Economic Value and the Marketing Mix

By Jonathan Bein, Ph.D.

Over the past year, Z2M4 consultants have created over a dozen different ROI models of our clients' product and service offerings. These ROI models include product benefits, cost of ownership, NPV, IRR, and time to payback. Along the way, we noticed two very interesting patterns with our clients:

1. **Value proposition -** When one asks a C-level executive about the value proposition for his company's product or service, the executive typically responds with a fairly well-rehearsed elevator pitch of three to six different claims that make up the value proposition. These different value claims are usually, though not always, also found in their print or electronic literature.
2. **Economic value -** When one asks the same executives about the economic value of the same product or service to their customer, *none* of these executives could even remotely answer the question! In fact, for lack of a better response, they reverted to discussing the claims in the value proposition.

When we noticed this trend, we began asking other successful executives the same questions. Like Z2M4's clients, they can recite their value proposition but have minimal grasp of their product's economic value to their customer.

Some companies have successfully used ROI calculators and economic value models to help in the sales of more complex products whose value cannot be "eye-balled." When used skillfully, these ROI calculators provide a meaningful basis for discussion of value, not just price. Our recent experience has led us to explore how ROI calculators and economic value models can be used in other parts of the marketing mix including price, promotion, and product. Based on this exploration, we believe that economic value can be used to change the nature of the dialog about a company's offering both externally with customers and internally with employees. We illustrate this change by looking at economic value as it relates to price, promotion, and product below.

Price

Pricing experts agree that the three main axes for determining list price or street price are cost, competition, and value. These experts further agree that the value of a product should be the main determinant of price and cost should serve as a floor for the price. However, in practice, many companies use cost-plus pricing methods combined with competitive prices to set list and street price. The problem with cost-plus pricing is that it has no relation to value: if it costs a company $1.50 to make something whose value is only $1.00, cost-plus pricing will fail. In the extreme, when value is (entirely) neglected in setting price, competitors in a market can devolve into very destructive price wars.

For software technology companies, the problem is even further compounded because there is no cost basis in the software other than the media on which it is delivered[1]. If value is neglected for these companies, the only axis for price setting is competition. A related dynamic is occurring with companies that sell hardware where the main value is in the software. Many of

[1] Currently, many software products are downloaded over the web, thereby eliminating the nominal cost of the media.

these companies have used cost-plus pricing methods for years. Now, they are de-bundling the hardware from the software and allow the customer to purchase commodity hardware. Many of these companies are at a loss for how to price the de-bundled offering.

So why do so many companies focus on cost-plus and not on value in setting price? In our experience, the answer is very simple: these companies have never taken the time to really understand the economic value of their product or offering. Without understanding economic value, price setting will necessarily focus on cost and/or competition.

We have one client who sells analytic software to cable companies. Cable companies are notorious for aggressively negotiating with their suppliers. Prior to our involvement, this analytics company had no idea about the value of their software other than what the cable company procurement department told them. Upon completing an economic value model, this software company understood that their product offered payback in less than 9 months, ROI exceeding 500%, and a very high NPV. The economic value model allowed them to change the dialog to focus on value and not price. The GM of the division (now the fastest growing division in the company) said “I will never again sell on price.”

Promotion

Value claims made in product messaging can be categorized as feature oriented, benefit oriented, or emotion oriented. Emerging and mid-market technology companies tend to over-emphasize feature oriented claims as a way to showcase new or disruptive technology. However, even when these companies make benefit oriented claims, the claims are not quantified. As a result, entire marketing campaigns are built on vague and unsubstantiated value propositions. In fact, our experience in modeling economic value shows that the claims a company makes about its value often have weak correlation with the offer’s true economic value. With equal frequency, we have validated some claims, debunked others and uncovered previously hidden value.

When economic value is incorporated into messaging, the best approach is to figure out the value before figuring out how to communicate it. By the way, it may not be possible to model the economic value of some claims because the economic benefit is intangible nebulous. It is important to realize that if you cannot model the economic benefit of a certain type of product, that means that your competitors cannot do it either. That is critical to know in messaging and competitive positioning.

When emerging and mid-market companies actually have a superior product to the market leader’s product and they have taken the time to understand their own economic value, then they can compete effectively against the market leader. As an example, we have one client who sells high speed internet and video services to the hospitality industry. Upon completion of the economic value model, this vendor was able to sell at a higher price than the leader who had an old product that delivered almost no economic benefit. This emerging vendor developed benefit oriented messaging that was the basis of their electronic and print literature.

As another example, we have a client who sells an email archive solution. Prior to our involvement much of the focus was on storage optimization and ease of administration. The economic value modeling exercise showed that the main benefit of their tool is productivity for end users. They made novel use of an industry leading analyst endorsement of their economic value model to compete more effectively against the market leader.

Product

Ed Olkkola, formerly of Austin Ventures, once shared a very interesting idea with me about the level of price/performance required for a market entrant to compete with an established vendor in a market. He said that the market entrant needs to be 5X along some important price/performance dimension to be able to compete. So, for example, the new entrant would need to have 5 times the throughput as the incumbent vendor for the same price to be able to compete.

At first, it seemed like the bar is too high for the market entrant. But, Ed pointed out two factors that discount the price performance:

1. Negotiation by a large customer with its installed and incumbent vendor could easily result in a 15%-20% price reduction.
2. Moore's law provides a double of performance every 18 months. If the customer remains with the incumbent vendor for a little, price performance will improve anyhow.

The combination of these discounts means that what used to be a 5X ratio, is now more like a 2.5X or 3X ratio. That ratio may be enough to overcome the inertia of remaining with the incumbent vendor. However, a 1.5X ratio is almost certainly not enough benefit to justify the switching cost and risk.

While this example is inspired primarily by enterprise and communications hardware, the basic idea remains for software and other technology products: for each class of product, there is some point of price performance that is necessary to overcome the perceived switching costs. The application of this idea to product strategy is very simple: the estimated economic value of features and functions should be a critical element in the development of a product roadmap.

Summary

The key ideas presented here are how to use economic value to change

- How to communicate economic benefits of a product with customers, not just features.
- How to price products based on value, not just cost or competition
- How to prioritize features in product development based on maximizing economic value for the end customer, not just on cost to develop or intuition about market needs.

We have seen these concepts applied successfully with our clients. In the future, we will explore each of these ideas in greater depth.

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