

Internet Pricing

A Creator of Value – Not a Destroyer

McKinsey
Marketing
Practice

Overview

As e-businesses struggle to become profitable, improved pricing represents a large and thus far untapped opportunity. Rather than pushing prices universally downward and squeezing margins, the Internet provides unique opportunities in pricing to enhance margins and generate growth.

Our research shows that there are three ways in which marketers can profit from the flexibility of e-pricing:

- **Precision in price levels and price communication** – The payoff is enormous for companies that can identify the range of possible prices within which customers are indifferent to increases or decreases.
- **Time adaptiveness in response to market changes** – Online pricing is adaptable, and allows companies to make swift adjustments in response to market conditions.
- **Segmentation of prices** – Online companies can use multiple sources of customer information to determine a customer's appropriate segment and set prices accordingly.

In order to execute an online pricing strategy that takes advantage of these opportunities, marketers must:

- **Identify degrees of freedom consistent with strategy and brand** – Choose e-pricing approaches that do not conflict with key strategic objectives, core business principles, or brand promise.
 - **Build appropriate technological capabilities** – Pursuing e-pricing opportunities does not necessarily require huge systems investments.
 - **Build an experimenting and nimble pricing organization** – Online realities require constant tests to find opportunities, and also require an empowered and responsive pricing organization.
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Contrary to conventional wisdom, the Internet offers tremendous advantages to companies that use its capabilities to set and manage prices more astutely for their products and services. These advantages far outweigh what is possible offline and permit a more precise and timely alignment of price with customer value, competitive actions, and market conditions.

Indeed, evidence is building that rather than pushing prices universally downward and squeezing margins, the Internet provides unique opportunities in pricing to enhance margins and generate growth. To capture that advantage, companies must understand that there's often a big difference between what consumers say and what they do (see Table 1). For example, 75 percent of respondents in an Ernst & Young survey identified low price as an important driver of their online shopping, contrasted to 50 percent for convenience and 48 percent for selection. Low price was identified by a similar margin in a joint Jupiter Communications/NFO Worldwide survey.

Behavioral research suggests, however, that neither individual consumers nor businesses are overly aggressive online price shoppers. We analyzed actual online behavior using a sample of the most active online consumers among the Media Metrix U.S. panel of 50,000 people under measurement. We found that:

- Eighty-nine percent of online book buyers purchase from the first site they visit, as do 84 percent of toy, 81 percent of music, and 76 percent of electronics buyers online.

- More than 29 percent of users are “Simplifiers,” looking more for the promise of superior “end-to-end” convenience rather than price.
- The 36 percent who use the Internet primarily to connect with friends and family generally default to their offline brand preferences if they do buy online.
- Only 8 percent of users are “Bargainers,” finding entertainment value by aggressively searching for the best deals online.

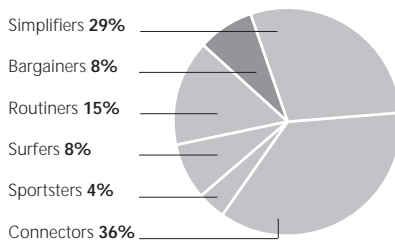
Furthermore, low-priced competitors online seldom command greater market share. Between 1997 and 1999, for example, market leaders Amazon.com and Barnes & Noble raised online book prices by 8 and 7 percent, respectively, while discount competitor Books-A-Million lowered prices by 30 percent. Even with the proliferation of shopping bots, Amazon’s market share increased from 64 to 72 percent and Barnes & Noble’s from 12 to 15 percent.

In online B2B markets, too, factors other than price are driving most buyers’ choices. In a McKinsey & Company study, only 30 percent of purchasing managers identified lower prices as the key benefit of buying online; instead, others cited reduced transaction costs and increased access to more products and suppliers. Indeed, most B2B buyers expect lower purchasing costs to be driven by lower processing and search costs – less time required for paperwork, and automated

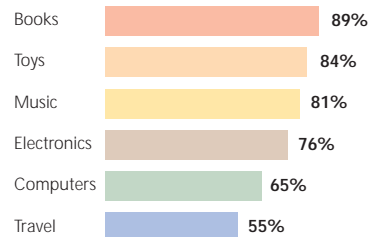
Table 1 **Actual Consumer “Clickstream” Behavior**

Few are active price shoppers

Online consumer segmentation*



Most visit only 1 site prior to purchase



*For a more detailed discussion of online consumer segmentation see “All Visitors Are Not Created Equal,” *McKinsey Marketing Solutions*, April 2000

purchasing information that lets them track their inventory and make better purchasing decisions. When asked where they expect price savings to come from, only 14 percent of buyers indicated lower supplier profit margins, explicitly recognizing that both buyers and suppliers should benefit from reduced transaction costs.

That is not to suggest that B2B e-commerce is free of price pressure. Companies buying through reverse auctions, for example, have propelled supplier prices down by as much as 30 percent – obviously cutting into their suppliers' profit margins. But the price pressure exerted even there is limited; 50 percent of companies buying through reverse auctions choose suppliers other than those with the lowest bid, and 87 percent stay with their incumbents even if the incumbents do not offer the lowest price. And given that reverse auctions are applicable only in unconcentrated industries where there are many capable suppliers and where buying attributes are functional and easily specified, it is not surprising that only 15 percent of companies have tried reverse auctions. And it is notable that only 2 percent actually prefer reverse auctions and only 3 percent intend to continue using them in the coming year.

What are the implications for e-commerce? Companies have much more flexibility than most have believed to manage prices aggressively as part of a thoughtful e-pricing strategy. And given the fact that a typical company's operating profit can surge by nearly 17 percent from just a 2 percent improvement in price levels,¹ those companies who understand and wisely use the pricing flexibility afforded by the Internet will emerge among the winners in e-commerce.

Three ways to profit from the flexibility of e-pricing

Of course, it is critical that prices both online and offline be set relative to competition to meet strategic volume and profit objectives. At both the strategic and tactical levels, the Internet allows companies to improve their pricing along three dimensions that are not as readily available offline (see Table 2).

1. Precision in price levels and price communication. The payoff is enormous for companies that can more precisely identify a product's

pricing indifference band – that is, the range of possible prices within which customers are indifferent to increases or decreases. Companies can profit by moving toward the top of even very narrow indifference bands. We have seen, for example, 17 percent for a branded consumer product, 10 percent for engineered industrial components, and 8 percent for a financial deposit product. A financial services company that moves from the middle to the top of a 2 percent indifference band for personal loan products would generate an 11 percent improvement in operating profit for those products.

Determining the indifference band for offline businesses requires market research that is usually so time consuming, expensive, and unreliable that fewer than 25 percent of companies have ever attempted it. Such research is quite straightforward online – relatively inexpensive to set up and simple to monitor. Companies can conduct virtually continuous price sensitivity testing with ease and precision – for example, offering every 50th customer a different price and then statistically extrapolating their response. These same tests can also be used to accurately predict volume fluctuations that result from price increases and decreases *outside* the indifference band as well.

Different forms of price communication can be tested in much the same way. FairMarket, for example, which sets up auctions and automated pricing technology on customer Web sites, frequently runs tests to determine how information around price affects consumer choice. For clearance items, they observed a faster sales rate and higher price realization when consumers were shown scheduled price reductions. However, customers shown the available quantity were more likely to delay their purchases to wait for the scheduled price reductions. Continual testing of Internet pricing approaches provides a low-risk way for companies to develop very practical “do’s and don’ts” for pricing.

2. Time adaptiveness in response to market changes. Price changes offline can be inflexible. In B2B markets it can take several months to a year to communicate to distributors, to print and distribute pricing sheets, and to implement system changes. In B2C markets, prices like those pre-printed on concert tickets are set far in advance of an

Table 2 **Choose the Dimensions for Internet Price Improvement**

	Source of value from the Internet	Conditions for selection	B2C examples	B2B examples
Precision	<ul style="list-style-type: none"> Greater precision in setting optimal price Better understanding of zone of price indifference More precise communications to influence customer price perception and choice 	<ul style="list-style-type: none"> Sufficient transaction volume to allow statistically significant testing (>200 transactions) 	<ul style="list-style-type: none"> Toys Books CDs 	<ul style="list-style-type: none"> MRO (Maintenance, Repair, and Operating) Products
Time adaptability	<ul style="list-style-type: none"> Speed of price change Ease of response to external "shocks" to the system (e.g., cost/competitive changes) 	<ul style="list-style-type: none"> Inventory/capacity is perishable Demand fluctuates over time 	<ul style="list-style-type: none"> Consumer electronics 	<ul style="list-style-type: none"> Chemicals Raw materials
Segmentation	<ul style="list-style-type: none"> Ability to choose creative, accurate segmentation dimensions Ease of identifying which segment a buyer belongs to Ability to create "barriers" between segments 	<ul style="list-style-type: none"> Buyers differ based on: <ul style="list-style-type: none"> – Profitability – Value received 	<ul style="list-style-type: none"> Credit cards Mortgages Automobiles 	<ul style="list-style-type: none"> Industrial components Business services

event, with no opportunity for later recalibration. Online pricing is far more adaptable, allowing companies to make adjustments in a fraction of the time and to profit from even small fluctuations in market conditions, customer demand, and competitor behavior. Tickets.com, for example, has been able to generate up to 45 percent higher revenue per event by dynamically adjusting concert ticket prices based on supply and demand.

Internet market dynamics and pricing flexibility create an imperative for companies to have both a timely and correct read of their industry's supply/demand balance and a mechanism to respond. For example, when products are in great demand – as measured by capacity utilization, order lead time, or inventory levels – prices might be temporarily raised. When demand lags, a company might experiment with lower prices, auctions, or targeted short-term promotions. The ability to react quickly and decisively is key. It is estimated that one supplier in the electronics industry realized a \$25 million profit gain by adjusting prices faster than other players after earthquakes in Taiwan caused temporary shortages and higher costs for a key component.

3. Segmentation of prices. It is commonly understood that because different consumers value a product's benefits differently, some segments of consumers are willing to pay more for a product than others. Differentiating price to target various groups is difficult offline because visitors to a physical store are a statistical mystery; companies have no idea what their buying histories are – or what combination of price and benefits would trigger a purchase. Online, companies can use multiple sources of customer information to help determine a customer's appropriate segment (e.g., from clickstream information about the customer's current online session or from customer buying histories tracked in data bases or stored in “cookies” created on customers' computers).

Once an online customer's segment is identified, a segment-specific price or promotion can be offered immediately. Ford, for example, expects online customer information to significantly improve the yield from the nearly \$10 billion it spends annually on promotional pricing. Historical efforts, such as discount financing and cash back, have been broadly offered to all customers over a given period of time. The Internet will enable Ford to track individual customer history and behavior and to more finely target tailored promotions at specific customers.

Executing strategic online pricing

How does a company determine and execute an online pricing strategy that fully exploits the opportunities which pricing precision,

timing, and segmentation afford? Below three important steps to success are discussed.

Identify degrees of freedom consistent with strategy and brand.

With all the pricing flexibility the Internet allows, companies must choose e-pricing approaches that do not inadvertently conflict with their key strategic objectives, core business principles, or brand promise. For instance, although online price sensitivity research might suggest that lowering the price for a new product would profitably increase near-term volume, that price cut might not make sense if a company were trying to position the item long term as a higher-benefit, higher-priced product. Similarly, a retailer might not be comfortable pursuing a strategy where widely different prices were offered to different consumers if that strategy would violate a desired image of consistency and trust. But a bank might decide to aggressively “price segment” online because consumers understand and accept that more profitable, more loyal, higher-asset customers justifiably receive better interest rates on loans.

Build appropriate technological capabilities. Pursuing e-pricing opportunities does not necessarily require huge systems investments. Even rudimentary tracking and testing initiatives can be well worth the effort, providing a strong foundation for more sophisticated systems, if required, later on. The key is to use limited “tests” of alternative price levels, structures, and price communication to see what level of granularity along the three dimensions is worth pursuing. On the time adaptability dimension, for example, a financial services company may realize tremendous value by changing interest rates hourly, which would require a fairly automated price analysis system. But an industrial manufacturer may find that bimonthly, rather than annual, price changes are sufficient – obviously requiring less sophisticated systems to identify peaks and valleys of supply and demand.

In most situations, there are clear, inexpensive, “no regrets” pricing technology steps, like using competitive price tracking “bots” to monitor competitive prices or employing online surveys to track overall customer price perception. One consumer electronics retailer, for example, used its simple ongoing Web-based survey to help determine the appropriate pricing strategy in response to the proliferation of

pure-play online retailers selling the same products at or below cost. To the managers' surprise, only 5 percent of nonbuyers cited lower prices as their primary reason for buying from a competitor. The retailer decided not to respond to competitors with lower across-the-board prices, which proved to be correct; in a matter of months, several competitors had either gone out of business or announced that they were raising prices.

Build an experimenting and nimble pricing organization. Online markets are extremely dynamic, with customer segments growing and evolving as the Internet matures and competitive environments respond. These online realities require a pricing organization that constantly probes and tests the Internet landscape for pricing precision, timing, and segmentation opportunities. They require an empowered and responsive pricing organization with the organizational seniority and decision-making authority to capitalize on what are typically fleeting opportunities. As one McKinsey survey confirms, the most effective pricers in e-business are the companies with the ability to move more quickly than their competition.

As e-businesses – both pure Internet plays and traditional offline companies venturing onto the Internet – struggle to become profitable, improved pricing represents a large and thus far untapped opportunity. Indeed, few e-businesses have even begun to explore the opportunities available through pricing precision, timing, and segmentation. Getting pricing right and taking full advantage of the unique opportunities afforded by the Internet is emerging as one of the ultimate keys to e-business success.

¹ For a more detailed discussion of this concept, see Michael V. Marn and Robert L. Rosiello, "Managing Price, Gaining Profit," *Harvard Business Review*, September–October 1992, pp. 85–94.

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