

**WILEY FINANCE**

# THE PRICE ADVANTAGE

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SECOND EDITION

Praise for

# THE PRICE ADVANTAGE

## SECOND EDITION

"This book is a treasure—a practical yet intellectually sound guide to pricing that is applicable to both large and small companies. Frankly, in all my years writing about economics and covering corporate decision making, I have not seen pricing strategy and tactics explained so clearly as in this book."

—Michael Mandel, former chief economist, *BusinessWeek*,  
and Editor-in-Chief, Visible Economy LLC

"This book is both insightful and practical. Many companies overlook the substantial profit opportunities from smart pricing. The authors show you not only where to look for, but also how to capture and sustain those opportunities."

—James M. Kilts, former chairman and CEO, The Gillette Company

"*The Price Advantage* is very straightforward and direct, with concise and easily applied coverage of each and every topic."

—David J. Reibstein, Marketing Professor, The Wharton School

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The *Second Edition of The Price Advantage*, written by three preeminent experts at McKinsey & Company, is the most pragmatic and insightful book on pricing available.

Based on in-depth, firsthand experience with hundreds of companies, as well as significant investments in new pricing research, this book is designed to be a comprehensive guide for managers through the maze of pricing issues.

The authors examine state-of-the-art approaches for analyzing and improving pricing performance, demonstrate those approaches with real case studies, and draw a pricing excellence blueprint for companies to follow. In good economic times or bad, achieving the price advantage is critical to corporate performance and profitability.

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# Preface

**A**s we approached the task of writing this second edition of *The Price Advantage*, we revisited a few basic questions—questions that our readers might have as well. Why a book on pricing? Why a book by McKinsey & Company? And finally, why a second edition now? Let us begin by addressing these basic questions.

## **WHY A BOOK ON PRICING?**

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Pricing, although one of the most critical management functions, remains one of the most misunderstood and undermanaged functions at many companies that are otherwise high performers. Pricing is far and away the most sensitive profit lever that managers can influence. Small changes in average price translate into huge changes in operating profit.

Although more companies have made gains in pricing in recent years, too few businesses have successfully tapped into the full potential that improved pricing holds. Even thoughtful general managers often feel helpless to make real progress on the pricing front. Many managers do not know where to begin to get a handle on identifying the exciting performance upside that pricing so often holds. And those who identify this upside struggle to really capture and sustain it.

This book is not designed to be an exhaustive review of the considerable body of pricing theory that has accumulated over the years. To the contrary, it has been written as a practical pricing guide for that thoughtful general manager who has been tempted by the unrealized promise of improved pricing and, perhaps, frustrated by attempts to translate pricing theory into bottom-line impact for his or her business. It is intended to provide a logical and structured approach for identifying where the most precious sources of untapped pricing opportunity reside in a business, along with practical, case-illustrated guidance on how to capture and sustain that opportunity.

## **WHY A BOOK BY MCKINSEY ON PRICING?**

Over the past 20 years, pricing has become one of the most frequent areas in which we have helped businesses across every continent (except Antarctica!) to improve their performance. These companies represent a rich and diverse range of industries, including industrial goods, consumer packaged goods, consumer durables, banking, telecommunications, chemicals, retailing, high-tech products, basic materials, insurance, pharmaceuticals, and transportation. To support our service to clients, McKinsey has invested more than \$25 million in developing practical knowledge in pricing over the past five years alone. We are credited with having developed and advanced a majority of the most useful contemporary pricing frameworks—the pocket price waterfall and the value map are just two examples.

## **WHY A SECOND EDITION NOW?**

Since the first edition of *The Price Advantage* was published five years ago, much has changed. First, our knowledge has advanced significantly in a number of areas—areas of growing currency and relevance that were not included in the original edition. A new chapter is devoted to the topic of managing price wisely over the course of a product’s lifecycle. In an ever-growing number of product categories, for example, high-tech products, consumer durables, and medical devices, product lifecycles are compressing, which makes this a topic of broad application and significance.

Included in this edition is an entirely new part titled “Advanced Topics,” which were not covered in depth in the first edition. This includes Chapter 12, “Complexity Management,” which addresses issues that complicate the pricing challenge, including the complexity of pricing custom-configured products, pricing when the number of individual products sold is extremely high, and pricing through a large and distributed sales force. Chapter 13, “Tailored Value,” explores issues around tailoring value to specific customers and markets, including segmenting price, pricing product line tiers, dealing with “razor/razor blades” offerings, and pricing new products and integrated solutions. Chapters 12 and 13 contain sections of information that do not apply to each and every business; but when they do apply, we have found that they are often central to a company’s realization of *the price advantage*. Chapter 14 “Software and Information Products,” is also new and discusses how to tackle the unique challenges of pricing software and information-based products.

Second, the legal landscape has also continued to evolve since we wrote the first edition. The United States' pricing rules have evolved and enforcement has been generally more aggressive. EU pricing law and enforcement has moved closer to and, in some cases, surpassed that of the United States in severity. Likewise, pricing and antitrust law in many Asia-Pacific countries is gradually becoming more strictly defined and aggressively enforced. Chapter 9, "Legal Degrees of Freedom," has been updated to reflect the changing degrees of legal freedom that companies must operate within today. Furthermore, we have updated language throughout this second edition to avoid pricing wording and phrasing that might be more likely to raise legal red flags in the current legal environment.

Finally, we have heard from businesses around the world asking for more details on how to build a sustainable capability in pricing; that is, what does a high-performing pricing infrastructure look like today and how do you best move an organization in that direction. Our overarching framework, "The Three Levels of Price Management" from the first edition, has been extended to include a cross-cutting pricing infrastructure level; Chapter 6, "Pricing Infrastructure," is completely new and dedicated to issues of pricing infrastructure—where we have synthesized our experience in helping companies build high-performing organizations, processes, and tools. So, as we mentioned above, much has changed since we published the first edition back in 2004—so much that we deemed the writing of the second edition of *The Price Advantage* timely and warranted.

## **STRUCTURE OF THE BOOK**

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This book is organized into six main sections. Part One describes *the price advantage* and explains why it is worthwhile for businesses to pursue that rare but valuable advantage. It then lays out our overarching framework for identifying and ultimately capturing pricing opportunity. This framework, the three levels of price management plus pricing infrastructure, provides the integrating thread that weaves through the book and is applicable to most business situations.

Part Two explores each of these three levels plus pricing infrastructure in considerable detail. Part Three addresses unique pricing events that almost any company might have to face on an occasional basis. Part Four explores some of the boundaries of *the price advantage*—boundaries that may affect a company's degrees of pricing freedom and boundaries that companies can expand to find opportunities beyond the fundamentals covered in Parts One and Two. Part Five covers a variety of advanced topics,

as mentioned earlier. Part Six is devoted to the practical enablers and constraints to making enduring and positive pricing change happen, including a detailed case study and some final thoughts. In addition, the Appendixes are designed to provide some useful examples of the application of core frameworks discussed in the book, an overview of key points in pricing law, a list of acronyms and abbreviations, and instructions for accessing a functional demo of *Periscope*, a web-based pricing tool that has been loaded with realistic transaction data for a hypothetical company. This book contains a number of disguised cases to illustrate pricing concepts, frameworks, and insights. These cases are rooted in McKinsey's extensive client work in pricing, and client identities are heavily disguised to assure protection of confidential client information and strategies. The location and nature of opportunities identified are consistent with the underlying cases, and the magnitude of improvements shown by these examples is real.

Unless otherwise noted, when we talk about a company's "product," we are referring to that company's comprehensive product, service, and support offering to customers. This convention allows for more economical word usage throughout the book.