Pricing, Competition and Customer Strategy

Interview preparation summary · SC track

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INT.KG.1.a · Pricing

Choose between cost-plus, value-based and competitor-based pricing for a given product, and set a defensible price range between the cost floor and the customer value ceiling.

There are three starting points for a price. Cost-plus adds a margin to unit cost: it is simple and defends a minimum, but it ignores what the customer will pay and can push prices up when volumes fall and unit costs rise. Competitor-based pricing positions against rivals' prices, which suits commodities where customers see no difference and the market sets the price. Value-based pricing starts from the customer: what is the next best alternative, how much better or worse is this product for the customer, and how much of that difference can we keep? Cost is the floor, the customer's value is the ceiling and the competitor's price is the reference between them. A strong answer sets all three on one line, then picks a price and shows the margin it leaves. Value-based pricing is best when the product is differentiated and the benefit can be measured in money. The usual mistakes are to stop at cost-plus, to match a rival whose product is different, or to give away all the customer's saving.

WORKED EXAMPLE: PRICING A VIBRATION SENSOR FOR HALDEN SENSORS

Halden Sensors, an invented maker of factory monitoring equipment, is launching a vibration sensor that costs £280 a unit to make. The usual alternative, a basic rival sensor, sells for £400. Over its life the Halden sensor saves a customer £300 of avoided downtime and £100 of calibration cost compared with the basic sensor, but a customer must spend about £100 on training and set-up. The firm's habit is a 30% mark-up on cost. What price would you set, and how does it compare with the cost-plus price and the rival price? Convention: per unit, over the product life, ignore discounting and tax.

Answer: Price at about £520: it sits between the 280 cost floor and the 700 value ceiling, gives the customer £180 of net benefit and earns £240 a unit, against £84 under cost-plus at £364.

> **Interview tip:** Say the three reference points in order (cost floor, competitor reference, customer value ceiling), then give a price inside the range and the share of the benefit you keep. Interviewers listen for the sentence 'cost sets the floor, value sets the ceiling'.

INT.KG.1.b · Pricing

Use price elasticity and the break-even volume change to judge whether a price rise or cut raises or lowers revenue and profit.

Price elasticity is the percentage change in volume divided by the percentage change in price, and it is normally negative. A figure between 0 and minus 1 (in size, below 1) means demand is inelastic: a rise in price increases revenue. Above 1 in size, demand is elastic and a rise cuts revenue. Revenue is the wrong target, though, because profit depends on contribution, which is price less variable cost, times volume. The cleaner test is the break-even volume change: the price change in pounds divided by the new unit contribution, which is the volume that can be lost before a rise stops paying, or the volume that must be gained before a cut pays. High-margin products need only a small gain to justify a cut and tolerate little loss on a rise; low-margin products are the reverse. Elasticity is estimated from past changes and varies by segment, over time and with the rival's response, so treat it as a range. Common mistakes are to confuse revenue with profit and to apply one elasticity to all customers.

WORKED EXAMPLE: A PRICE RISE AT BRINDLE BAKERY

Brindle Bakery, an invented regional chain, sells 100,000 loaves a week at £4.00 with a variable cost of £1.50. Past price changes suggest elasticity of minus 1.2. Management proposes a 5% rise to £4.20. What happens to weekly revenue and contribution, and how much volume could the bakery lose before the rise stops paying? Convention: elasticity treated as constant over this small change; fixed costs unchanged.

Answer: Revenue falls from 400,000 to £394,800 but contribution rises from 250,000 to £253,800. The rise pays as long as volume falls by less than 7.4%; the estimate is 6%.

Interview tip: Say that you would not judge a price change on revenue. Give the break-even volume loss first (price change ÷ new unit contribution), then compare it with the volume loss you expect.

INT.KG.1.c · Pricing

Explain how price discrimination, bundling, subscription and freemium models capture more value from different customers, and test each with simple numbers.

Customers differ in what they will pay, and one price leaves money on the table: some customers would have paid more, others do not buy at all. Price discrimination charges different customers different prices for the same or similar product, according to willingness to pay. It needs a way to tell the groups apart and a fence that stops the high-paying group buying the cheap version, such as timing, features, location or proof of status. Bundling sells products together at one price; it raises revenue when customers value the parts differently, one liking A and the other B, because valuations of the bundle become similar. A subscription turns a one-off sale into recurring revenue and its value depends on churn. Freemium gives a basic version away to build a base, and works only if enough users convert and free users cost little to serve. The checks are conversion, churn, cannibalisation and cost to serve. Common mistakes are ignoring cannibalisation and treating a free user as costless.

WORKED EXAMPLE: BUNDLING TWO MODULES AT QUILLON SOFTWARE

Quillon Software, an invented firm, sells two modules, X and Y, each at zero marginal cost. It has 1,000 customers of type A, who value X at 100 and Y at £40 a year, and 1,000 customers of type B, who value X at 60 and Y at £90. Each customer buys a module if its price is at or below their value. What is the best revenue from selling X and Y separately, and what could a bundle of both earn? Convention: one price per product, no discounts, all customers decide independently.

Answer: Separate pricing earns £210,000 (X at 60, Y at 90); a bundle at £140 earns £280,000, 70,000 more, because the two types value the parts in opposite order.

Interview tip: Show each price option as a table of who buys at what price, then compare the totals. Explain in a sentence why the bundle works (opposite preferences, low marginal cost) and when it would not.

INT.KG.2.a · Competition and customers

Segment customers by needs and behaviour, size the value of each segment, and shape a value proposition for the segments worth targeting.

Segmentation divides customers into groups that want different things and respond differently to an offer. The most useful segments are based on needs and behaviour, such as what the customer is trying to get done, how often they buy and how they choose, not just on age or location, which describe who customers are but not why they buy. A segment is worth targeting if it can be measured, reached through a channel, is large enough, and is profitable after the cost of winning and serving it. Compare segments on profit per customer, lifetime value (contribution per period divided by churn) and total profit pool, because the biggest segment by numbers is often not the most valuable. The value proposition then states, for the chosen segment, the benefit offered relative to alternatives and why the firm can deliver it. Trying to serve every segment with one offer usually serves none well. Common mistakes are segmenting by what is easy to measure and chasing the largest segment.

WORKED EXAMPLE: WHICH SEGMENT MATTERS AT CORRIN KITCHEN

Corrin Kitchen, an invented meal-kit service, has 40,000 customers in three segments. Busy families: 12,000 customers, contribution of £36 a month each, monthly churn of 3%. Young professionals: 20,000 customers, £18 a month, churn of 8%. Empty nesters: 8,000 customers, £22 a month, churn of 2%. Which segment is most valuable, and what does that imply for the proposition? Convention: contribution is after variable costs, lifetime value is monthly contribution ÷ monthly churn, undiscounted.

Answer: Families and empty nesters are the valuable segments (lifetime value 1,200 and £1,100) while the largest segment, young professionals, is worth only £225, so focus the proposition and the spend on the first two.

Interview tip: Compare segments on three numbers: share of customers, share of profit and lifetime value. Then state which segment you would target and what that segment needs, not just what it is worth.

INT.KG.2.b · Competition and customers

Predict how rivals will respond to a price move using simple game-theory logic, and choose between differentiation and cost leadership as a way to compete.

Strategy is a game: the payoff to a move depends on what rivals do. In a price war, each firm gains by cutting whatever the other does, but if both cut they are both worse off than if both had held, the shape of the prisoner's dilemma. To judge a cut, estimate the payoffs under each response and the likelihood of a match: cutting pays only if the chance of a match is low enough. Rivals are more likely to match when they have spare capacity, high fixed costs, share the same customers and can see the cut quickly. Repeated contact, price signalling and non-price moves can keep prices stable. Competing is a choice between cost leadership, a lower cost than anyone else so that the firm can profit at a price rivals cannot match, and differentiation, a product customers value enough to pay more for. Lowest price without lowest cost is a trap. A good answer tests the breakeven, names the likely response and proposes a move that does not start a war.

WORKED EXAMPLE: A PRICE CUT AT NORTHGATE STORES

Northgate and Eastmere are the only two supermarkets in a town. Monthly profits in millions are: both hold prices, 50 each; Northgate cuts and Eastmere holds, 70 for Northgate and 20 for Eastmere (and the reverse if Eastmere cuts); both cut, 30 each. Should Northgate cut prices? Convention: one move each, payoffs as given, simple expected values.

Answer: Cutting is each firm's best reply to anything the other does, but together they end at 30 each instead of 50. A cut only pays if the chance of a match is below 50%; at 60% Northgate should hold and compete on other things.

> **Interview tip:** Draw the two-by-two payoff grid aloud, find the best reply, then say the threshold probability of a match at which you would change your mind. That shows judgement, not just theory.

INT.KG.2.c · Competition and customers

Evaluate channels, loyalty and churn with customer lifetime value, acquisition cost, payback and incremental marketing return.

Customers are an asset that is bought through marketing and channels and kept through loyalty. The core numbers are monthly churn (the share lost each month), expected lifetime (one divided by churn), lifetime value (contribution per month times lifetime), customer acquisition cost (CAC), the ratio of lifetime value to CAC, and payback (CAC divided by monthly contribution). A common rule is that lifetime value should be well above acquisition cost, perhaps three times, and payback short enough for the cash the firm can fund. Small changes in churn matter a lot: churn of 4% instead of 5% lengthens lifetime by a quarter. Channels differ in reach, margin retained and quality of customer: a distributor earns less per unit but may reach more units. Marketing return must be measured on incremental contribution, not on all sales after a campaign, because some customers would have bought anyway. Common mistakes are to use revenue instead of contribution and to ignore who would have bought without the spend.

WORKED EXAMPLE: RETENTION AT SWIFTREAD

Swiftread, an invented reading app, has 20,000 paying subscribers, each contributing £12 a month after variable costs, with monthly churn of 5%. Acquiring a subscriber costs £150. A retention programme could cut churn to 4%. What are the lifetime value, the LTV to CAC ratio and the payback now, and what is the programme worth? Convention: churn constant, contribution constant, no discounting.

Answer: Today a subscriber is worth £240 against a £150 cost (ratio 1.6, payback 12.5 months). Cutting churn to 4% adds £60 each, £1.2m in total, so the programme is worth about 0.7m after its 0.5m cost.

> **Interview tip:** Give lifetime, lifetime value, the ratio to acquisition cost and the payback in that order, then say what a one-point change in churn is worth. Always use contribution, not revenue, and ask whether the effect is incremental.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.