per se* value is delivered to the customer. The only method see the one before, prerequisite the other 2 pricing approaches is the value based pricing method – therefore it can be seen as the only integrated pricing approach.

2. Research design

The empirical part of the article consists of examination of the pricing approaches in Austria, particularly in medium-sized companies. (According to the Austrian Economic Chamber of Trade, Commerce and Industry, the parameters of such companies are as follows: number of employees from 50 to 249, turnover \leq 50m € and total assets \leq 43m €).

The main goal of the research is to find out the extent to which Austrian companies have developed different pricing approaches and why they have chosen them. The purpose of the research is to find more information about the topic and to analyze the data gathered about it.

The survey was conducted as an online questionnaire. The research covers companies operating in the sectors of commerce (18.3% of responses) - industry (30%), trade (16.7%) and service (30.6%). "The qualified contact person" for completing the surveys is defined as a person who occupies a managerial position related to pricing knowledge and tasks, namely: CEO (53%), Head of Sales Department (18%), Head of Marketing Department (8%), marketing department personnel, business unit manager, pricing managers, sales department personnel, key account manager, etc. The total number of responses is 224, however several of them (44) were incorrectly completed or not completed by an appropriate person.

Of 180 responses, 71% were from B2B companies and 29% from B2C companies.

3. Main findings

Several questions in the survey were asked in order to find out the current situation of Austrian based SME's regarding their pricing approach. The following research questions were defined:

- “To what extent is the value-based pricing approach established and used as a prominent practice in medium-sized companies in Austria?”
- “What are the obstacles that hinder the implementation of the value-based method in medium-sized companies in Austria?”
- “Why does it make sense to apply the value-based pricing approach in medium-sized Austrian companies in the long run?”

“To what extent is the value based pricing approach established and used as a prominent practice in medium-sized companies in Austria?”

The basic impression about value-based pricing communicated by existing literature and previous studies is that this approach is enjoying growing recognition and importance but still remains a method applied by only a minority of companies (Hinterhuber, 2008; Woodside, Golfetto, & Gibbert, 2008; Cavusgil, Chan, & Zhang, 2003). Findings from the analysis of information gathered through the survey support this statement also for Austrian medium-sized companies. Only 13 % of the companies responding to the survey have already developed and applied value-based approaches as their pricing strategies. The majority of companies still use the cost + method.

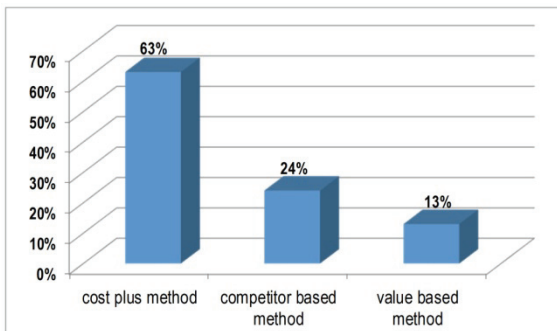


Figure 1 Used methods for pricing determinations
Source: Authors

The second research question was formulated as: “What are the obstacles that hinder the implementation of the value-based method in medium-sized companies in Austria?”

The most frequently named reason, and therefore the obstacle which was identified as the main cause for why companies of the investigated segment in this study struggle to implement value-based pricing, was the highly competitive situation in the market (price wars). This obstacle was mentioned by 37.7% of respondents. The second most given reason for not using value-pricing, indicated by 34.4% of survey participants, was that the nature and composition of a company's product or service itself just makes it difficult to differentiate from the competition and provide a unique and differentiated value that could justify charging a premium. The third reasons why companies do not apply the value-based approach was difficulty of assessing the values of individual customers.

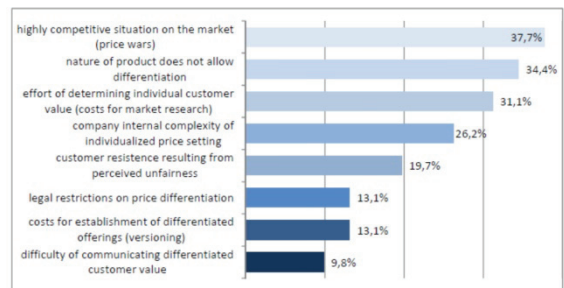


Figure 2 Reasons why companies don't apply the value-based approach
Source: Authors

The answer to the last research question “Why does it make sense to apply the value-based pricing approach in medium-sized Austrian companies in the long run?” lies in the fact that this method guarantees the highest profitability amongst all others if it is successfully implemented.

Figure 3 shows the profit situation of Austrian SME's in 2012. The majority of companies had a profit margin of between 0-10%.

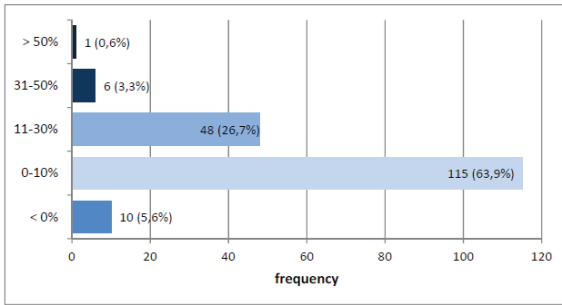


Figure 3 Profit situation of Austrian SME's
Source: Authors

Around 64% of the companies in the study had a rather low profit margin of between 0 -10% and the second largest category (around 27%) had a margin between 11-30%.

The picture looks quite different when we take the pricing method into consideration. In Figure 4 we can see that the categories 0-10% and 11-30% are equal for companies using the added - value price method and the upper categories higher than 31% are significantly stronger than with traditional methods. Moreover, not a single company (using the value-based method) was found in the negative category.

The reputation of the value-based approach for tapping higher profits is thus underscored by the results of this study than other approaches to pricing.

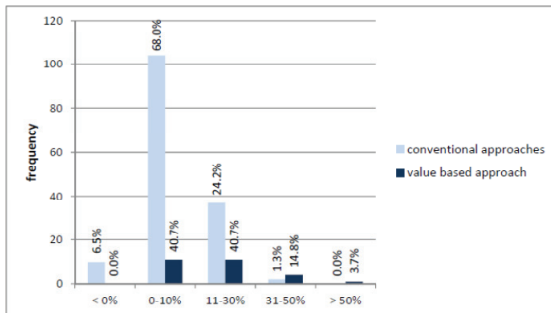


Figure 4 Comparison of profit margin for companies using traditional vs. value-based pricing
Source: Authors

Another reason mentioned in existing literature of why it makes sense to incorporate value-based pricing in a company is related to the high level of communication required and a company's necessity to intensively study its customers' requirements and closely focus on their ultimate needs. This extremely painstaking and intensive communication and examination of the customer might even provide the firm with the ability to exceed the client's expectations, leading to highly

profitable long term relationships with a positive outcome for all participants (win-win) and higher customer satisfaction. (Baker, 2009; Macdivitt & Wilkinson, 2012; Anderson, Kumar, & Narus, 2007)

In addition companies participating in the survey, which was conducted in the course on an empirical study, appeared to more intensively interact and communicate with their customers and also achieved a higher level of overall customer satisfaction.

Especially with regards to the observed frequencies of communication with customers in a B2B environment, the differences between "value pricers" and "conventional pricers" were especially significant. Thus, information about the advantageous effect of value-based pricing regarding customer relationships and customer satisfaction provided in existing literature, appeared to also be valid for the investigated segment of this study.

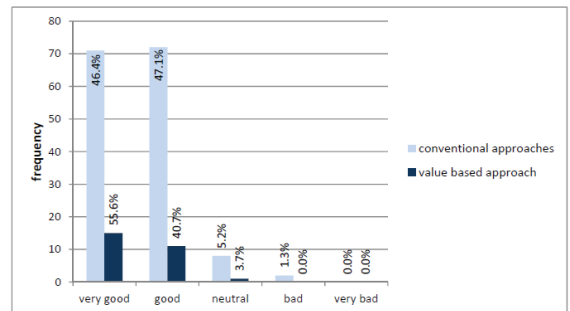


Figure 5 Reputation of the companies using conventional vs. value based approach
Source: Authors

An additional question raised in the survey was, whether companies that applied the value-based pricing approach are more successful in tapping the full up-selling and cross-selling approach. As can be seen from the results of the conducted online survey, it is not sufficient to confirm in full the positive effect of the value-based pricing approach and to reveal up-selling and cross-selling potential from a market perspective. However, the value-based pricing method is in its infancy and hence very difficult and complex to explore, and therefore further in-depth research should be conducted so that detailed and more precise conclusions may be drawn.

4. Limitation of the research

In the course of the conducting research some limitations affecting the results were detected due

to the fact that the value-based pricing approach is a relatively new topic in the scientific literature and is in its infancy as far as the implementation of the method in companies is concerned. It is neither fully perceived nor widely applied yet.

In the process of analyzing the results of the online survey it became clear that some of the companies have not entirely comprehended the meaning of “value-based pricing” itself, hence discrepancies occurred among the answers of the different sections of the questionnaire.

Last but not least, the authors would like to mention that data gathered by surveying actual customers of a given company is more likely to be accurate and to authentically represent the level of the customer’s satisfaction and a company’s reputation from a market perspective. Because of some obstacles the study was not conducted in the above mentioned manner. Therefore, testing concerning the correlation between a chosen pricing method and the level of the customer’s satisfaction or the company’s reputation from a market perspective should be considered crucially important.

5. Further research

The outcomes and the results of this research are estimated as insufficient and limited although some interesting facts about the present situation in medium-sized companies in Austria became evident in regard to the penetration and the popularity of the customer oriented approaches. That is why the authors suggest supplementary research in this regard is convenient for more thorough study of the value-based pricing method.

Furthermore, one of the most important issues – whether companies applying customer oriented approaches achieved a better reputation as far as market perspective is concerned or reached a higher level of customer satisfaction – could be only partially answered with the methods used in this study. **SM**

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