How Can You Price Effectively During Periods of Inflation?

Inflation poses a significant challenge for businesses. Success in turbulent markets requires leveraging data for pricing optimization. Among three common approaches, only value-based pricing ensures reliable ROI, outlined with an actionable plan.

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Inflation is a critical challenge facing every business today. To have any chance of thriving during this kind of market disruption, your business must leverage data effectively to optimize pricing and protect profits.

There are three common approaches to inflation pricing that people depend on to weather inflation: descriptive, predictive, and prescriptive.

Only value-based pricing, however, delivers dependable ROI. Here's why, as well as an action plan to get you started.

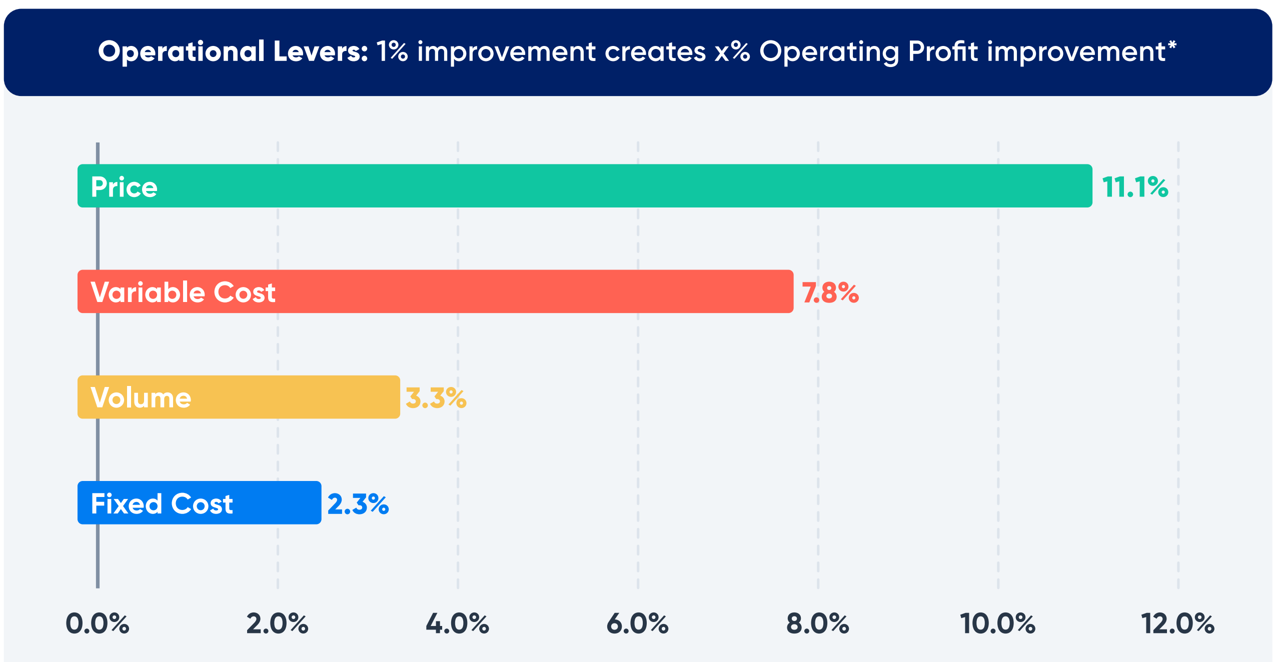
The Impact of Inflation on Pricing Strategy

Right now, every business is worried about inflation. With averages hitting over 8% in the EU and the United States in June 2022 and peaking worldwide[i], inflation has started squeezing margins. Costs are rising, and customers have less disposable income. This has complicated pricing strategy.

And yet, inflation is nothing new. Even before the Covid-19 pandemic, over half of all countries in the world had double-digit inflation, according to the IMF[ii]. What's changed is the impact in an increasingly customer-pull world. In other words, customers want precisely what they're looking for without waiting at an increasingly lower price point. Inflation heightens these trends and puts significant pressure on margins.

Optimal pricing, therefore, becomes even more critical during inflation. The gains available from improving prices are always significant. According to research by the Harvard Business Review, a 1% change in pricing efficiency can have an 11-12% per cent improvement in operating profits[iii]. The leverage effect on the company during economic upheaval can be even greater. If you are looking for the best way to protect your bottom line during times of high inflation, improving pricing strategy is the place to start.

Using data science to optimize price files provides a strategic advantage as you control volumes



* Source: Managing Price, Gaining Profit - Marn & Roiello. Harvard Business Review.

[i] DeSilver, Drew. "In the U.S. and around the World, Inflation Is High and Getting Higher." Pew Research Center, Pew Research Center, 15 June 2022, https://pewrsr.ch/3mOsb5N.
[ii] "Consumer Price Index (CPI)." International Monetary Fund, https://data.imf.org/?sk=4FFB52B2-3653-409A-B471-D47B46D904B5. Accessed 20 June 2022.
[iii] Marn, Micheal V, and Robert L Rosiello. "Managing Price, Gaining Profit." Harvard Business Review, 1 Aug. 2014, https://hbr.org/1992/09/managing-price-gaining-profit.

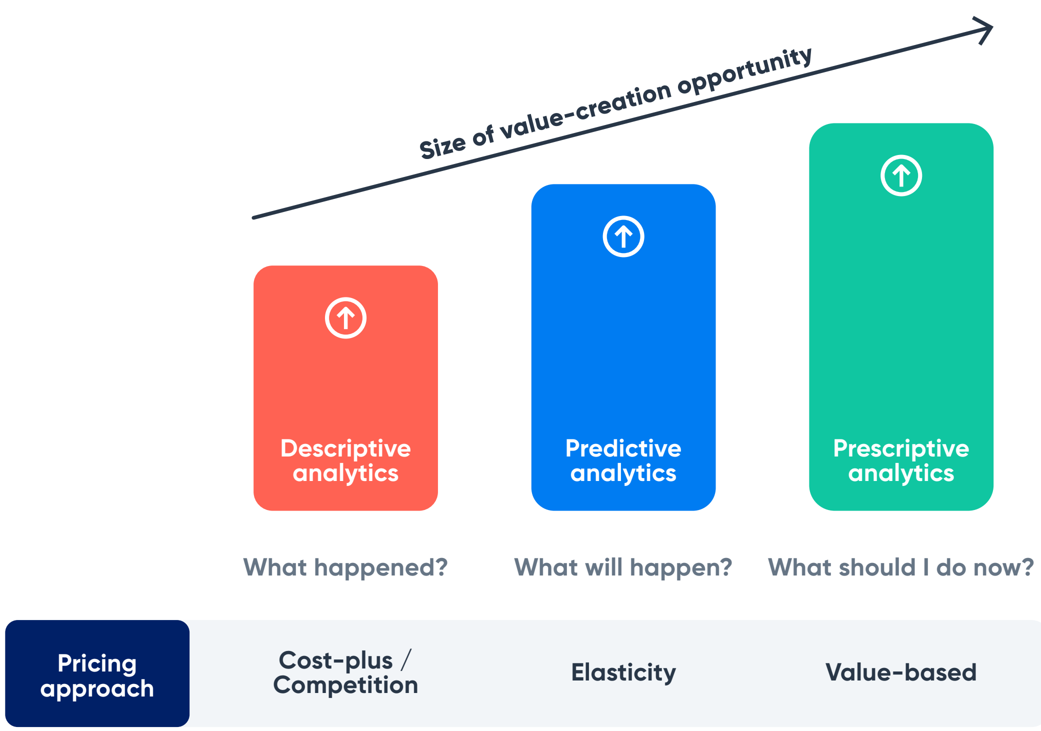
Inflation Pricing: Three Basic Approaches

Pricing is a lever that carries a lot of impact, but almost every decision requires a complex trade-off. Supply and demand, substitution, customer perception, costs, and so many other factors impact outcomes. So how do you even begin to optimize prices?

Easy. Use your data.

That may seem overly simplified. After all, there's tons of data out there. Every piece of information you have that could possibly affect pricing decisions is a data point. In reality, however, there are three basic approaches to data-driven inflation pricing — and each requires different types and usages of data:

1. **Descriptive:** cost-plus or competition pricing
2. **Predictive:** elasticity pricing
3. **Prescriptive:** value-based pricing



Descriptive Approaches to Inflation Pricing

Descriptive analytics answer the question "What happened?". Essentially, you look at historical data to educate you on facts that may inform future decisions. The two most common pricing strategies that fall into these categories are cost-plus pricing and competition pricing.

Cost-plus pricing is the most straightforward strategy. You choose a mark-up and add it to your current costs. This directly passes inflation costs on to your customers. Very little data is needed other than an up-to-date cost breakdown. The benefit of this approach is that you guarantee a target margin: it's built right into the price. Unfortunately, this approach does not ensure profits despite the guaranteed margin. If the new price doesn't appeal to the customer, you will eventually eat away at profit through unsold inventory, markdowns and promotions. This approach has zero-customer centricity; internal concerns drive all prices.

The next descriptive inflation pricing strategy is competition pricing: anchoring your prices to those of your customers. You monitor your customers' prices in real time and match or slightly beat their offer. The data can usually be scraped off the internet automatically, making it easy to collect relevant data. This approach is also more customer-centric. You are lining your offer up with the other offers customers will access in the market.

The problem, of course, is that customer perception of prices is not entirely rational. Very simple tricks like anchoring a price in the customer's mind can make a competitor's offer more appealing. Versioning may make an identical product seem like a better offer by seemingly including more features in the description. Plus, customers may not even be rationally searching the market for the best deal. Some customers are simply looking at trusted providers or choosing the first "good" offer that they find. Even the most cost-sensitive customer may not always choose your offer even if it has the lowest base price.

Predictive Approaches to Inflation Pricing

Predictive analytics answer the question "What will happen?". Essentially, you calculate the most probable outcome based on a particular input. In pricing, you generally predict the likely sales based on a particular price for each product. This is done by calculating a product's price elasticity. You will create a simple graph, allowing you to pinpoint what price would maximize your revenues. Most of the data you need is available, either widely or within your sales data already.

Elasticity pricing sounds easy and accurate, but in practice, the calculations are fairly imprecise and fragile. If sales of a product mainly or only depended on price, this approach would be all any company would need for optimal prices during inflation. Unfortunately, the relationship is not so secure. Based on the r-squared measure of these graphs below, only about 10-30% of all sales can be explained by prices[iv]. Even if you had perfect data to set prices for inflation using predictive approaches, the low correlation makes pricing optimization very slow and inefficient. As for fragility, the minute some element in the calculation changes, you must reevaluate all these elasticities. During periods of inflation, this expiration date arrives ever-faster.

[iv] Gallo, Amy. "A Refresher on Price Elasticity." Harvard Business Review, 30 Nov. 2017, https://hbr.org/2015/08/a-refresher-on-price-elasticity.

So yet again, this approach falls short for inflation pricing. You cannot predict the outcomes efficiently enough to follow through on advice before it is out of date.

Prescriptive Approaches to Inflation Pricing

Prescriptive analytics answer the question "What should I do now?". Essentially, you stop trying to set the perfect price in anticipation of future conditions and start setting prices closer to real-time conditions to get you closer to your goals. This is known as value-based pricing. You set the price of a product as close to its real-time value to the customer as possible.

For many companies, this seems like an impossible task. After all, your customers don't walk in with a price tag. Even if you asked each customer and they tried to answer honestly, you would likely still not get a clear answer as to what price they are willing to pay. Neuroscience research at Harvard suggests that we don't consciously know our maximum willingness to pay, as it is constantly affected by new references and implicit expectations[v]. The data needed for value-based pricing seems as though it would be exhaustive.

But in reality? Prescriptive pricing lets your customers do your market research for you — and you certainly already have the most valuable data.

[v]Nobel, Carmen. "What Neuroscience Tells Us about Consumer Desire." Harvard Business School, 26 Mar. 2012, https://hbswk.hbs.edu/item/what-neuroscience-tells-us-about-consumer-desire.

How does this customer-driven market research work? There are two critical elements:

Test constantly

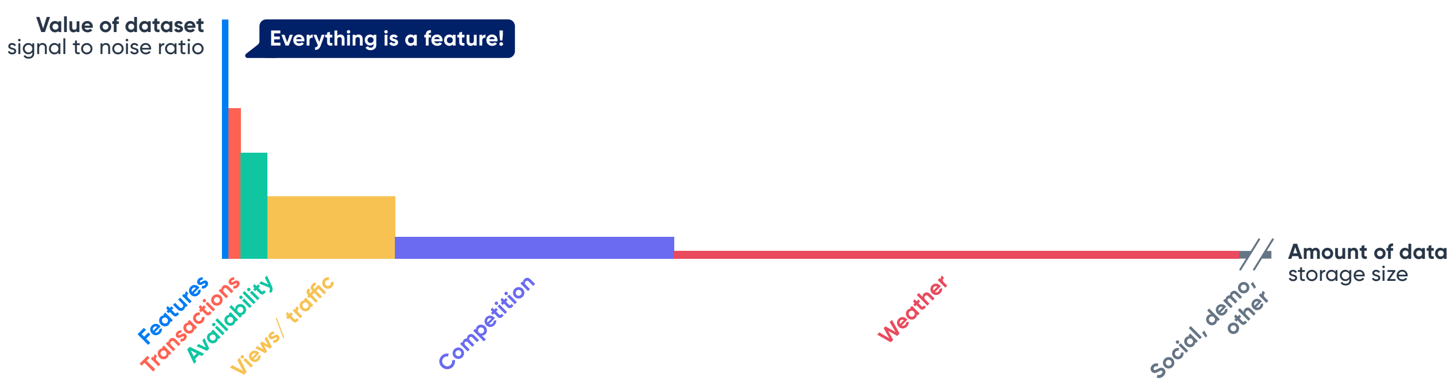
Learn from your data

Testing constantly is a very simple idea. Rather than spending a lot of time doing desktop or market research, you change some prices and then observe the results. The impact of the new price on your customers and KPIs will tell you whether or not this price is optimal. When it comes to inflation, you may find that customer willingness to pay has increased or decreased, which often does not match your intuition.

Next, you learn from that data to apply lessons to other products. Similar products often behave similarly to price changes in the same direction and percentage. By learning from the data, you accelerate and multiply your impact. If any new price has a negative impact, you can revert to the old price immediately with limited downside. Then, you continue the learning loop: keep testing and adjusting to adapt to determine the new optimal price for your customers. The more you test, the more your impact grows.

As for the data required to test and learn? Luckily, you already have the most impactful data internally. After years of testing and research, it's become clear that product features, transactions and availability have the greatest impact on prescriptive pricing models—all of which you certainly have in your CRM or ERP. Additional data sets like traffic, social media trends and weather add value but with increasingly diminishing results. To start learning, it's not critical to add this information. Still, you can easily incorporate this information by working with an outside expert on prescriptive models to use effectively right away. The key is starting with what you already have and growing your dataset as you test and learn.

The prescriptive approach is the only strategy shown to optimize prices when facing market disruption like inflation. If you want to maximize your impact, you must adopt a value-based strategy immediately.



Source: proprietary research on ~1.8 Petabytes of data. Each use case has its own specific, different proportions.

The Case for Prescriptive Inflation Pricing: Wine Prices Post-Brexit

Laithwaites

Prescriptive, value-based pricing is the fastest way to recover value and protect margin amidst inflation. It works across every industry and customer base because the data guiding your pricing strategy comes from your unique customers. Learnings are specific and targeted, but no example illustrates this as well as the case of Laithwaites' wine:

Laithwaites is a leading UK wine retailer known for importing European wines. The rapid impact of post-Brexit inflation, fluctuations in exchange rates and growing import costs caused by Brexit hit the company hard. They needed a more effective and agile pricing strategy that could react quickly to the ongoing market disruptions.

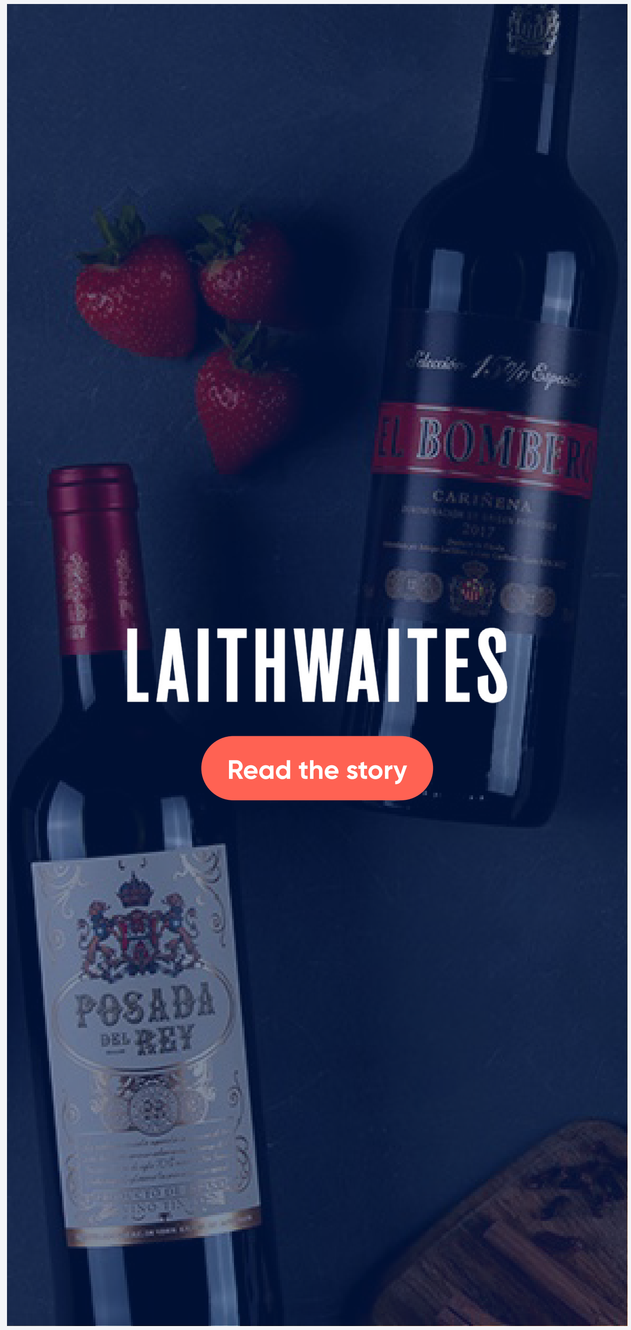
After implementing Evo PriceAI solutions:

Strategic price adjustments in response to real-time customer needs.

Daily identification of high-impact pricing opportunities, as well as quarterly executive review of overall pricing impact.

Expansion to markets beyond the UK to optimize prices company-wide.

- 3.1 margin point increase
- £5.5M initial margin gain
- 3% increase in long-term revenues



Action Plan: Five Simple Steps to Start Implementing Value-Based Pricing

1. **Dig into your dataset.** You already have the right data; you just need to find it! At Evo, we help our clients identify and prioritize features, attributes, category trees and product mappings to use in their models. This is where you should start, too. If you work with a company like ours, we can add our own learning data set to accelerate the pace of learning, but even limited internal data will get you results.

2. **Codify strategy and rules for your testing loop.** If you test without a clear framework, it will be difficult to learn anything useful for your test. Make sure you've written out how you will conduct your tests and track results.

3. **Set your goals.** What do you want these prices to accomplish? Are you hoping to maximize revenues, or would you instead protect margin? Is it essential to eliminate as much of your inventory as possible? Each of these goals will be best served by a different price, so you must clearly identify the KPIs measuring success.

4. **Test new price points.** Change a few prices and see what happens. You can use some elasticities or other market research to guide yourself to the products that may get the fastest results, but the key is not to wait too long. Let your customers do the research for you!

5. **Measure impact.** The second half of the loop: learn! You need to track the outcome of the test and apply the results before testing again. Iteration is how you can ensure that impact is optimal and sustainable.

Pricing is critical to the success of your business. You can't afford to wait to implement a value-based pricing strategy. Take action now, and impact will surely follow.

Learn more about how ToolsGroup solutions powered by **EvoAI** helps companies optimize decision-making for **greater efficiency, enhanced customer satisfaction,** and **better margins.**

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