PREFACE

The quickest route to a healthy and profitable business is to develop pricing power. But how does this work in practice? There is no shortage of pricing theory, but before now, there was no practical book to help entrepreneurs and managers set up a rock-solid pricing policy. That is why I decided to write this book. The goal was clear: producing a simple, practical book that readers could start working with right away.

In this book, I demonstrate how to develop pricing power based on a number of practical pricing principles. No heaping mounds of theory, but simple principles that can make your company more profitable immediately. I hope the principles in this book will help you get rid of price and margin pressure, and I am convinced that applying these principles to a meaningful extent will help you regain control of your prices. You will no longer feel that your prices are at the mercy of the whims of the market.

I hope that applying the principles will feel like a reward for hard work, because creating a good product and a good reputation is hard work. However, a good product alone is not enough. Take Apple, for example. Apple may be known for its innovative, high-quality products, but you will also see that Apple applies most of the principles in this book to actually get the price that their quality products merit. So even Apple needs more than a good product or just good luck. A rock-solid pricing policy is crucial to make sure that you get a good price for your good product.

The book opens with a brief introduction that stresses the importance of price as the main driver of profitability. Then, in chapter 2, value-based pricing is explained to serve as a foundation for your pricing policy. Chapters 3 to 12 then cover all pricing principles, which together will get you a better price for your products. To conclude, Chapter 13 explains how you can organize pricing power in your business.

I use as many cases and examples as possible in this book to make it as practical as possible. All cases are inspired by real-life situations, which have been anonymized and sometimes simplified. As you progress through the book, you will notice that highly tactical pricing principles alternate with more strategic pricing principles. This is typical for pricing, as you have to get both the finest details and the overall strategy right.

For an even more practical touch, I end each chapter with a summary and some questions that you can ask to foster discussion in your business. You could answer these questions with your leadership team, for example, in order to take the first steps towards a better pricing policy.

I hope you enjoy reading this book and wish you lots of inspiration and, above all, pricing power.

Joris Smits

JUSTIFICATION

The ideas in this book are based on the author's ample experience and knowledge in the field of pricing. Wherever specific ideas of others are used, a reference is always included to the reading list at the back of the book, which contains a detailed bibliography. In some cases, the ideas of others were adapted for this book to, in the author's view, make them better suited to the purpose of this book, which is to give readers practical tools to improve their pricing. If this is the case, it is explicitly stated. Any ideas that are based on the author's knowledge and experience but resemble other similar ideas are explicitly mentioned with a reference to the alternative ideas in question. Finally, it is possible that, during the writing process, thoughts have been developed that are inspired by the ideas of others. This, too, is explicitly mentioned where applicable. The message of this book is based entirely on the author's vision and cannot in any way be related to the policies of the companies with and for which the author has worked during his career.

‘If you can’t explain it simply,
you don’t understand it well enough.’

Albert Einstein

CHAPTER 1

PRICE, THE MAIN PROFIT DRIVER

> *'The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by a tenth of a cent, then you've got a terrible business. I've been in both, and I know the difference'*
>
> ***Warren Buffett, investor***

Why is price so important for a successful business? Let me kick off this book by answering this question.

Most companies want to make profit. And you make profit by selling a product at a higher price than it costs. Profit = (price - variable costs) × volume - fixed costs. If you're looking to raise your profits, there are three ways to do so: increase your price, increase your volume (sell more) or cut costs. That's it. Mind you, none of these options are easy, so before you spend tons of time and money, you want to know which is the most effective. Here's a straightforward example.

Figure 1.1 shows a company and its profits. Suppose you are responsible for this company and you want to grow its profits. The company is now making $ 1 million (m) profit, as you can see in the current situation in the second column from the left. After all, profit = (price - variable costs) × volume - fixed costs so: ($ 5 - $ 2) × 1 m - $ 2 m = $ 1 m. Imagine that a lot of hard work can net you a 10% improvement. Where would you allocate that 10% - price, volume, variable costs or fixed costs?

Figure 1.1 ***Price: The main profit driver***

With an improvement of 10%...

Profit driver	Current situation	Price (+10%)	Variable costs (-10%)	Volume (+10%)	Fixed costs (-10%)
Price	$ 5	**$ 5.50**	$ 5	$ 5	$ 5
− **Variable costs**	$ 2	$ 2	**$ 1.80**	$ 2	$ 2
× **Volume**	1 m.	1 m.	1 m.	**1.1 m.**	1 m.
− **Fixed costs**	$ 2 m.	$ 2 m.	$ 2 m.	$ 2 m.	**$ 1.8 m.**
= **Profit**	**$ 1 m.**	**$ 1.5 m.**	**$ 1.2 m.**	**$ 1.3 m.**	**$ 1.2 m.**
Profit %		+50%	+20%	+30%	+20%

As Figure 1.1 clearly shows, improving price is your best course of action. Because a 10% price increase will boost your profits by 50%. 10% volume growth, on the other hand, only results in 30%

more profits. If we look at costs, we can see that reducing variable or fixed costs by 10% will only increase profits by 20%.
There is a one-to-one relationship between hiking prices and profits: Every extra dollar you get for your product is an extra dollar of profit. You are effectively getting a free dollar, as you do not have to increase production, do more work, or incur any extra costs. And because your costs stay exactly the same, increasing your price by one dollar will mean increasing your profit by one dollar.

If you're curious, head to box 1.1 to find out why volume growth and cutting costs do not impact profit as much as price hikes do.

Box 1.1: Why volume growth and cost cuts will net you less than raising prices

Volume growth is less beneficial than increasing prices, because selling more generates both extra income and extra costs. Because these costs have to be deducted from your extra revenue to get to profits, volume growth has less of an impact on profits.
To find out why cutting costs does not have the same impact as raising prices, all you have to do is look at the numbers again:

- Your **variable costs** are always lower than your price (at least we'd hope so! You'll be filing for bankruptcy sooner or later if they're not.). Necessarily, a 10% improvement of a

smaller number (variable costs) will always have less impact than a 10% improvement of a larger number (price).

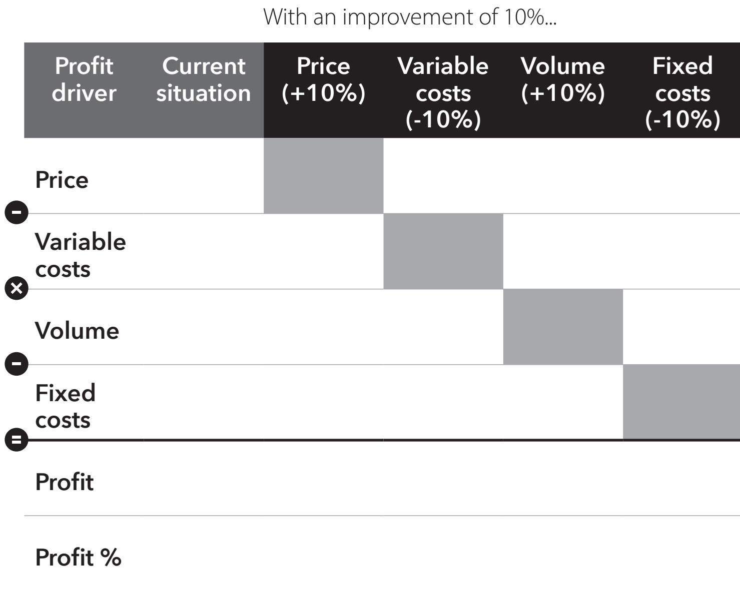
- As far as **fixed costs** are concerned, the same principle applies, only matters are a bit more complicated. For this, we have to look at the total contribution margin ((price - variable costs) x volume). The contribution margin always exceeds fixed costs (the same story: it's the only way to stave off bankruptcy). And since a 10% price increase will necessarily translate to at least a 10% increase in your contribution margin (larger number), lowering your fixed costs by 10% (smaller number) will never weigh up to the same.

Now you may be thinking: the company in Figure 1.1 is hardly representative of all companies out there. True, but the underlying reasoning remains the same. Just do the math for your own company or the product you are selling. You can use the template in Figure 1.2 as an aid. Try entering your figures into the equation and you will surely find that price is the most effective way to boost your profits. Not convinced yet? Get your hands on a P&L statement. It does not matter where it's from, any one will do. You will always see that price is by far the main profit driver. And that is why price should always be priority number one for any company, including yours.

Price elasticity

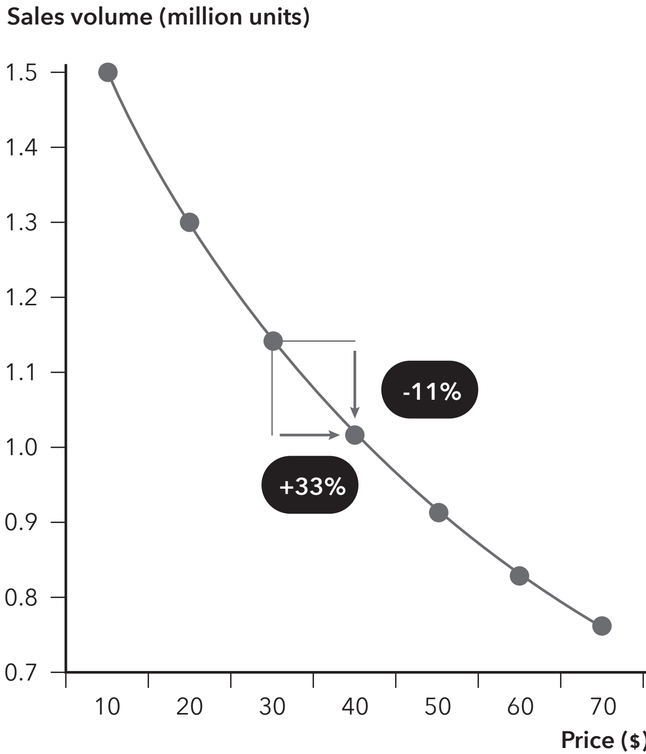
You might have noticed that in Figure 1.1, I always assume a scenario in which all other factors stay the same. When we increased the price by 10%, for example, volume and costs stayed the same,

Figure 1.2 Template to identify the main profit driver



and when we increased volume by 10%, price and costs stayed the same. According to the economic law of price elasticity, this is impossible, because price elasticity stipulates that when prices rise, demand falls. The extent of the increase or decrease can be captured in an elasticity value as shown in Figure 1.3, where we explain price elasticity using a so-called demand curve.

<u>Figure 1.3</u> Demand curve and price elasticity



Price elasticity = change in volume/change in price, so -11%/+33 % = -0.3. Rule of thumb: if price elasticity is lower than -1, demand is elastic. This means that volume responds strongly to price changes. When demand is elastic, you have little pricing power, because any price increase will come at the cost of a lot of volume. When price elasticity is higher than -1, demand is inelastic, which means that volume does not respond strongly to price changes. When demand is inelastic, you have a lot of pricing power. The concept of price elasticity was first introduced by Alfred Marshall at the end of the 19th century.[1]

Pricing power

The effect of a price increase is greatest when you don't lose much (or any) volume, i.e. when price elasticity is low (or inelastic). Warren Buffett, one of the world's best-known and most successful investors, calls this pricing power, as you may have already read at the start of the chapter. The less volume you lose when you raise your price, the more pricing power you have. The more pricing power you have, the greater the impact of price on your profits. And that is exactly what you want.

For the purposes of this book, I am adopting a slightly broader definition of pricing power. Pricing power does not always come down to increasing the price of a product, because that is not always the optimal road to profitability. As you can read in this book, pricing power can also come from increasing the average spend (or ticket price) or from using smart pricing techniques such as dynamic pricing to maximize your production capacity at the highest possible price (but not the very highest). In this book, developing pricing power is equated with establishing a solid pricing policy, in which 'price' is deliberately used to contribute to accomplishing company objectives.

Price determines relevance

Besides being the main profit driver, price is also a key factor in your strategy. After all, "expensive" and "cheap" are perhaps the strongest associations that buyers can have with brands. Consider the following. What are dominant associations that come to mind with car brands like BMW or Porsche? Would one of your

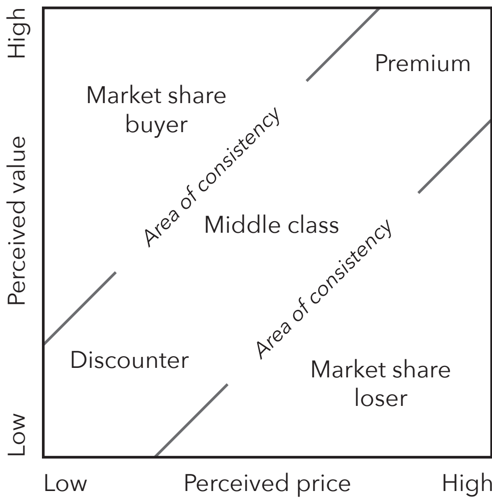
first suggestions not be ‘expensive’ or ‘pricey?’ And what about Rolex? Or Louis Vuitton? Examples from another extreme: what are your associations with Aldi and Lidl? Probably, the first words you thought of were words like ‘cheap’, ‘low-cost’ and/or ‘discounter’.

As buyers, we plot brands along the axes of value and price. As long value and price are balanced, products will be seen as good value for money. When enough people in the market are looking for your price-value ratio, you will be considered relevant and will usually have a successful future ahead of you. However, if your price-value position is off-kilter, you will run into problems sooner or later, as shown in the price-value matrix in Figure 1.4.

A price-value matrix compares your price-value ratio with that of your competitors. If you deliver relatively more value than your price represents, you are buying your market share and will ultimately run in to trouble, along with your competitors. After all, they will often feel compelled to lower their prices as well, shrinking everyone’s margins, as delivering value generally comes at a cost. If your price is too high for the value you represent, on the other hand, you have priced yourself out of the market and you marginalize your market share. You are no longer relevant. The trick is to stay in the band of consistency, which requires clear price positioning, in which price and value have been carefully balanced. There is nothing wrong with charging low prices, as long as they represent low value. This is where you will find low-cost companies and so-called discounters, many of which have turned out to be successful. There are multiple successful low-cost airlines, for instance easyJet and Southwest. Premium brands populate the other end of the spectrum. This is where you find

airlines such as Etihad and Emirates. This is not to say that the mid-range is by definition a bad choice. After all, some consumers demand the middle ground, which is where KLM-Air France, Delta Airlines and Lufthansa have positioned themselves.

Figure 1.4 Price-Value Matrix



A price-value matrix is a simple model that compares 'price' and 'value'. Several versions of this model have been developed, e.g. by consulting firm McKinsey.[2] The model in Figure 1.4 is the author's own.

Coming full circle: the price of your product sets the price of your business

For a successful company, price is everything. If your pricing policy is in order, chances are you will be profitable and the value

of your company will increase. In fact, it will literally increase the 'price' of your business, for example due to rising share prices. And with that, we have come full circle, learning why investors like Warren Buffet use pricing power as a key criterion when deciding to invest in a company.

Summary

Price is the main profit driver, because raising prices leads to a one-to-one increase in profits. The impact of price is greatest when you have pricing power, because you will lose little volume when your price goes up. Price is also a major factor in determining relevance. If your price-value positioning is in order, you will be relevant and your company will, generally speaking, be successful. If it is not, you will have to fold your hand at some point.

Questions that will kick-start the discussion in your company

- How will raising prices impact your company's profits? Try using the template in Figure 1.2 to answer this question.
- How much volume do you expect to lose with any price increase?
- What do you think about your price-value position? Are you in the band of consistency and are you relevant? If so, please turn to the next page to become even more profitable. If not, there is no time to lose. Continue reading to become relevant again.

PRICING POWER

A rock-solid pricing policy is the key to profitable growth. Don't let the market determine your prices and make sure that customers are willing to pay what you ask.

Price is the main profit driver. A percent price increase yields much more than a percent cost reduction or a percent volume increase. But how do you know what the right price is? In this book you will discover step by step how to set attractive prices based on the value you provide to your customers. This will give you pricing power and ensure that you're no longer at the mercy of the vagaries of the market.

Pricing Power is the first book that makes pricing simple, practical and immediately applicable. Whether you're an entrepreneur or leading a multinational, this book is a must-read for anyone looking to grow their business in a profitable way. Joris Smits shares his knowledge and experience, using dozens of recognizable practical examples.

Joris Smits is a passionate pricing expert who has supported numerous companies in various industries improve their pricing policies. His mission is to help companies in getting the best price for the value they deliver.