Pricing as the Glue for Effective Product Combinations

Digital technology and cost-cutting are creating a world in which many customers now prefer integrated solutions for their product and service needs. We see such increased integration in diverse arenas: in the convergence of cable and telephone services; in the merger of stand-alone avionics into integrated flight systems; in comprehensive banking/brokerage/real estate offers; and in integrated architect/builder/owner work flows in construction projects, to name a few.

These solutions—called bundles—can transform markets. To stay competitive, your company must meet the demand for bundles. It must build them so they are responsive to the market and priced to offer a cogent value proposition; and yet they must still be profitable. Pricing is the most important “glue” that holds together effective bundles.

In this new world, effective bundling of your products and services is crucial. Yet pitfalls lurk because the more novel the bundle, the greater the danger of mispricing the offer. If a company attempts to combine products or services without giving enough thought to price, the result is often gross overpricing or underpricing.

In helping clients with their bundles, we find there are four marketing mistakes that typically lead to mismatches and mispricing:

♦ Failing to create bundles for special purposes.
♦ Making bundles too big.
♦ Using tiering instead of bundles.
♦ Failing to innovate on bundle definition.

As the marketplace grows more competitive, companies find they must constantly adjust the marketing of their products. One such innovation takes the form of integrated solutions or bundles. But be wary, there are four common marketing mistakes that can derail bundling efforts, and this article explores two of them.

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Sometimes mistakes are obvious, but often, the more successful the core product, the more its related bundles fall short while the total bundle appears to be successful. In this article, we’ll examine the first two issues listed above, leaving the latter two issues to a subsequent article.

### Failure to Employ Special-Purpose Bundles

Bundles can have very different objectives. Bundle missions can include reducing customer churn, displacing competitors, rendering competitor pricing irrelevant or deterring aggressive price behavior by upstarts. Such differing objectives typically demand different bundle structures; a company may even wish to have a suite of bundles available for specific competitive situations. The day of the general-purpose bundle is drawing to a close.

Each special-purpose bundle is associated with a list price that reflects market prices and switching costs, as shown in figure 1. However, there is more to special-purpose bundles than their price tags. The price structure and bundle components differ with the purpose.

**An attack bundle seeks to displace a competitor**; to achieve this, it must better the incumbent vendor’s price/value proposition, typically via a lower price. The price must naturally account for switching costs as well, but still preserve long-term profitability.

An interesting example of this involved a market for data services, with a steep 15% switching cost for users to move from one company to another. The task was to define an attack bundle—yet it was clear that an unadulterated 15% price reduction would cut too deeply into margins to be viable. The solution was to create a more sophisticated bundle, reflecting an understanding of how customers’ decision points change over time.

During the initial bidding process, decisions were typically made under the harsh spotlight of CFO and even CEO approval, with price the key criterion rather than modest differences in performance. To satisfy the CFO, an aggressive price cut was built into the initial pricing. Once the initial system had been sold, however, further additions did not require CFO approval, and the seller could recover lost margins by offering add-on modules with performance improvements sought by the users.

Such a two-stage strategy is especially effective in cases where the process is complex and the product relatively intangible. This is not uncommon: The biggest change in pricing over the last 15 years has been the decreasing ability of both consumers and B2B customers to fully understand what they’re buying. In the old days of standalone products, customers could rely on being able to kick the tires. Tire-kicking is not possible where complex software is involved; buyers can do only limited assessment of software functionality and completeness. This creates additional opportunities for add-on sales once the buyer has figured out the real nature of what has been purchased.

Another type of bundle is defensive in nature, and thus typically employed by market leaders and incumbents. Very often market leaders must fend off upstarts; in doing so, they have a wider range of options than they typically realize. One such option—we call it the “Bear Hug”—is especially useful for discouraging upstart entrants from continuing to offer lowball prices to customers.

**The objective of the Bear Hug is to devalue competitor offers.** For instance, in a market where companies typically purchased a dozen or so core services, one incumbent offered all or nearly all of the services. The upstart’s strategy involved offering fewer services—only three core offers—at lowball prices.

Where the upstart had made inroads, the incumbent successfully defended by offering customers an “all you can eat” bundle. This customized bundle consisted of all services currently being purchased by that account—but at a price equal to the market rate for the relevant non-overlapping products, plus a bargain rate on the overlapping products offered by the upstart.

This bundle was hard to resist, and revenues steadily increased. Because the offer was sold selectively to complex, larger accounts that were already splitting purchases between the incumbent and the upstart, it was immune to comparisons by other customers—no danger of a general price melt-down. The pricing sent a strong message to the upstart challenger not to poach on existing customer relationships. Most importantly, the upstart could not retaliate because the bundle product scope was wider than its own offers.

Many companies react to low-price competitive offers by tying a weaker product to one or two stronger products. Unlike the comprehensive Bear Hugs, such bundles tend to be mispriced because the ratio of weak to strong products is often too high. If the bundle price does not accurately reflect the value of bundle components, then—like a poorly fitting shoe—it will start to chafe. Customers will tire of the forced marriage between strong and weak bundle components, and market share will begin to erode.

An example comes from the high technology arena, where a producer of op-
timization software for server farms bundled high-priced support and maintenance charges. This worked well for a few years, but as soon as rivals matched the software, cancellations rose because the maintenance was overpriced and customers resented having to buy both. Ironically, the software company knew of the growing problem, but held onto the lucrative maintenance in order to reach revenue targets. Today the company is an also-ran in that market space.

The grow bundle is perhaps the most intriguing, but the least known. This bundle is sold at the same price as an attack bundle, but it has embedded in it the potential to grow back revenues lost in such discounting. The key point in this bundle is to incent buyers to further reduce their costs by finding other customers.

For instance, if the items sold as a bundle face high one-time installation costs, or enjoy strong economies of scale, then buyers may be told, “If another department at your company buys this product, you will get a discount on your current contract.” This can turn the first department into a sales agent with other departments.

Examples are software with material installation or customer-specific customization costs or products with significant spare-parts inventories. These characteristics are found in ERP systems, aircraft engines and entertainment rights.

Making Bundles Too Big
An example of over bundling comes from a B2B online service that garnered a premium position early on, pioneering the conversion of forms and print to online. It constructed its bundles around federal materials and grew by adding further legal jurisdictional categories such as states, international and arbitration.

The jurisdiction-based growth of the bundle made sense in the short term—each additional element added incremental revenues—yet the increments became smaller and smaller each time, particularly as niche competitors established offers in more categories. Soon, the sales force began discounting heavily, unable to sell the value of the incremental components.

Our approach to this situation was to break up the legacy bundle to match component values to user needs, and reprice accordingly. In fact, when this information service provider split its comprehensive bundle into functional sections, it obtained price uplifts for virtually all customers (see figure 2).

Why did this happen? Because although the individual smaller bundles had lower list prices than the larger bundle, most customers needed multiple new bundles—the smaller, more relevant bundles carried much higher value. The internal consistency of each specialized bundle was much higher than that of the old, fat, flabby bundle. It turned out that few customers had needed most of the big bundle, which is why they’d negotiated so fiercely to reduce its price.

Another perfect example of over bundling comes from the cable television industry. Although subscribers welcomed the first few waves of channel expansions, enthusiasm dimmed as packages went far beyond the number of channels they would ever watch. A much better approach would be to sell narrower, specialized packages, each extracting value from particular audiences. However, management is often reluctant to create different bundles, citing operational and cost constraints.

Sometimes operational costs can be minimized. We have found that in many cases there’s no need to touch the product, and that limiting the breadth of the bundle is less important than narrowing the product’s value message and price plans. In many cases, customers won’t notice they’re getting “more” than advertised—and even if they do, complaints are generally few. In other words, actual changes in the product can be minimal: the work is in the message and price, not the actual product.

Why Bundles Matter
There are two reasons to understand and to differentiate between bundle strategies. The obvious one is that if the bundle is wrong or if the wrong bundle price is presented, the market won’t buy.

For example, customers consistently have shown that they exact a disproportionate penalty on bundles that contain too many elements. Bundles must be razor-sharp in purpose and pin-point targeted. Otherwise, customers find it too hard to understand the total value they’re obtaining.

The other reason is that different types of bundles drive very different operational costs. On the low end of the spectrum, the Bear Hug bundle is typically used only with a few very large accounts, with the price calculated by judgment and use of standard financial reports. And because the bill is a single number, it is only a slight exaggeration to say anyone with a typewriter can render the bill. Bear Hugs may be relatively inexpensive to implement. On the other hand, creating specialized bundles can be quite expensive, with complex billing, sales and customer service requirements.

Both of these factors—effectiveness and cost—make it important to have the right bundle for the right market mission. To be wrong can be disastrous to both the top and bottom lines.