

# Pumping More Profit

Leveraging Business Growth with Value-Based Pricing



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## Pumping More Profit: Leveraging Growth with Value-Based Pricing

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*Give me a lever long enough, and a fulcrum on which to place it, and I shall move the world. ~Archimedes*

Pricing is one of the most powerful and underused strategies for growth in any business. Most companies focus on metrics other than price: fixed and variable costs, revenue or increase in unit sales, decreases in inventory. In fact, because price is not commonly associated with bottom line profitability; the result is often reactive pricing strategies which undermine rather than enhance profitability.

Proactive pricing is a lever for profitability, and the fulcrum for proactive pricing is value. This combination can have a profound impact on business growth. The higher the value of a company's offerings, the greater the pricing leverage, and the greater the profits. Unlike legacy strategies such as cost-plus, historical-based, and volume-driven pricing, which tend to decrease price premiums and profits over time, value-based pricing optimizes a company's pricing structure for the current market conditions. It is also highly adaptable and can therefore accommodate market changes without loss of profit.

Value-based pricing is a strategic tool to be championed by the executive suite and business unit leads. This paper outlines the elements of a successful value-based pricing strategy.

### Defining the Fulcrum

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As a major factor in leveraging business growth, it is important for a company to fully understand the concept of value. The basic definition is:



# Three Ingredients for Value-Based Pricing

There are three necessary “ingredients” that must be in place in order to establish value-based pricing in a company:

1. Focused Data Analytics
2. Appropriate Company Culture
3. Positive Stakeholder Behavior

### Focused Data Analytics

Data is the place to start. There is a range of data and information that must be captured in order to effectively pursue a value-based pricing strategy. This data is analyzed to determine the key analytics that will help convert value to numeric expression. These focused data analytics may vary by product line and customer type.

In our engagements across a range of companies, we have found that many companies have one or usually more of these challenges to address before they can move forward:

Unlike other factors that contribute to pricing, value is neither quantifiable nor static. It is a buyer-side quality that is founded on perception, proportional to the buyer’s perceived benefits and inversely proportional to the buyer’s perceived costs. Benefits are those aspects of your product or service that differentiate it from competitor offerings—in ways that matter to the buyer. Cost can include factors besides the financial price; the product or service may require a time or resource expenditure by the buyer, or it may involve opportunity costs (see Table 1). If benefits outweigh costs, perceived value will be positive, and the higher the benefit-to-cost ratio, the higher the value—in the perception of the buyer.

Influence buyer perception, then, and you influence value. Influence value so that it increases in the view of the buyer, and you have the makings of a value-based pricing strategy.

**TABLE 1. EXAMPLE BENEFITS AND COSTS THAT CONTRIBUTE TO VALUE**

| EXAMPLE BENEFITS |               |                       |                     | EXAMPLE COSTS                     |                       |                                  |
|------------------|---------------|-----------------------|---------------------|-----------------------------------|-----------------------|----------------------------------|
| Product          | Service       | Relationship          | Financial           | Financial                         | Time                  | Resources                        |
| Brand Name       | Warranty      | Expertise             | Discounts           | List Price                        | Installation          | FTEs for Preparation             |
| Specifications   | Return Policy | Reliability           | Allowances          | Contractual Commitments           | Delivery Time         | Training                         |
| Options          | Quality       | Personal Contact      | Payment Plans       | Penalties                         | Prerequisites for Use | Other Vendors/Suppliers          |
| Features         | Location(s)   | Long Term Agreement   | Volume Rebates      | Defer other purchases/investments | Training              | Materials/Supplies               |
| Style            | Shipping      | Strategic Alliances   | Depreciation        | Interest Owed                     | Testing               | FTEs for Upkeep/Maint            |
| Quality          | Support       | Communication Quality | Leasing Arrangement |                                   |                       | Defer other projects/initiatives |
| Ease of Use      | Delivery Time |                       |                     |                                   |                       |                                  |

- Incorrect data
- Poor data quality
- Too much data
- No clear metrics or measures defined
- Overall poor transformation of data into information
- Lack of competitive data

If any of these challenges are present in an organization, a data quality initiative must be undertaken before value-based pricing can be embedded in the company culture, which involves the second required ingredient.

### **Appropriate Company Culture**

Pricing practices are usually well-embedded in the company culture—often expressed as “the way we do things here.” Company culture is driven from the top down, and any culture change effort must be actively sponsored by the executive suite.

Shifting to value-based pricing generally calls for a change in company culture in virtually all instances. Like focused data analytics, an initiative must be created and implemented to foster this change. Such an initiative will include:

- Characterization of the current pricing organization.
- Documentation of gaps between current pricing practices and practices that support value-based pricing.
- Definition of clear pricing goals, targets, measurement/metrics, and accountabilities.
- Design of new pricing processes and procedures.
- Creation of effective communication and knowledge transfer activities.

A critical part of effecting a change in company culture as it relates to pricing is to achieve buy in and active support by key stakeholders in the organization. Stakeholder behavior,

therefore, must be aligned with the goals of the change initiative, which is why this is the second ingredient that facilitates the shift to value-based pricing.

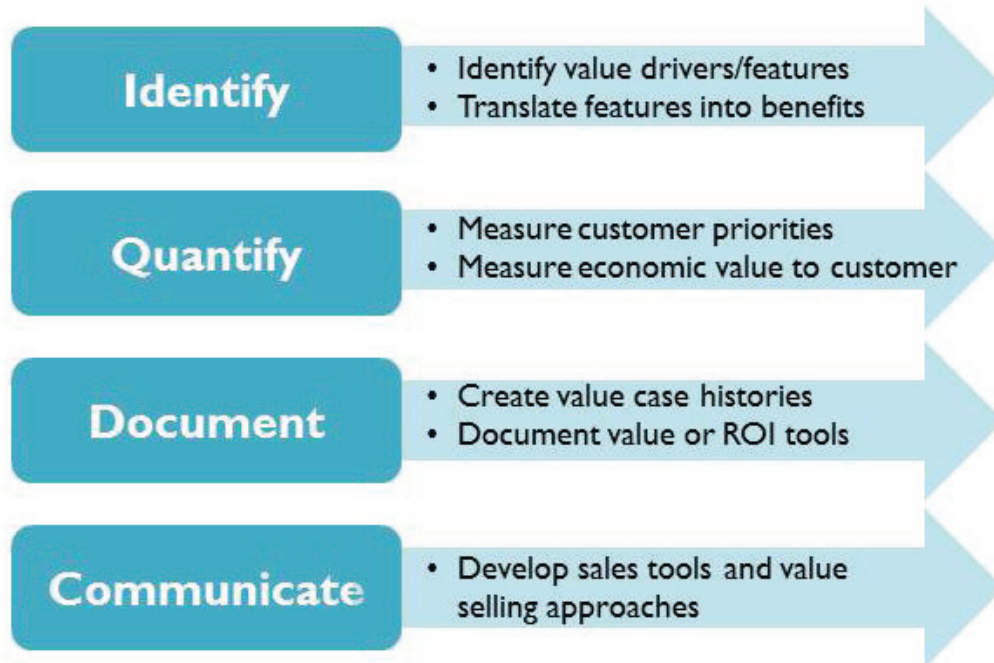
### **Positive Stakeholder Behavior**

Stakeholders are strong influencers of the behavior of the rest of the company. It is important to ensure that key stakeholders relative to the pricing organization are identified and enrolled in the move to value-based pricing. Active support of the change by executives and senior management will help mold positive stakeholder behavior. In addition, focus on the stakeholders themselves and their inclusion in the change initiative will significantly impact the move to value-based pricing.

Aligning stakeholder behavior with value-based pricing processes and strategies requires:

- Identification of key stakeholders relative to the pricing organization.
- Interviewing stakeholders to understand their pricing practices.
- Understanding the issues of each stakeholder group.
- Achieving buy in for the change from key stakeholders.
- Conducting knowledge transfer sessions of key pricing processes and best practices.
- Training for new technologies to be implemented for the new pricing organization.
- Supporting stakeholders to communicate and support change into the company at large (e.g., talking points, standard presentations, online Q&A/FAQs).

# Four Steps to Establish Value-Based Pricing



Since value is a subjective measure based on buyer’s perceptions, the pricing organization must find a way to quantify value, apply this to pricing, and prepare the sales force to demonstrate value to prospects. Wipro has developed a four-step process to establish and leverage value-based pricing to pump up profits. In addition to discussing each step, we will go through the process with AcmeCorp (a fictional example) to demonstrate its use.

### Example Scenario

Most oil and gas services companies sell drill bits. At the bottom of the drill system is the bit, which is used to drill the rock formation when drilling a well for oil/gas production. In general, the drilling operator would choose the bit according to the type of the rock formation. The most common types of bits are roller cone bits and diamond bits, they vary in size to drill different sizes of holes.

AcmeCorp , a large drilling operator serving the oil and gas industry in North America, plans to drill 20 holes for gas production. Each hole is expected to be 5,000 feet below ground. AcmeCorp will incur \$10,000 per day in labor costs

for the drilling project. The company wants to purchase roller cone drill bits for the job, and identifies two candidate suppliers: Company A and Company B. Company A uses a cost-plus pricing model, while Company B decides to use value-based pricing.

**TABLE 2. COMPANY A AND COMPANY B DRILL BITS**

|  | Company A                | Company B                |
|--|--------------------------|--------------------------|
| <b>Type</b>                            | Tricone Tungsten Carbide | Tricone Tungsten Carbide |
| <b>Size (diameter)</b>                 | 18 inches                | 17 inches                |
| <b>Average Drill bit life</b>          | 2,500 feet               | 5,000 feet               |
| <b>Average Time to drill 5000 feet</b> | 72 hours                 | 60 hours                 |
| <b>Cost to company</b>                 | \$6,000                  | \$8,000                  |
| <b>Price</b>                           | \$10,000                 | To be determined         |

### Step 1: Identify Value Drivers

The first step of the Value-Based Pricing Process is to determine all the value and benefits the customers receive from an offering through research and surveys that translate perceived benefits into quantitative values. The quantified benefits are analyzed to determine which represent competitive differentiators (e.g., a particular product feature, product quality, cost of ownership). These differentiators are prioritized according to value and those with the highest customer benefit are identified as value drivers.

- Customer Value Research
- Customer/Product Surveys
- Conjoint Analysis
- Competitive Data Analysis

#### AcmeCorp Example

From this assessment, Company B realizes two value drivers which increases customer perception on value and can be considered as product benefits in comparison to Company A's product:

Table 3 helps a company identify customer value drivers through some product and customer value research.

1. Longer average drill bit life: 5000 feet compared to 2500 feet
2. Shorter time to drill a hole: 60 hours compared to 72 hours

Some tools which help identify customer value drivers include:

**TABLE 3. RESEARCH BASELINE FOR VALUE DIFFERENTIATOR IDENTIFICATION**

|                 | Benefits  | Value Differentiators   | Focus On  |
|-----------------|---|---|---|
| <b>Consists</b> | The benefits the customer receives from the product/service | Value differentiators of a product/service relative to next-best alternative            | The one or two value differentiators that delivers the greatest customer value                                    |
| <b>Answers</b>  | "Why should the customer purchase our product/service?"     | "Why should the customer purchase our product/service instead of the competitor's?"     | "What is most worthwhile for our customer to keep in mind about our product/service?"                             |
| <b>Requires</b> | Knowledge of own company's products/services                | Knowledge of own company's products/services and understanding of next-best alternative | Knowledge of how own company's product/service delivers more value to customers compared to next-best alternative |

## Step 2: Quantify Value Drivers

After identifying the value drivers and benefits to the customer, the next step involves ranking the favorable points by importance and measuring the driver impact on company performance. This step requires the usage of published scientific tools such as Economic Value to the Customer (EVC).

Economic Value to Customer (EVC) is a framework to determine pricing for products and services. It helps to gain maximum price for products and is expressed as follows:

$$\text{EVC} = \text{competitor price} + \text{our positive differentiation value} - \text{our negative differentiation value}$$

Measures of economic value are based on what people want – their preferences or value drivers. These can be determined through customer surveys and statistical analysis like conjoint analysis.

Steps in estimating EV are:

- Understand your customer and identify the value drivers which are most important for product offering.
- Quantify the financial worth of the value drivers.
- Combine quantified value with customer economics, competitive reference, and differential performance data to develop an actual value estimate.

*AcmeCorp Example:*

Company B decides to use Economic Value to the Customer to quantify the two identified value drivers or benefits to the customer.

$$\text{EVC} = \text{competitor price} + \text{our positive differentiation value} - \text{our negative differentiation value}$$

We know the competitor price is \$10,000 for one roller cone drill bit. How do we calculate Company B's positive differentiation value?

**TABLE 4. ACMECORP EXAMPLE VALUE DRIVER 1**

|                                 | Company A               | Company B               |
|---------------------------------|-------------------------|-------------------------|
| Required time to drill 20 holes | 20 X 72 = 1,440 hours   | 20 X 60 = 1,200 hours   |
| Days required to drill 20 holes | 1,440 / 24 = 60 days    | 1,200 / 24 = 50 days    |
| Cost of labor to Customer       | 60 X 10,000 = \$600,000 | 50 X 10,000 = \$500,000 |

**TABLE 5. ACMECORP EXAMPLE VALUE DRIVER 2**

|  | Company A                       | Company B                       |
|--|---------------------------------|---------------------------------|
| Total feet to be drilled for 20 holes                    | 20 X 5,000 = 100,000 feet       | 20 X 5,000 = 100,000 feet       |
| Number of drill bits required to purchase                | 100,000 / 2,500 = 40 drill bits | 100,000 / 5,000 = 20 drill bits |
| Total Cost to Customer using price of Company A offering | 40 X 10,000 = \$400,000         | 20 X ?                          |

If Company B estimates different price points for their offering, total cost to AcmeCorp will vary as shown in Table 6.

**TABLE 6.ACMECORP EXAMPLE COMPANY B PRICE SCENARIOS**

|                          | Case 1    | Case 2    | Case 3    | Case 4    |
|--------------------------|-----------|-----------|-----------|-----------|
| Estimated Price          | \$20,000  | \$18,000  | \$15,000  | \$10,000  |
| Total Cost to AcmeCorp   | \$400,000 | \$360,000 | \$300,000 | \$200,000 |
| Cost Saving for AcmeCorp | 0         | \$40,000  | \$100,000 | \$200,000 |

### Step 3: Document Value Drivers

This step involves documenting use cases and examples which show the ROI results of a specific value driver or benefit. These use cases can be either customer dependent or product dependent like a proprietary product.

It is important to use published tools such as Economic Value to the Customer (EVC) when it comes to documenting and illustrating the process and results.

#### AcmeCorp Example

Let's calculate total costs to AcmeCorp and see how much cost savings result from choosing Company B's offering.

**TABLE 7.ACMECORP EXAMPLE COMPANY A/B PRICE COMPARISONS**

|                           | Company A   | Company B (Case 1) | Company B (Case 2) | Company B (Case 3) | Company B (Case 4) |
|---------------------------|-------------|--------------------|--------------------|--------------------|--------------------|
| Total Labor               | \$600,000   | \$500,000          | \$500,000          | \$500,000          | \$500,000          |
| Purchase of Drill bits    | \$400,000   | \$400,000          | \$360,000          | \$300,000          | \$200,000          |
| Total Cost                | \$1,000,000 | \$900,000          | \$860,000          | \$800,000          | \$700,000          |
| Cost savings for AcmeCorp |             | \$100,000          | \$140,000          | \$200,000          | \$300,000          |
| Cost savings per unit     | \$0         | \$5,000            | \$7,000            | \$10,000           | \$15,000           |

Total cost savings for using Company B's offering ranges from \$100,000 to \$300,000.

Now let's return to consideration of EVC:

$$\text{EVC} = \text{competitors price} + \text{positive differentiation value} - \text{negative differentiation value}$$

Although Company B has higher manufacturing cost for their offering, this is not considered negative differentiation value as manufacturing costs are hidden to AcmeCorp.

**TABLE 8. ACMECORP EXAMPLE EVC-DRIVEN PRICING BY SCENARIO**

|   | EVC (Case 1) | EVC (Case 2) | EVC (Case 3) | EVC (Case 4) |
|---|--------------|--------------|--------------|--------------|
| Competitors Price                                     | \$10,000     | \$10,000     | \$10,000     | \$10,000     |
| Positive Differentiation Value (cost saving per unit) | \$5,000      | \$7,000      | \$10,000     | \$15,000     |

**Step 4: Communicate Value Drivers**

The final step of the Value-Based Process to develop the sales tools and the value selling approaches. The sales force needs to understand the value of the product and be able to communicate the benefits to the customer. The tools should focus on selling value, and not price. As mentioned earlier, the customer chooses a product/service for a reason. The sales force is required to understand the customer’s motivation in making a decision and the value drivers associated with that decision.

*AcmeCorp Example*

Communicate Company B’s value drivers to the sales force, explain how they are benefits to AcmeCorp, and how they can translate into cost savings and quicker ROI for AcmeCorp. Set pricing guidance rules based on the benefits of offering and communicate to sales force in the form of a policy. Don’t just offer one price, offer benchmarks the sales force can use. EVC per unit is a good baseline for pricing guidance benchmarks. Make sure the sales force understand the impact each price point has on company gross margin and customer value (cost savings).

**TABLE 9. PRICING POLICY FOR COMPANY B’S OFFERING TO ACMECORP**

|                           | Stretch Price  | Target Price  | Market Price  | Floor Price  | Match Comp   |
|---------------------------|--|---|---|--|--|
| Price (EVC)               | \$25,000   | \$20,000  | \$17,000  | \$15,000   | \$10,000   |
| Gross Margin to Company B | \$340,000  | \$240,000   | \$180,000   | \$140,000  | \$40,000   |
| Cost to AcmeCorp          | \$500,000  | \$400,000   | \$340,000   | \$300,000  | \$200,000  |
| Cost Savings to AcmeCorp  | \$0  | \$100,000   | \$160,000   | \$200,000  | \$300,000  |
| Notes to Sales Force      | <ul style="list-style-type: none"> <li>Company B has higher margin than Company A while selling half the number of units</li> <li>No cost saving to AcmeCorp, but holes are drilled 10 days earlier</li> </ul> | <ul style="list-style-type: none"> <li>Company B has higher margin than Company A while selling half the number of units</li> <li>AcmeCorp saves in cost and holes are drilled 10 days earlier</li> </ul> | <ul style="list-style-type: none"> <li>Company B has higher margin than Company A while selling half the number of units</li> <li>AcmeCorp saves in cost and holes are drilled 10 days earlier</li> </ul> | <ul style="list-style-type: none"> <li>Company B has lower margin than Company A but sells half the number of units</li> <li>AcmeCorp saves big in cost and holes are drilled 10 days earlier</li> </ul> | <ul style="list-style-type: none"> <li>Company B loses in margin but sells half the number of units</li> <li>AcmeCorp saves big in cost and holes are drilled 10 days earlier</li> </ul> |

# Conclusion

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Applying value-based pricing processes is an excellent way to increase profitability for the supplier and the buyer. Identifying and quantifying value drivers is critical for value-selling to the customer. Value drivers are defined from the customer's viewpoint. In other words, value perception is directly related to customer perception. To improve your customer's perception of your product/service, you need to focus on value, not on price.

When a company focuses on price:

- The customer perceives that the product/service may be questionable.
- The product/service features and drivers are questionable – possibly a lack of quality.
- The company is destroying their own value position through self-cannibalization.

When a company focuses on value:

- The customer chooses the product/service for a reason. This reason could be the value drivers most important to the customer.
- The company has a better understanding on their customer's motivation in making a decision, and the value drivers associated with that decision.

Price is the most effective way to pump more profit. Developing the right pricing processes is always a difficult task in any organization. Educating price stakeholders and gaining culture adoption are important parts of the value-based pricing adoption process. With the right sponsorship, and focus on customer value, a value-based pricing process will prove to be an effective tool for long-term profitability improvement.

The following references were used in preparing this paper:

- Steve Haggett (Philips Healthcare), An Evolution to Value-Based Pricing, keynote presentation at 2010 Professional Pricing Society annual conference
- Mike Calogridis (The Pricing Practice), Mastering the Three Attributes of Value Based Pricing, Powerpoint presentation

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**Ahmed Megahed** is a Manager of Pricing & Profitability Solutions at Wipro Technologies. He has a distinctive skill set revolving around Business/Marketing Strategy and Information Technology, including: innovative problem solving, best practices, proven leadership, account management, solid negotiation tactics, and exceptional communication with C-level executives.

Ahmed's depth of experience includes developing and documenting pricing and marketing strategies as well as business process improvements for major companies. Most recently, Ahmed is helping develop the Wipro's Pricing & Profitability Solutions practice for the Energy, Natural Resources, and Utilities sectors, managing the relationship with vendors and showing clients how to leverage pricing to increase profitability.

## About the Wipro Pricing and Profitability Practice

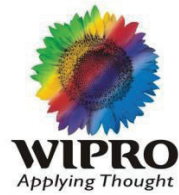
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With strong strategic alliances with the world's top pricing system vendors, Wipro's Pricing and Profitability Solutions Practice offers a beginning-to-end approach for all aspects of pricing improvement and management for profit growth. Our services include organizational readiness, process strategy, scientific analysis and optimization, technology selection, system integration/implementation, and change management. Our consultants and analysts help customers realize quick value, increase competitive advantage, and lower total cost of ownership through improvements in pricing strategies, processes, and technologies.

## About Wipro Technologies

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Wipro Technologies, the global IT business of Wipro Limited (NYSE:WIT) is a leading Information Technology, Consulting and Outsourcing company, that delivers solutions to enable its clients do business better. Wipro Technologies delivers winning business outcomes through its deep industry experience and a 360 degree view of "Business through Technology" – helping clients create successful and adaptive businesses. A company recognized globally for its comprehensive portfolio of services, a practitioner's approach to delivering innovation and an organization wide commitment to sustainability, Wipro Technologies has 120,000 employees and clients across 54 countries.



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