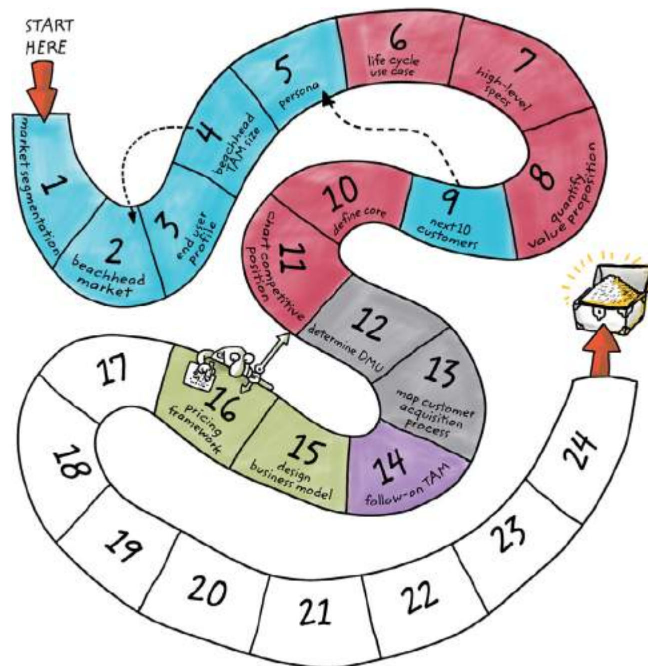
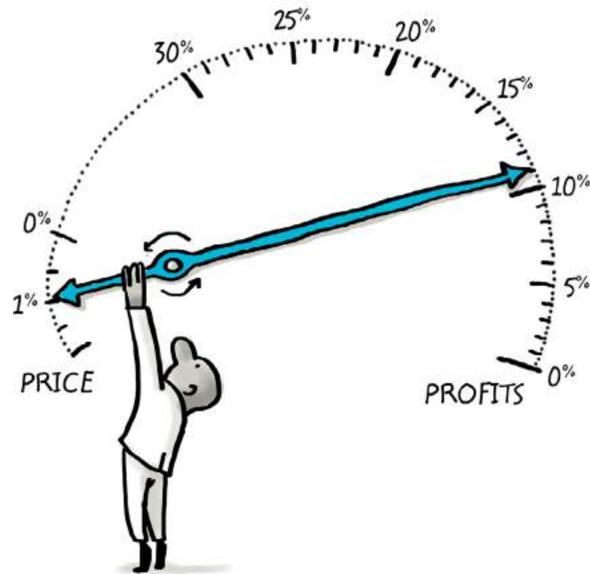
STEP 16

Set Your Pricing Framework



IN THIS STEP, YOU WILL:

- Use your Quantified Value Proposition and Business Model to determine an appropriate first-pass framework for pricing your product.



Now that you have settled on a business model, it is time to start coming up with a pricing strategy. Fine-tuning the strategy can have a huge impact on your earnings.

With a business model in hand, you can now make a good first estimate on your Pricing Framework, understanding that it will likely change as you continue through the 24 Steps. This step is the beginning of a pricing process, because you will likely end up with multiple price points and pricing strategies, and you will iterate as you experiment and get feedback from the market about price points. Whereas your Business Model is much less likely to change, price points are often subject to change based on market conditions. Some businesses even change pricing on a daily basis (e.g., gas stations) or, even more dramatically, on a real-time basis (e.g., dynamic pricing of airline tickets).

Your goal for the moment is to create a first-pass strategy that will allow you to calculate the Lifetime Value of an Acquired Customer, which along with the Cost of Customer Acquisition is an important variable that indicates the profitability of your business. You will find it easier to go back and change your Pricing Strategy once you have gone through and made your other calculations, as opposed to trying to get everything right at first. Much like many of the other steps in this book, getting pricing right is an iterative and ongoing process where you start at some point that is the best guess for that moment and then you spiral closer and closer to a better answer.

The Pricing Framework is extremely important in influencing your profitability, so it is important you price your product correctly. In his book *The 1% Windfall*, Dr. Rafi Mohammed cites a McKinsey & Company study that shows that for companies in the Global 1200, a price that is 1 percent higher would lead to an 11 percent increase in overall profits, because once costs have been paid, the remaining revenue is all profit. Of course, there is always an upper limit to your price due to the dynamics of the Decision-Making Unit, Process to Acquire a Paying Customer, and sales cycle. The Pricing Framework is your attempt to strike a balance between attracting as much revenue as possible and attracting as many customers as possible.

BASIC PRICING CONCEPTS

1. **Costs Shouldn't Be a Factor in Deciding Price.** Set your pricing based on the value the customer gets from your product, rather than on your costs. Cost-based strategies almost always leave money on the table. In software, for instance, the marginal cost (the cost of producing one more copy of the software) is virtually zero, so pricing based on cost would make it extremely difficult to make any money. Instead, use your Quantified Value Proposition, determine how much value your customer receives from your product, and charge some fraction of that. The exact fraction depends on the competition and the industry, but 20 percent tends to be a reasonable starting point, leaving 80 percent of the value for the customer, who is taking a risk by incorporating your product into their infrastructure. Some companies,

like Microsoft and Intel, have been able to take advantage of monopolistic positions to price even higher, but short-term gains through this strategy may create long-term problems for your business if your customers think you are gouging them and other companies emerge with different or lower-priced products.

a. The percentage of customer value that you can capture with your pricing depends on your business model and how much risk you are pushing onto your customer. A monthly subscription model, where a customer is paying over time, but can also cancel at any time, will allow you to price higher than an up-front charge model, where the customer is taking additional risk by paying for the product in full before knowing how beneficial the product will be for them.

b. If costs come up in conversations about your product, make it clear that your price is not based on cost. Immediately turn the discussion around to how much value you create for the customer. As Steve Walske, the successful CEO of Parametric Technologies, is reputed to have said, "My business is very simple. My customers give me two dollars and they get back ten. That is why we are so successful."

c. Don't give out your cost numbers to anyone who does not have a real need to know. Definitely do not tell your sales group, because any good salesperson will use any and all of their resources to make a sale, even if it means driving the price down to costs. This mentality is in fact why you hired them, love them, and what makes them effective. (If you doubt this, read about the behavior of real estate agents in *Freakonomics* by Steven Levitt and Stephen Dubner.) If you open yourself up to conversations about costs it can lead back to inappropriate conversations about your pricing, which will lead to decreased morale, productivity, and potentially profitability.

2. **Use the DMU and the Process to Acquire a Paying Customer to Identify Key Price Points.** The Decision-Making Unit and Process to Acquire a Paying Customer provide invaluable information about how your customer's budget works. Knowing an individual's purchasing authority limits can help reduce friction in the sales process. One example of using this information to inform your pricing comes from Kinova of Montreal, Quebec. Kinova sells the Jaco assistive robotic arm for disabled people in wheelchairs (Figure 16.1). When Kinova entered the market in the Netherlands, their primary market research found that consumers could get reimbursed up to 28,000 euros from their health insurance for purchasing the product. If the price went above 28,000 euros, Kinova would need the consumer to pay the extra amount out of pocket, creating friction in the sales process. Despite an extremely strong value proposition that could have supported a higher price, Kinova priced its product at

Figure 16.1 Kinova's Jaco assistive robotic arm.

28,000 euros, which dramatically decreased the company's sales cycle length and Cost of Customer Acquisition. As a result, the company quickly ramped up sales and enjoyed a much larger market share than it would if it had priced the product at a higher amount.

3. **Understand the Prices of the Customer's Alternatives.** It is imperative to understand, from the customer's perspective, the alternative products available, and how much the customer would pay for each, including the customer's status quo. Carefully research what other alternatives would achieve similar benefits for the customer, what the prices of those alternatives are, and how much better your solution is. Data collection and analysis is very critical in this step.
4. **Different Types of Customers Will Pay Different Prices.** When I was getting one of my companies off the ground, I got some sage advice after presenting to legendary entrepreneur Mitch Kapor. "The bad news," he said, "is you will sell half as many units as you think you will. But the good news is you will be able to sell to the first group of buyers at twice the price you think you will." He was spot-on. Geoffrey Moore explains why in *Crossing the Chasm*. Different types of customers will pay different amounts, depending on how early or late they are buying relative to other customers, so a differentiated pricing strategy and structure for these distinct customer segments will mean substantially higher profits for your business.

Moore breaks customers down into five waves:

a. **Technological enthusiasts** are the first people to buy a product. They love technology and will buy one of anything. Some are consumers, while others work in university R&D labs, national labs, or companies like General Electric. They will only buy one (hence half the number you expect) but since they want to have it right away, before anyone else, they are willing to pay a much higher price (hence twice the price).

b. **Early adopters** are also price-inelastic but are very interested in feeling like they got a special deal and will require lots of attention and extra service; so make sure to build that into your pricing model.

c. **The early majority (pragmatists)** is where you will make yourself a great and truly scalable company. That is the price point that most of us think about when we are talking about and planning for a pricing strategy.

d. **The late majority (conservatives)** are later in the process and your pricing strategy will be very clear by then; they like well-defined, conservative plans.

e. **Laggards/skeptics** come so late in the process that you may have already sold your company at this point.

5. **Be Flexible with Pricing for Early Testers and "Lighthouse Customers."** These two types of customers are beneficial to have early on. Early testers will collaborate with you to improve your product, and lighthouse customers strongly influence the purchasing decisions of others in the industry. Allow for flexibility on pricing with these two groups of customers, whether through discounting an up-front charge or through a free or low-cost trial period, as it is important to get them committed and satisfied. These customers may help you create case studies or do on-site seminars where you can promote your product, or otherwise be strong references in the market. However, do not give your product away to these customers, and do not discount any ongoing revenue streams, because that would signal that your product has a very low value, setting a dangerous precedent. Have early customers sign an agreement where their pricing terms be kept confidential, and be firm with other, later customers who try to secure the same pricing terms, because you do not want your early one-time-only deals to define your general pricing strategy. Additionally, if you have the option to discount hardware or software, I much prefer to discount the hardware and hold the line on software pricing. Customers can more easily understand hardware value versus software value, and it will be easier to reestablish higher hardware pricing as opposed to reestablishing software pricing.

6. **It Is Always Easier to Drop the Price Than to Raise the Price.** It is best to price high and offer discounts initially, rather than price too low and find you need to raise the price later. Usually, your first customers will have larger budgets than your later customers who are more likely to accept less-than-cutting-edge technology in exchange for a lower price. Also, you will find it difficult to convince customers to accept a higher price when they are used to paying a lower price. Sometimes, a price increase is necessary as you learn more about the market, but successful price increases do not happen frequently.

EXAMPLE

Helios

This student team was working on developing an exciting new thin-film technology that captured solar energy and could release the energy on demand. The team's beachhead market was remotely deicing windows on corporate and government fleets of automobiles.

The team factored in that the primary alternatives to their product were drivers manually deicing their individual cars, or maintenance employees manually deicing a fleet. Union rules and desires also had to be included. To get to a good educated guess on pricing, the team had to clearly understand its Quantified Value Proposition, as well as the rational and emotional qualities of the Decision-Making Unit.

The team created a first-pass Pricing Framework, and then once they calculated their Lifetime Value of an Acquired Customer and Cost of Customer Acquisition in later steps, they went back and revised their Pricing Framework based on those calculations. In the revised pricing framework, they set the price at $100 per unit, which would provide $100K in the first year of sales (based on the target customer's average vehicle fleet size of 1,000). With average 20 percent fleet turnover, they would net $20K per year afterward. As part of their framework, they compared their technology to window tinting, concluding that customers would judge their pricing against what they were used to paying for tinting. The strategy also discussed a discounting strategy for pilot customers to jump-start positive word of mouth.

This case is a good reminder that different steps depend on each other, and you should continually revisit and revise your assumptions based on work done in later steps.

SUMMARY

Pricing is primarily about determining how much value your customer gets from your product, and capturing a fraction of that value back for your business. Costs are irrelevant to determining your pricing structure. You will be able to charge a higher price to early customers as opposed to later customers, but be flexible in offering special, one-time-only discounts to select early testers and lighthouse customers, as they will be far more beneficial to your product's success than the average early customer. Unlike your business model, pricing will continually change, both as a result of information you gather and as you progress throughout the 24 Steps, as well as in response to market conditions.