

# Value-Based Pricing Strategies in Retail: Effective or Not?

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## ABSTRACT

Customers are the key stakeholders for developing and running a successful business. From this perspective businesses must create positive perception in the eyes of their target customers. It is of key importance to create value proposition and the path for value creation can be very difficult. At the extreme, customers want great products with great quality for the lowest possible price. On a competitive market, it is the customer's value perception that will determine the sales volumes of the products and services and the ultimate success of businesses. For this reason, companies have to choose pricing strategies based on the customers perceptions of the value products will bring to them. This paper focuses on the question whether using more customer oriented pricing strategies, such as value-based pricing strategy, in light of its benefits and disadvantages, is effective or not, especially considering the fact that most companies still use cost based and competitive based pricing strategies. Will it be effective if companies base their pricing strategies on the perceived value by the customers or it will be ineffective?

Keywords (bold): pricing, value-based pricing, customer, efficiency, retail industry.

Three digit JEL classification code: D4, L81, L11.

## 1 Introduction

In today's market economy, companies have arisen to the point where they understand that generating profit is of an immense value rather than only focusing of increasing revenues. Companies have full-grown the concept that pricing has a crucial impact on profitability and are progressively accepting value-based pricing leading to increase of profits thus letting go on the cost based pricing. Price and costs are two highly adjustable elements of business and even the slightest changes to either of these parameters influence competitiveness, profitability and financial success. Value-based pricing is a promising pricing strategy that focuses on increasing margins and profits. Customer value based pricing is recognized as pricing strategy where in most of the cases both sides are satisfied, the company with its profitability improvement and the customer for the value and benefit of the products. The reason is that customer –value based strategy meets the needs of the customers and sets the prices into function of value. The question this paper examines is whether that is really effective or not? With all its elaborated positive aspects this pricing strategy plays minor role as a pricing strategy in terms of usage. The low adoption of customer value-based pricing approaches is surprising since marketing scholars as well as marketing practitioners nearly universally regard customer-value based approach as the superior approach to set new product prices or to adjust prices for existing products (Simon et al., 2003). The purpose of this paper

is to examine whether using value-based pricing strategy is efficient or not, taking into consideration its benefits and disadvantages. The following section of the paper presents the theoretical background for the study. The research methodology of the study is explained by presentation of the findings in regard to the implementation of different pricing strategies with focus on value based pricing. The findings of this paper will lead to new insights regarding the pricing strategies in the retail industry, especially in Macedonia as similar research has not been conducted in the industry.

## **2 Pricing Strategies and Their Implementation**

Eacotts (2012) states that a business might set or adjust prices when they start up, when introducing a new product or service, to achieve a new business objective or in response to changes in the market place or the general economic climate. Whatever the occasion setting prices for products or services is, possibly one of the most important business decisions one businesses can make. It does have a considerable impact on profitability and thus can be deceiving factor in the financial success or failure of your business. In relation to the above state, Roth (2007) has developed a precise targeting of the pricing needs that need to be made in order to adopt appropriate strategies. If the chosen strategy is contrary to the defined goals, then it is necessary to audit the entire marketing plan. Various pricing strategies can be used at different times in order to fit into changes that occur in marketing, market conditions and product life cycles. Roth (2007) defines the following top three mostly used strategies deriving from the objectives: Competition based pricing strategy is used in determining the prices of the company itself based on the prices competitors have for the same product, i.e. products. This strategy is very useful when it comes to mutually the same products. The goal of forming product prices is to enable businesses to maintain a sustainable market status or simply survive the difficult period, thus competitive prices will allow businesses to keep their profits by avoiding price wars (from competitive prices) or the fall in sales (from prices above the competition). Good, better and best pricing strategy is a kind of strategy that occurs when over time the image of the product gets a higher value, mostly in terms of packaging or sorting. This pricing strategy is great when the company seeks to maximize its revenue and maximize its goals quantitatively. Increase in income may arise as a result of a quantitative increase in sales. While the quantitative increase in sales comes from the price strategy itself, i.e. the supply of consumers to one good in three price levels. And the "Loss leader" pricing strategy which as a pricing strategy refers to the formation of low product prices in order to attract consumers and businesses to pursue their further bargains in the particular company. The strategy of prices "loss leader" should be related to maximizing the amount of sales or partly by reducing the costs that would restore the goals. Haller and Gersappe (2014) point when it comes to maximization of profitability and sustainable growth, while satisfying the needs of the customers new strategies had emerged which are cost-based pricing, competition-based pricing and value-based pricing. For decades, a widely accepted formula has ruled pricing strategy, the cost-based pricing strategy: determine a base cost, then apply a standard mark-up you think the market will bear. This "cost-plus" method is frequently inefficient because the price either ends up too high, which hurts sales, or too low, which leaves money on the table. Cost-plus models are becoming even less effective in a global economy where products are increasingly commoditized and prices are easily comparable as customers are well informed. Being aware of those disadvantages, companies were targeting pricing strategies that will focus on profits' increase in price value and that will justify the client's estimated value. One promising pricing strategy that focuses on developing such strategy is value-based pricing. Kühn and Pfäffli (2007) state that also, researchers and practitioners generally agree that "Value-based pricing leads to higher profits than cost or competition-

based pricing". In the following table are shown alternative approaches to pricing with focus on pointing out the advantages and disadvantages that they have in between.

**Table 1:** Alternative approaches to pricing

	<i>Cost-based Pricing</i>	<i>Competition-based pricing</i>	<i>Custom</i>
<i>Definition</i>	the company sets a price at a percentage above the cost it incurs to manufacture the product or to provide the service	the company is setting the price of a product or service based on what the competition is charging	the com the pote product bring to
<i>Examples</i>	cost-plus pricing, mark-up pricing, target-return pricing	parallel pricing, umbrella pricing, penetration/skim pricing, pricing according to average market prices	perceive perform
<i>Advantages</i>	easy calculable and makes sure all costs are covered	avoids price competition that can damage the company	gets ins the inte to prec custome willing product the idea
<i>Disadvantages</i>	ignores the price elasticity demand and ignores what competitors are charging	need to attract customers in other ways, since the price will not grab the customer's interest	this app to relativ it needs term p account value is needs commur
<i>Overview evaluation</i>	overall weakest approach	sub-optimal approach for setting prices	overall direct li needs

Source: Authors, with reference to [Hinterhuber](#) (2008, p. 4)

The literature review however shows that value-based approaches remain in a significant minority. As McCormick (2016) explains, that for example in the manufacturing the most popular pricing strategy used within is cost-based pricing. This type of pricing is used because it uses the manufacturing costs of the product as its basis for coming to the final selling price of the product - either a fixed amount or a percentage of the total product manufacturing cost is added as profit to the cost of the product to arrive at its selling price. The travel, hospitality, ecommerce and retail industry use dynamic pricing for natural increase of revenues but still allowing the businesses to set flexible prices for products or services based on current market demands. Dynamic pricing is a strategy that is taking place as well in the retail business. When it comes to the Macedonian retail market, as will be shown in the results discussion, cost-based pricing is widely used due to the specific dynamic of the market and the nature of the supply and demand. As McCormick (2016) points out, customer value-based strategies are used in the industries that claim necessity (pharmaceuticals), emotions (fashion), in niche markets, in shortages (e.g. drinks at open air festival on a hot summer day) or for indispensable add-ons (e.g. printer cartridges, headsets for mobile phones). Clearly, only a small minority of companies really accept and incorporate value-based pricing as practice though it is widely supported in the literature by academics and practitioners. The effectiveness or the opposite of this price strategy is a topic addressed in this study.

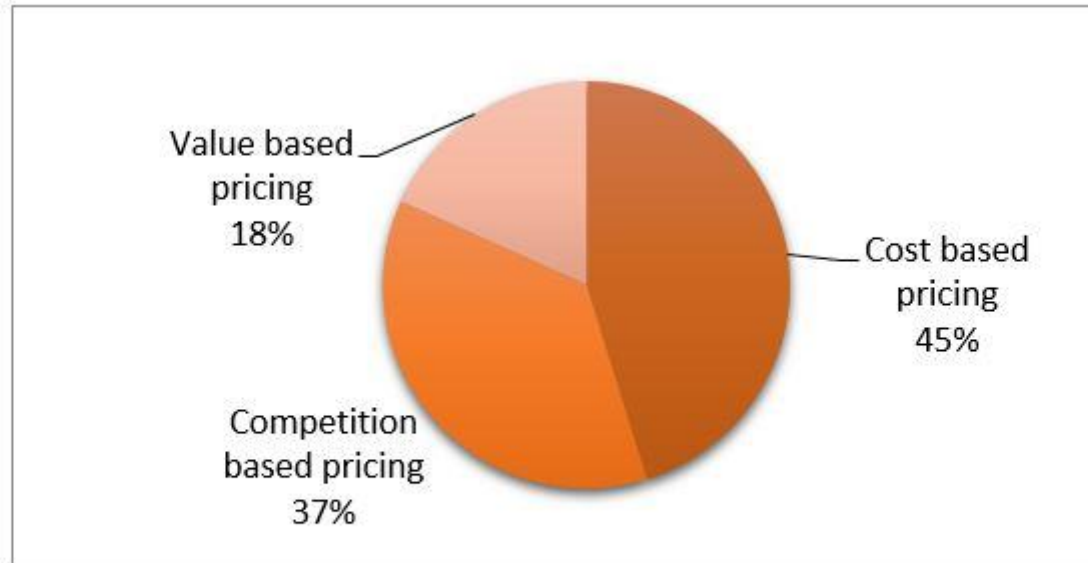
### **3 Research Methodology**

To investigate the key research question was conducted by quantitative approach via questionnaire in the period from December 2016 until April 2017. Quantitative approach (the questionnaires were delivered by e-mail) was used as it is more relevant and objective, and it provides possibility to use statistics for generalization of particular results. It decreases the complexity and restructures a complex problem for limited number of variables and causal effects can be shown in highly controlled conditions. The questionnaire was tailored according the circumstances and characteristics of doing business in Macedonia. The employees and managers in the commercial department of the biggest food retailer in Macedonia were selected to take part in this survey as in the retail industry in Macedonia they are setting the prices in accordance with corporate procedures. We also additional used a qualitative approach in the form of in-depth a structured interviews with 9 employees and 2 managers from the commercial department of the largest food retailer in Macedonia.

The questionnaire consisted of four groups of questions. The first group focused on the marketing mix of the company and the importance of the price as element of the marketing mix. The second group focused on the classification of the good assortment and its influence on the price strategy, and on the internal and external factors that influence pricing strategies of retail good. The third group of questions focused on the methods and tools used to identify competitive prices and pricing strategies and the fourth group of questions consisted of general questions.

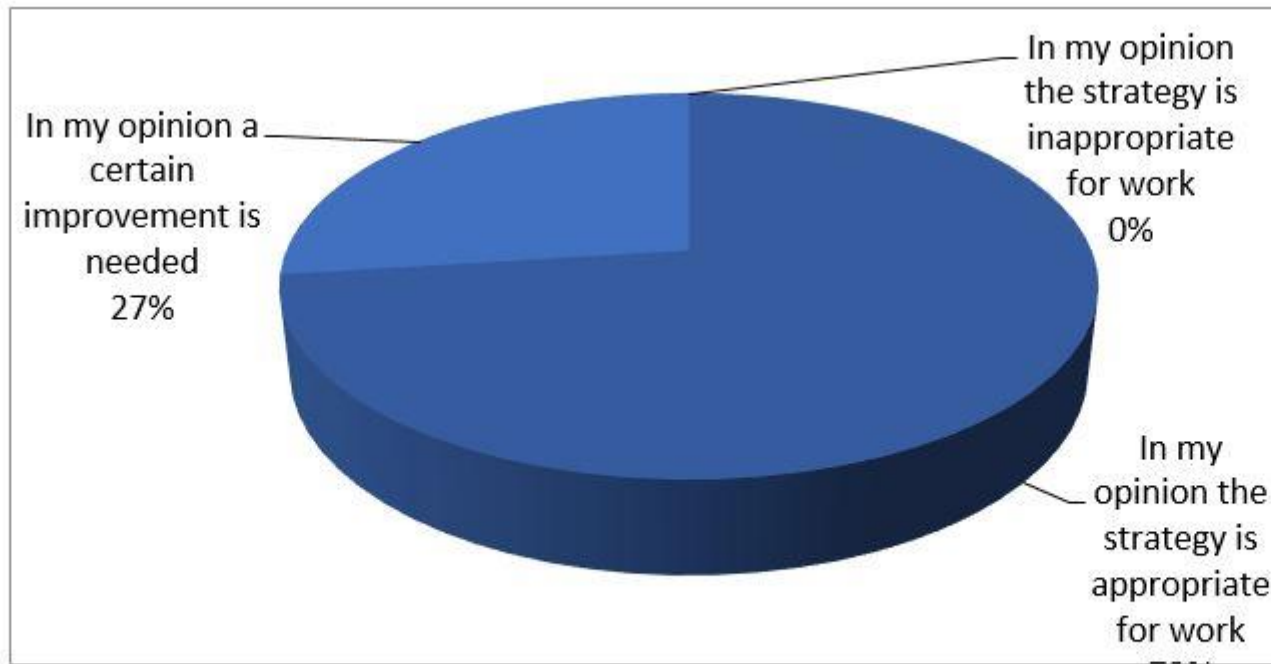
### **4 Results and Discussion**

In response to the questions regarding pricing strategies and implementation of value-based pricing, an extensive set of answers was received. To examine the most widely used pricing strategy in the supermarket that was part of this research a question was asked regarding the most commonly used pricing strategy (Graph 1).



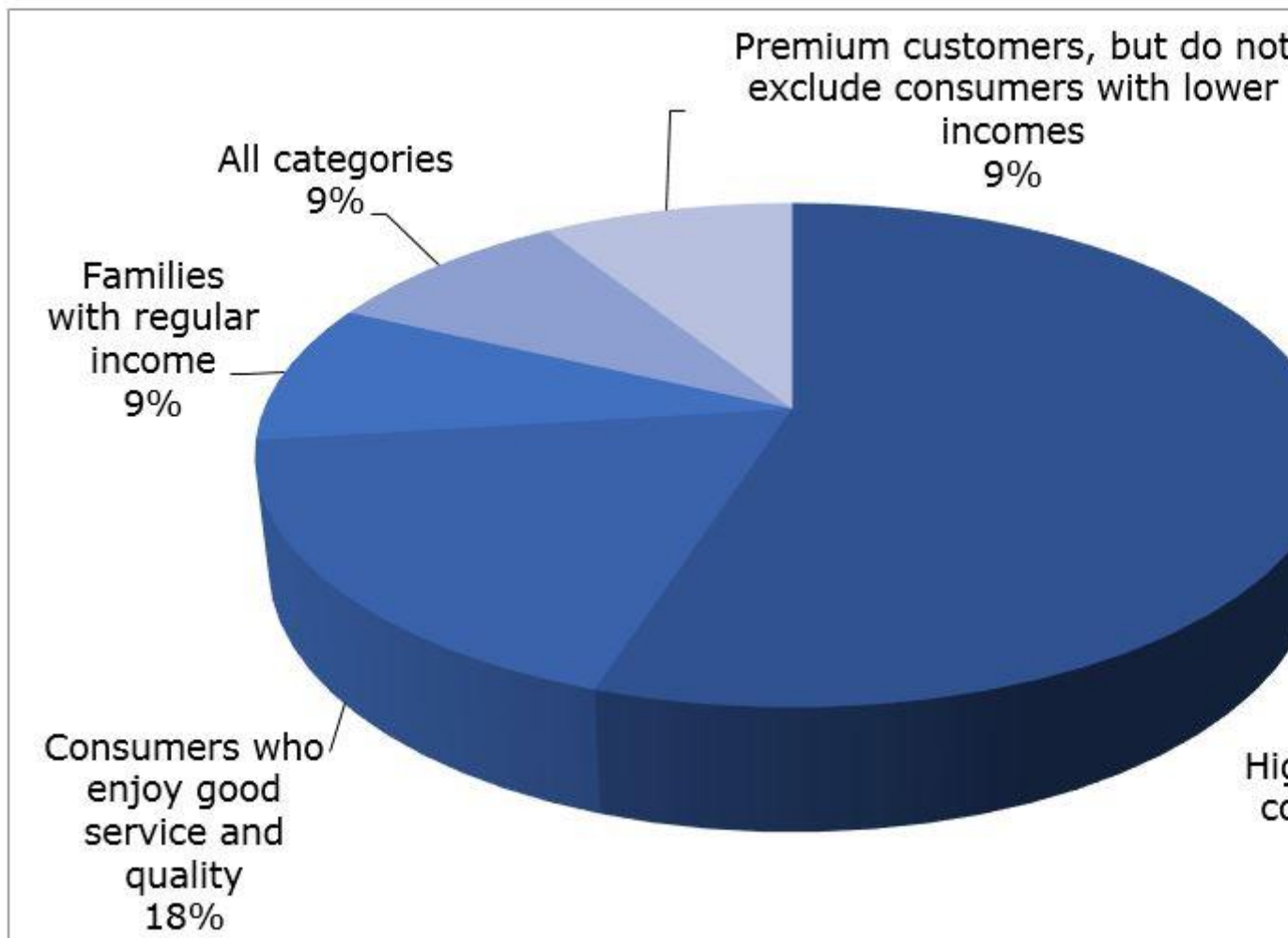
**Graph 1:** Which of the following pricing strategies are commonly used (Source: authors research)

From the presented data we are able to conclude that although customer-value based strategy is largely accepted and supported in the literature, in practice is implemented much less. Retailers in Macedonia with 45% are no exception to other companies in Macedonia that dominantly use cost based pricing strategies. Competitive based pricing strategies are as well largely used with 37% and value based strategies with moderate 18%, low percentage, but shows that companies in this case large retailer start to recognize that customer experience and customer value are important elements for brand differentiation. It is a clear sign that that they are slowly moving towards accepting and implementing this type of pricing strategy. This is also shown in the results of the question where the interviewed expressed their opinions whether the implemented strategy is appropriate or needs improvement (Graph 2). The results show that 27% of the respondents are aware that the employed pricing strategy needs to undergo some changes which supports the opinion that companies are making a step towards implementation of pricing strategies other than cost based as currently dominant. Nevertheless, still a large portion of the interviewed strongly support as an effective strategy the one that is already taking place, cost-based strategy with 73%. The logic behind strong implementation of this kind of strategy may be found in the major competitive advantages that this pricing strategy offers. As Locke (2014) explains, cost based pricing identifies the cost of the product, and adds mark-up that ensures margin and profit. If the company can ensure more efficient and productive operation with lower costs than it can either go for lower price and higher market share, or for the same price with higher margins and profitability.



**Graph 2:** Do you think that the most commonly used strategy is appropriate for your company or needs improvement? (Source: authors research)

When considering value based strategy it has to be planned in the larger framework of value based steering and customer centric marketing. The company in this case has to focus on the customers thus ensuring proper customer segmentation, brand positioning and long run value steering. (Graph 3) shows customer segments based on income and their readiness to buy the products at the retailer. The most common answer, more than a half of respondents believe their customers are high income customers and only 18% believe that are customers that enjoy and value good service and quality. However, Gilmore (1997) points out that new technologies create numerous opportunities for product and service customization, innovative marketing and communication approaches that can go in hand with value based pricing.



**Graph 3:** Who are the target consumers who are willing to pay for the premium products in your supermarkets? (Source: authors research)

Customers will always want off-the-shelf offers and mass communication. The challenge is to find balance between offering standardization and customization. At the end it is all about making the best value proposition for the customers. Taking into consideration the results from the conducted research, when considering value based pricing strategies for the premium customers we have to consider it in light of the other majority of customers as the supermarket is at the same time striving for higher sales, higher market share and at the same time higher profitability. There is a reason for a balanced approach. It would be ineffective to neglect the majority of customers and to use only value based pricing for one segment of the market. The results would not show beneficial neither in the short nor long term. That still does not exclude the possibility of implementation value based pricing strategies in the retail industry. It can be used for specific products with proper marketing communication. As Stiving (2017) states:

*“If you have tens of thousands of products to price, it is challenging to use value-based pricing on every one. Imagine you are pricing every item at a retailer or every item at a distributor. Pure value-based pricing it is not practical. However, in these situations we can and should use value-based pricing for portfolios of products. There may be brands or product lines where you have no competition. Those should have higher margins. The brands or product lines that attract new customers should have a very low margin. Even though you*

*are likely using a cost-plus pricing model, the plus shouldn't be identical for every product. The margin you can earn should be dependent on the product, the competition, the buyers and their buying process.”*

Ultimately, getting the fundamentals of service right is about prioritizing the business around what the customer prefers. Retailers that achieve this will have a significant opportunity to differentiate and distinguish value for their customers (Taylor, 2013).

## **5 Conclusion**

Taking into consideration the academic literature and the results from the conducted research, regarding the effectiveness of value based pricing strategies, it can be concluded that this pricing strategy can be used as part of a planned marketing approach considering target customers and product groups and supported with tailored marketing tools. Implementation of the value based pricing with elimination of the already used cost-based pricing will prove to be ineffective. Additionally, in retail it is more effective to use cost-based pricing versus competitive based pricing. On one side cost-based pricing can deliver appropriate margins and sustainable business, while competition- based pricing may lead to price wars as prices are driven more by the competitions' prices than by own costs and mark-ups. However, a competition monitoring and price strategy must not be neglected as competitors' moves must be followed and must be ready to react.

Finally, companies in the retail industry should continue with the cost-based pricing strategy, follow the competition and develop customer-value steering including pricing strategy, but for suitable products and/or services. By this, competitive differentiation can be achieved, at the same time starting long-term relations with the customers leading to higher levels of satisfaction and loyalty. Only those companies that truly understand their customers and their value for money perceptions can fully take advantage of this approach.

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