

# Leverage Pricing to Realize Your Product's True Potential

## Executive Summary

Product pricing is often misconstrued as a fancy and cosmetic layer in the overall business environment. Pricing requires extensive study and thorough analysis of the market players & segments, and can really determine the success of the companies. Though companies can measure the cost incurred to build a product, with some marginal errors and approximation, selling it with a reasonable markup on top of the cost, will keep the company profitable and successful. Companies can expect to recover most of the invested cost within some period of time, but in reality many organizations are bound to fall short of their overall goal. Fortunately, industry experience and academic research over the last few decades provide considerable reference materials to help companies adopt a scientific approach to pricing.

This white paper seeks to better understand the pricing objective and offers insights into traditional pricing strategies and importantly, their application and implications in the IT Software market.

## Background Discussion - Pricing Overview

As the first step, let us define a price that maximizes our profit. Represented mathematically,

$$\{\text{Price}\} P = \{\text{Cost Incurred}\} CI + \{\text{Profit Margin}\} PM$$

In a true business environment, arriving at a number for each of these variables is an interesting but complex activity. There are more latent variables behind these two figures, and in some cases, numbers are fixed subjectively, as cost incurred to estimate the values is just too great compared with the values themselves.

Typical, pricing strategies involve a variant/com-  
bination of the following three basic versions:

- **Cost-based Strategies** - Simple pricing strategy where a % of the cost is added to the top of the cost to increase the profit.
  - Cost-Plus Price = Cost-Price + mark-up (as a % of Cost)



- **Competition-focused Strategies** - Strategy that revolves around prices set by the competitors within the industry segment.
- **Value-based Strategies** - Customer Perception of the product / the product manufacturer via use of branding initiatives carries additional value, which gets added to the cost, irrespective of the basic qualities of the actual product.

A regular approach is to consider components of all of the above three version to arrive at an optimal price. Thus,

$$\{\text{Price}\} P = \{\text{Cost Incurred}\} CI + \{\text{Profit}$$

Margin determined through Competition and/or customer value perception} PM

Additionally, there are couple of other factors that significantly impact the profit margin. These are **Market Dynamics** and **Transaction-level changes**.

Market Dynamics focuses on the overall economics of the industry, including supplier price changes and customer demand changes. Transaction-level changes include managing the implementation of discounts away from the reference, or list price, and other promotion activities.

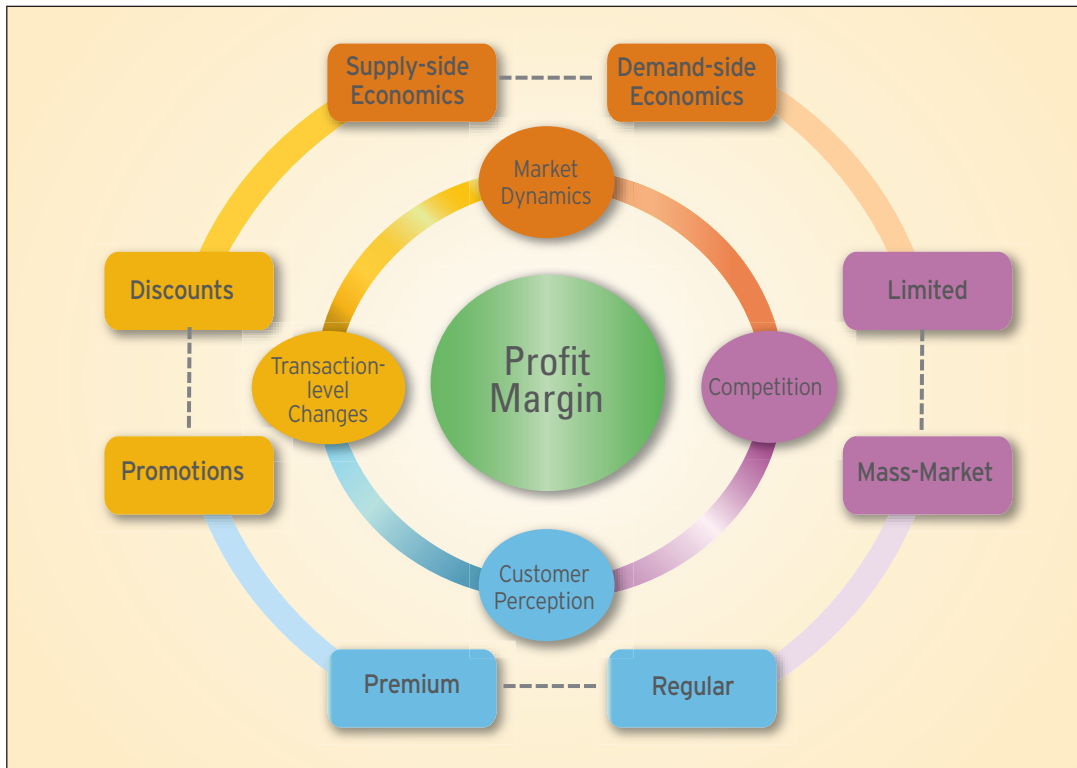


Figure 1

## Price Determination for IT Products

### Understanding Cost functions for an IT product

“Cost” of a product, as a term is easy to comprehend but equally difficult to determine. There are a number of steps & processes, each of which has its own complexity and

dependencies, which must be flowed before, a product is released to the market. At a broad level, the following elements form the key process constituents:

1. **Market Study and Business proposition: The Maiden Step in the long journey**

Analysts and marketing professionals study the length and breadth of the potential market segment and the business viability of launching a product into the market. Certainly, product manufacturers do not deliver products to the market where there are no buyers. In-depth

internal study and external market research reports must clearly meet the following criteria to get a green light from the executive sponsors of the product, be they Venture capitalists (VC), or the Board of an organization. Some of the steps in this process include:

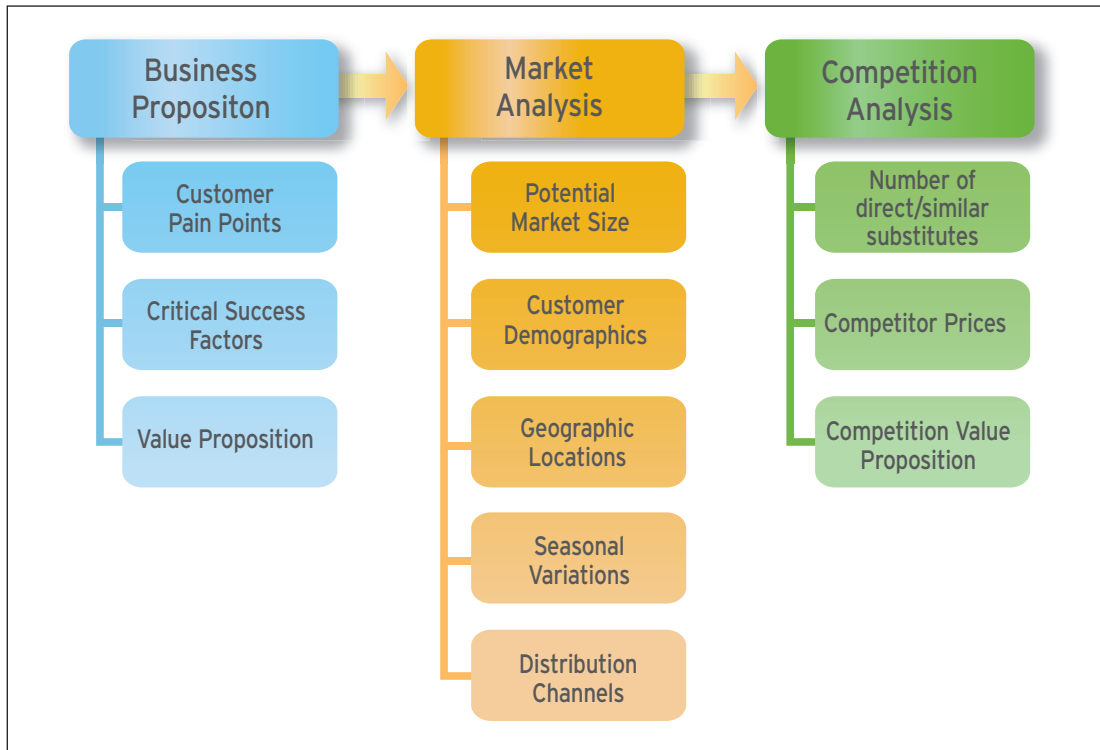


Figure 2

The above parameters provide sample data towards product feasibility analysis. In other words, this data can help an organization better understand its target market, competition and its own business proposition.

Typically cost incurred at this stage is not factored into costing of the end product, rather classified under Investments or Marketing or R&D buckets in financial statements. However 20% of the numbers here can really go into costing of the product.

## 2. Ideation -> Concept -> Engineering

Details from the initial assessment can be used as input for analysts, marketing professional and enterprise architects to define and design a model that depicts the concept of the product being visualized. Metamorphosis and transformation from ideation to the actual

product starts at this step. Closed room discussions within the group, stakeholders, line of business team; interviewing industry experts; understanding the end user perspective; studying the infrastructure (for example technology, marketing or internet channels) will be used to give some context, shape, categories and color to the product. Study suggests that 40% of a proposed product launch die at this stage because the result of such discussions yields an understanding that the product will not find any buyers in the market during the time period forecasted.

Study and analysis will also focus on releasing multiple features of the same product targeting multiple types of customers. For example, in a typical IT environment, one would compare the individual licensing/cost of a product vs. enterprise cost of a software product. Cost

varies between these two cases as the usage pattern varies. This means the vendor must assess whether to filter out certain features for an individual of the software vs. enterprise version.

Once the concept is drafted, reviewed and signed off, the engineering team (ET) takes over to translate the concept into reality. The following resources will be required to take the proposed product to the next stage.

- Hardware cost
- Software cost
- Human resource cost
- Administrative and other logistical cost
- External interface & Integration cost
- Travel & Entertainment cost
- Campaign, Sales & Marketing

Each company has a timesheet entry tool, which will play a vital role in arriving at the cost incurred by human resource to be subsequently transformed to a monetary value based on their compensations & benefits.

Once tested by various internal entities within the organization, product arrives at a stage where it can be launched to the external world, or to a subset of the external world.

### 3. Product Launch - Sales and Marketing, Beta to Final launch

Product launch activities will be characterized by a host of product road shows, e-mail / Web campaigns, print advertisements and participation in industry trade fairs. A percentage of the expenses incurred in this step should be added to the cost of the product, though this may not be case in all organization as it may also be bucketed under R&D cost.

Additionally, it has been observed that certain organizations choose to go the route of having an Alpha or a Beta release before the final launch. Organizations may choose to launch to specific "well-wishers", to specific geographic regions, or to customers who are highly critical of the product. This representative sample of the population will provide a good indication of whether budgeted ROI will be met or not. Study reveals that about 10% of projects are shelved at this stage of the product launch cycle. Depending on the market segment and the product features, and suggestions received from this soft launch, companies can start the complex task of pricing the product, or return to the drawing board to add or modify certain features.

#### ■ Discussion on Profit Margin

Though the factors influencing the profit margin for IT products essentially remain the same as detailed above, there are some aspects that need additional consideration. Some of these include:

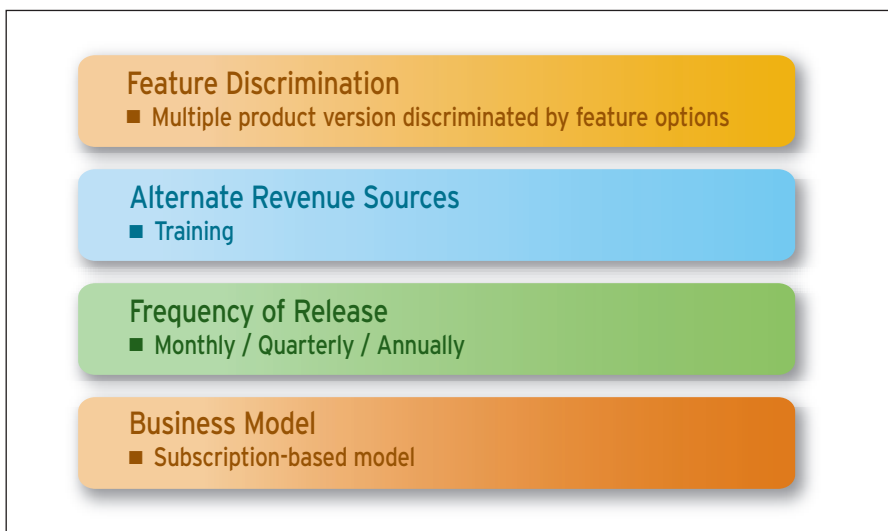


Figure 3

- All In Equations

Organizations and the business stakeholders would have calculated the following numbers before launching the product

- a. **Number of potential buyers (PBn)** - Though it may be a ballpark number, this math is required before moving forward.
- b. **Break-even Time (BEt)**- Time taken to recover all the cost incurred to build the product.
- c. **Total Cost Incurred (TC(i))** =  $CI1 + CI2 + CI3 .. ..+ CIn$ , - As explained above, there are many parameters like this
- d. **Cost-Per-Unit (CPu)** - Cost incurred per individual/atomic item.

Putting into mathematical format,

$$\left( \left\{ \text{Profit Margin} \right\} PM(\text{per unit}) + CP(u) \right) * (PBn) > (TC(i)) \text{ in time} = (BE(t))$$

Here are some easy inferences that can be drawn from this equation:

- The greater the number of buyers, the earlier the time to achieve BE(t)
- The greater the profit margin, the faster the time taken to reach the BE(t)
- The lower the cost incurred to build the product, faster to reach the BE(t)

These equations are fairly consistent over time, but stakeholders need to update the values assigned to these variables from time to time, to remain competitive in the market. Otherwise, they can quickly be marooned. Studying the trend continuously and adjusting these values will help in a long way to achieve top-line and bottom-line objectives, and most importantly, motivates the organization to excite the market with another product.

### Pricing isn't Easy....Do we have Help at Hand?

The good part is...YES! Vendors, such as Vendavo, PROS, and others product suites to help understand pricing optimization. Equations mentioned above are easy to interpret theoretically but in reality, they require thorough understanding of the business landscape, quality of the product, vision, mission, culture and trademark of the particular product development company.

These software suites help deliver higher profits by delivering to executive management full visibility into pricing performance and by providing the tools to drive action across the organization. These products help customers:

- Segment their markets effectively
- Set and optimize prices and terms by customer
- Manage complex price lists, policies and approval structures
- Negotiate more profitable deals
- Execute all of the above processes through existing enterprise systems

A follow-up white paper will cover specific product based experience and expertise.

### Summary

Companies are under constant pressure to improve profits. Most companies have already squeezed significant cost benefits through programs like efficient resource management, supply chain optimizations and online initiatives. In this scenario, Pricing offers companies with a much needed lifeline to augment their bottomline and realize their business goals.

However, in complex large companies, pricing processes can vary significantly based on geographic locations, business units and even product lines. This makes the task of ensuring effective pricing across the organization a very challenging process.

The key to effective pricing is to determine a pricing strategy which works best for the company, identify all the cost components associated with the product since inception to launch and pin down all parameters needed to arrive at an acceptable profit margin.

Although, we have market players offering pricing management software suite, it takes more than just the software to get the process right. A rich blend of domain and technical expertise is needed to comprehend the various parameters involved in pricing management and guide a company's senior management towards effective decision making.

## About Cognizant's Technology Practice

Cognizant's Technology practice addresses business and technology challenges of Online companies, Independent Software Vendors (ISVs) and Hi-tech companies working on cutting-edge technologies. With over 2500+ technologists spread across delivery centers in multiple geographies and 12 Centre of Excellences in multiple emerging technologies like Web 2.0, SaaS, Usability, Mobility, Open source, and others the Practice works with all top technology companies in Online (5 out of top 7), ISV (5 out of top 10) & Hitech companies (Top 2 out of 3 EDAs, Top 2 out of 5 Network OEMs).

## About Cognizant

Cognizant (NASDAQ: CTSH) is a leading provider of information technology, consulting and business process outsourcing services. Cognizant's single-minded passion is to dedicate our global technology and innovation know-how, our industry expertise and worldwide resources to working together with clients to make their businesses stronger. With over 50 global delivery centers and more than 64,000 employees as of June 30, 2009, we combine a unique onsite/offsite delivery model infused by a distinct culture of customer satisfaction. A member of the NASDAQ-100 Index and S&P 500 Index, Cognizant is a Forbes Global 2000 company and a member of the Fortune 1000 and is ranked among the top information technology companies in BusinessWeek's, Hot Growth and Top 50 Performers listings.

## Start Today

For more information on how to drive your business results with Cognizant, contact us at [inquiry@cognizant.com](mailto:inquiry@cognizant.com) or visit our website at [www.cognizant.com](http://www.cognizant.com).



**Cognizant**

Passion for building stronger businesses

### World Headquarters

500 Frank W. Burr Blvd.  
Teaneck, NJ 07666 USA  
Phone: +1 201 801 0233  
Fax: +1 201 801 0243  
Toll Free: +1 888 937 3277  
Email: [inquiry@cognizant.com](mailto:inquiry@cognizant.com)

### European Headquarters

Haymarket House  
28-29 Haymarket  
London SW1Y 4SP UK  
Phone: +44 (0) 20 7321 4888  
Fax: +44 (0) 20 7321 4890  
Email: [infouk@cognizant.com](mailto:infouk@cognizant.com)

### India Operations Headquarters

#5/535, Old Mahabalipuram Road  
Okkiyam Pettai, Thoraiipakkam  
Chennai, 600 096 India  
Phone: +91 (0) 44 4209 6000  
Fax: +91 (0) 44 4209 6060  
Email: [inquiryindia@cognizant.com](mailto:inquiryindia@cognizant.com)