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How Companies Can Get Smart About Raising Prices

Marketers too often do precisely the wrong things, alienating customers and getting little return. Here's how they can do it right.

By KUSUM L. AILAWADI and PAUL W. FARRIS

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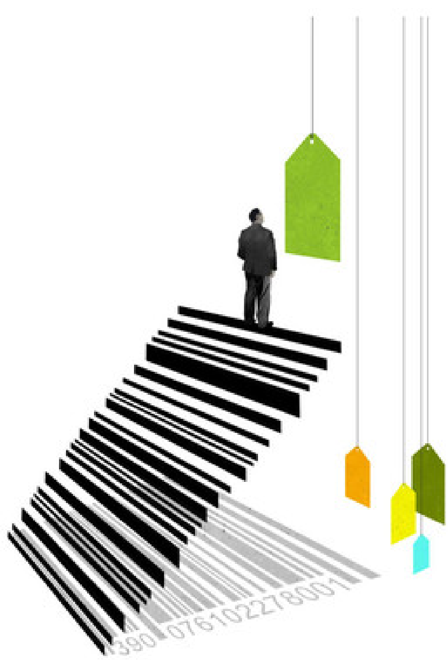
It's a question no company wants to face. Raise prices in the middle of a sluggish economy, and they risk alienating customers they can't afford to lose and leave themselves vulnerable to competitors.

Yet they have little choice but to ratchet up. The cost of making consumer goods and getting them to stores has been rising for some time. And a lot of the old strategies for shaving overhead, such as outsourcing, are getting less effective in economic terms and more unpopular in humanitarian terms.



Brian Stauffer

Passing along costs while keeping customers happy is a tough balancing act—but it can be done. Companies should resist the urge to cut promotions or camouflage price increases, which often backfire. Instead, they should focus on minimizing the pain for shoppers who are the most sensitive to price increase, by targeting discounts at them and offering different versions of their product at different price levels.

Here's a look at some things companies shouldn't do—but often do anyway—along with some smarter alternatives for raising prices.

The Big Mistake: Slashing Promotions

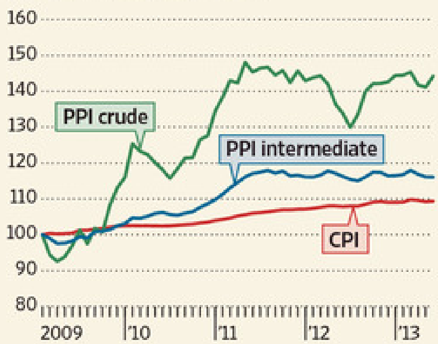
On the surface, it seems like a good idea. A higher price tag is obvious as soon as somebody picks up a product in a store. So, why not keep the price the same, and make a move that may not be noticed at all: pull back on coupons, special offers and other deals?

The trouble is, customers *do* pay attention. Our research shows that shoppers put much more weight on coupons, markdowns and other offers than even sophisticated companies realize.

In the early '90s, Procter & Gamble Co. cut promotions and coupons significantly. Our research showed this experiment misfired, and after a few years of share losses, the company restored promotions. More recently, there's J.C. Penney Co.'s failed strategy of cutting back on the frequency of sales; the company lost nearly $1 billion in 2012. (P&G and J.C. Penney declined to comment.)

Caught in a Squeeze

For many companies, costs—as reflected in two parts of the Producer Price Index, crude and intermediate materials—have risen faster than the prices they charge, as seen in the Consumer Price Index (Jan. 2009 = 100)



Source: Bureau of Labor Statistics

No, people often don't know the exact price they paid for something. But they have a very strong perception of whether something is a good value. And they base this judgment on how often a brand or store offers markdowns, promotions and coupons. Promotions also let companies hold on to customers who are on tight budgets and need the deals the most.

Let's say a food maker raises the price on a cereal but offers a coupon at the same time. Only people who are watching their pennies will take the trouble to clip the coupon and redeem it, while many others will simply pay the higher price.

So, the company is raising the *average* price consumers pay for their product—without driving away customers who might otherwise seek out a cheaper brand.

Along those lines, there's also an important psychological component to promotions. It takes a lot of work for people to clip coupons and mail in proofs of purchase. The effort involved makes deal-prone consumers feel like smart shoppers—and smart shoppers are happy shoppers.

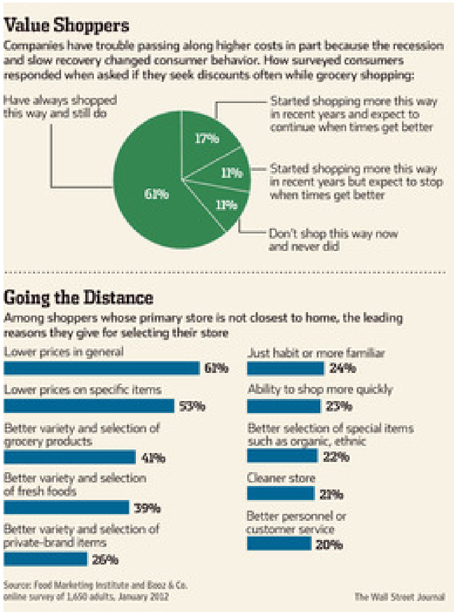
Cutting Quality Can Backfire

Sometimes companies try to cut costs by lowering the quality of their main product line. Or they keep quality high for their main brand and introduce a lower-price, lower-quality extension—called a fighter brand—to satisfy shoppers on the tightest budgets. Think Bounty Basic and Charmin Basic, which were rolled out a few years ago. Or, for a bit of ancient history, recall Kodak Funtime film.

But the move is likely to backfire. People may just buy the cheap brand instead, so sales of the regular brand will end up suffering.

Or the company may not make it clear that the fighter brand is a budget offering that doesn't have the same quality as the main brand. People may buy it, be disappointed and turn away from the whole product line.

Another move that usually backfires: cutting how much product people get in a similar-looking package while charging them the old price. A bottle of soda might shrink by a couple of ounces, or you might get four fewer cookies in a pack—so the price tag doesn't go up, but the price per unit goes up.



Why doesn't this approach work? For one thing, most of the cost of a typical packaged good is tied up in packaging, transportation and other aspects of production—not in the product itself. As a result, lowering the quantity is unlikely to preserve a company's margins.

Plus, when consumers discover that, say, the chocolate bar they just bought is smaller but the price is the same, the backlash can be costly and visible. People who feel that they're being cheated or tricked can be very angry customers—and these days, social media give them an easy way to publicly voice their anger.

Less *can* be more, but only if companies can position small packs as a virtue and charge a premium for them. Think 100-calorie Oreos or Marlboro Shorts, for instance.

Raising Prices Right

So, what's a more effective way to raise prices? Start off with basic considerations.

First off, unless you're an airline, you can't raise prices every day. So, when companies do make the move, they should cover not only the higher costs that they've incurred up to that point, but also costs they anticipate down the road.

Companies should also spell out, as much as possible, what's behind the increase. They should tell customers *why* the price is going up, whether it's higher costs for ingredients or soaring transportation costs.

Research shows that consumers respond not just to the price level but to how fair they think it is. If they think that a price increase is tied to profit-taking or to other hidden motives, they'll consider it unfair. They are more likely to accept the increase if it's tied to higher costs, such as a fuel-price surcharge.

It's also important to consider *which* products get a price increase. Think about this: If a food company has vegetables and ice cream in its stable of products, which one should get a price increase?

The ice cream. Everyone, even people who are financially strapped, needs staples, so it's important not to price them out of reach. On the other hand, indulgences like ice cream, cookies and cosmetics are discretionary purchases, so people tend to be less price-sensitive when they buy them.

Wait for an Opening

Another important consideration: timing. It's better to raise prices when introducing a new product, for instance. New products are usually improvements, and new features can justify new prices.

Timing also involves keeping a close eye on the competition. Price increases can turn into a standoff—with nobody wanting to make the first move, even if all of the companies in a market are facing the same cost pressures.

Rather than wait to see who blinks first, the market leader should lead at the appropriate time and give rivals a chance to raise their own prices and follow along.

Likewise, companies that don't dominate the market should follow the market leader quickly, unless they're not facing the same cost increases as the leader or if they're prepared to see their profit margins shrink for strategic reasons. It's going to be their best chance to raise their prices and cover their costs.

Keep the Deals Coming

After raising prices, companies should rely on discounting to keep their coupon-clipping customers—the ones most likely to jump ship if they think they're getting a bad deal. That means taking a close look at who their customers are and who should get what promotions. Think about the coupons that are printed on your receipt at the checkout line and how they're tailored to what you just bought and what you've bought before.

There are a number of ways to tackle the job of targeting deals. Companies can start online communities to take the pulse of their customer base and work with stores to get access to the data they collect at checkout. They can drill down pretty far into that information, targeting unique deals to individual shoppers, but that can get expensive and isn't even necessary. It's enough to group customers into segments based on things like their purchase history and how sensitive they are to price.

When evaluating the success of these plans, though, companies should be sure that they look at the right metrics. They should remember the bigger point of offering promotions: holding on to their most price-sensitive consumers by allowing them to use the discount, while letting others pay full price so that the average price paid for products goes up.

Percentage of sales with a discount and coupon redemption rates do not measure success. Customer retention, incremental sales, and incremental profit are much better measures, even if tougher to assess.

Give Them Good, Better and Best

Instead of coming up with low-quality fighter brands, companies should "unbundle" the features of their products and let customers pay for the extras they want.

For instance, companies might take their core product, remove the bells and whistles and lower the price. Call that the "good" version. Then they might add a pricier "better" version that has extras and a "best" option fully loaded with features at an even higher price.

Consider Apple's iPad Mini, which ranges in price from $329 to more than $659, depending on how much connectivity and memory people want. The $329 iPad Mini isn't low quality by any means—it works fine for people who just want a machine for browsing and don't need to save a lot of files.

This strategy works in a couple of ways.

First, a bare-bones "good" version becomes a competitive option for price-sensitive consumers who might otherwise choose a cheap product from a rival. Let's say that a shopper is prepared to spend $250 or so on a Kindle Fire. If there's a $329 iPad out there, it isn't hard to convince them to make the switch.

Likewise, people who were interested in a company's product in the first place may trade up to a more expensive version because of context effects—which basically means changing your preference based on what else is on the shelf.

If somebody is planning to buy an iPad Mini and the only choices are a $329 and a $659 model, they are less likely to leap to the higher price. But, if there is an intermediate "better" option at $459, it looks like a reasonable compromise.

Companies should be sure that "better" products have attractive margins, though, since an array of good, better and best products favors the compromise option in the middle.

Make Products Look More Valuable

Finally, it's important for companies to make their products seem more valuable, so price increases will go down easier with shoppers.

Consumers form ideas about what a company usually charges and what the product is worth compared with competitors—a concept called the reference price. They judge the value of a product based on the difference between what is being charged and the reference price in their head. One way to boost that reference price: put together packages of goods.

Let's say a company makes skin-care and beauty products. It can put a bunch of those items into the same box, call it a "home spa package" and sell it at a premium. The idea is to get customers to compare the price to a day at a spa—the reference price for the product goes up, in comparison to which the package is a much better deal.

Likewise, companies might package a number of foods together into a complete family meal that supermarkets can sell in their deli section. Encouraging customers to compare the price to dinner at a restaurant or takeout raises their reference price—and therefore raises the perceived value of the packaged meal.

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