

## Differentiated-Value Pricing

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Pricing has a profound impact on a company's bottom line: It influences perceived value in the marketplace, and influences how well a product will sell. Most importantly, it determines profit. For example, when a product is underpriced by 10% or a salesperson cuts price by 10%, that money comes directly from profits! A company's costs remain the same:

Costs	\$100	Costs	\$100	
Price	\$120	Price	\$108	← 10% price cut
Profit	\$20	Profit	\$8	← 60% profit cut!

Because pricing is so important, it pays for a company to determine its pricing carefully. A poor but commonly used method of determining price is cost-plus pricing. With cost-plus pricing, a company adds up all the costs associated with a product and then adds a "reasonable" profit margin to determine the price. Cost-plus pricing is easy. However, cost-plus pricing also leads to overpricing, which can limit sales, and underpricing, which leaves money on the table. After all, customers don't care about a company's costs; they care about value to them.

A company will be more profitable if they use the Differentiated - Value Pricing method. Using this method, companies learn how much consumers value their product or service and then price accordingly. This ensures products aren't overpriced, and sales are maximized. This also keeps products from being underpriced, and therefore, profit is maximized. Differentiated - Value Pricing takes more work, but pays big dividends.

## Differentiated-Value Pricing Requires Research

To explain Differentiated-Value Pricing, I will use the example of Alpha Copier Co., an imaginary maker of copy machines. Alpha has a newly designed copy machine for the small business market and the company needs to determine a price before it can be introduced. The company's Sales and Finance departments have agreed on a price of \$1,750 based upon manufacturing costs and Alpha's standard 40% profit margin:  $\$1,250 + 40\% = \$1,750$ ). This price is only \$100 more than Alpha's older, more basic model, but Sales explains that the market is tough. Nevertheless, the CEO thinks the new copier is worth more and has hired a management consultant to help determine a more accurate price.

The first step is to look at the competition and find the low-price alternative to Alpha's offering. Beta Copier Co. has a copier that costs just \$1,200. This is well below Alpha's cost-plus price, and even below Alpha's costs; however, Beta's offering lacks many features:

Attributes / Benefit	Alpha	Beta
Pages per minute (Benefit: Greater productivity)	30	15
Resolution (Benefit: Professional appearance)	600 x 600	300 x 300
Paper capacity (Benefit: Convenience)	500 sheets	1,000 sheets
Duplex capable (Benefit: Saves paper / environment)	Yes	No
USB (Benefit: Copy direct w/o computer)	Yes	No
Internet capability (Benefit: PDF to email / fax)	Yes	No
Brand image (Benefit: Proven reliability)	Reliable	Low cost
Cost	??	\$1,200

The next step is to research how much Alpha's target market actually values each feature. To do this, the consultant would survey Alpha's customers. Ideally Alpha would commission a special type of survey called a conjoint analysis. Alpha could guess how much each feature is worth, but the company would run the risk of assigning too much or too little value to various features. In contrast, a conjoint survey gives robust statistical data on customer preferences and the monetary value they assign to those preferences.

From the research, the consultant finds that customers in the target market value the features according to the table on the next page:

Attributes / Benefit	Avg. difference in value (Alpha vs. Beta)	Alpha	Beta
Pages per minute (Benefit: Greater productivity)	\$75	30	15
Resolution (Benefit: Professional appearance)	\$200	600 x 600	300 x 300
Paper capacity (Benefit: Convenience)	-\$50	500 sheets	1,000 sheets
Duplex capable (Benefit: Saves paper/environment)	\$50	Yes	No
USB (Benefit: Copy w/o computer)	\$50	Yes	No
Internet capability (Benefit: PDF to email/fax)	\$100	Yes	No
Brand image (Benefit: Proven reliability)	\$300	Reliable	Low cost
Cost		??	\$1,200

When added up, the consultant finds that the average customer values a copier with Alpha's attributes \$725 more than a copier with Beta's attributes.

To calculate a price based on the copier's differentiated value, the consultant would add the additional value created (\$725) to the price of the base product (Beta's \$1,200 low-end copier). The consultant would then recommend that Alpha should begin with a price of \$1,925 – \$175 more than their cost-plus price! This foundation price will then be adjusted up or down depending on other strategies.

## Differentiated-Value Pricing is the Foundation for Strategic Pricing

The example of Alpha Copier Co. assumes that Alpha has already determined a target market. This is important because different market segments will value features differently. For example, a very small office may not value the additional speed of Alpha's machine, and a very large office may not value the entire machine at all. Therefore, to develop a robust model, it's important that the research be focused.

There are also broader strategic reasons to adjust price up or down from the Differentiated-Value Price. For instance, Alpha's strategy may be to engage in penetration pricing to maximize market share or take advantage of the learning curve and economies of scale when launching a new product. Or the company's strategy may be to raise the price to enact a skim strategy, focusing on early adopters, signaling quality, and/or maintaining their brand image. Regardless, Differentiated-Value Pricing is the foundation from which to make these strategic adjustments.

## Differentiated-Value Pricing Gets Results

Although Differentiated-Value Price is straightforward, many companies—maybe most—still use cost-plus pricing. There are three reasons. First, Differentiated-Value Pricing is a function of the Marketing department whose goal is maximizing profit; yet pricing decisions are usually made by the Sales department whose focus is maximizing sales and the Finance department whose focus is metrics like gross-profit margin. Second, Differentiated – Value Pricing requires a greater investment of resources including time, money, and effort and is, therefore, more difficult. Third, pricing on differentiated value is a complex topic that isn't covered in many training courses on management so, more often than not, managers don't know about or understand it.

Nevertheless, companies that do make the switch get big results. For example, the industrial-parts maker Parker Hannifin used cost-plus pricing since the company's inception; however, when better pricing was implemented, it added \$200 million to its operating income (profit).

Similarly, a Differentiated-Value Pricing model helped a startup client (of McKinney) go from two years of near-zero sales and cash burning to significant sales and positive cash flow in just a few months. Before, the company was guessing at price—pricing extremely low—and then approaching potential customers with value propositions that were perceived as mere sales puffery.

The client couldn't justify the value because the price wasn't quantifiable. But developing a Differentiated-Value Pricing model allowed the startup to quantify their value proposition and develop marketing communications and sales presentations accordingly. When the value was quantified, it was easy to justify—and sell. Sales went up significantly—and at a higher price.

## Summary

Price is a function of customers' perceived value – not a company's invested costs. Therefore, it makes sense to set price based on customers' perceptions instead of a company's costs. Differentiated-Value Pricing allows companies to stop guessing at price and start quantifying their product's value, and, therefore, their product's price. In turn, a quantified value proposition allows companies to overcome consumer skepticism and begin making sales.

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## For more information

To learn more about other components of strategic management, visit [www.McKinneyStrategicManagement.com](http://www.McKinneyStrategicManagement.com).

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