Pricing in a Market with Disruption

Maximizing the value of innovations

DR. ROBERT VAN CLEEF
CONSULTANT

HOLDEN ADVISORS

INTRODUCTION

When OpenAI launched ChatGPT in November 2022, a new innovation arms race began. Rather than providing a list of website links in response to a natural language query with varying levels of usefulness, ChatGPT's generative AI engine synthesized results into a response reminiscent of a human conversation.

Within a mere 7 months, ChatGPT reached 100 million users, 1.6 billion visits, and 200 plug-ins. Google—the established leader in search—was forced to release Bard potentially before it was ready for prime-time release (by stating it is still an experiment and positioning it as a supplement to traditional search).

With the explosive growth of generative artificial intelligence, disruption is again in the spotlight, along with all the associated pricing challenges. Regardless of the AI platform used, many businesses are seeking to leverage an expected productivity lift (estimated to exceed $4.4T annually across the global economy). Entrepreneurs are also seeking to formulate entirely new business models.

Special pricing challenges emerge in markets marked by disruption for both incumbents and the new disruptive entrant. Incumbent firms are typically optimized to serve high-profit customers with complex demands for service. When faced with a disruptive threat, incumbents can perceive a no-win situation. Moving to a lower price position to match lower-price competitors en masse is simply not possible without cannibalizing needed revenue to serve demanding customers. But not responding could equally be damaging in the long run as market share bleeds away to lower-price competitors.

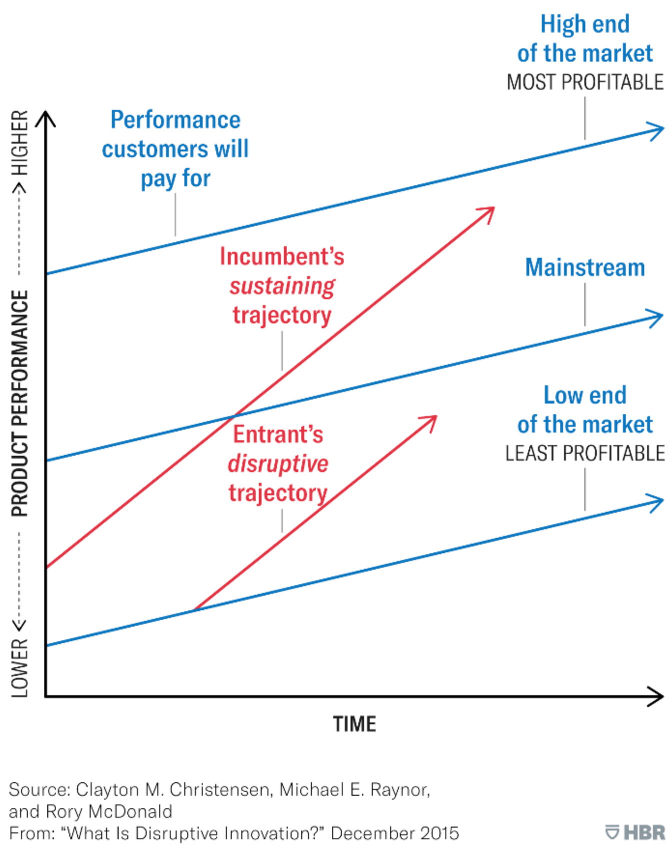
For the disruptive new entrant, there are also critical problems to solve. Disruptive firms entering the market need to balance targeting underserved markets at a low penetration price while also having a plan to increase price as technology improves and future and more profitable market segments can be served. The low entry price potentially could serve as an anchor that choke-holds future profitable growth.

The goal of this whitepaper is to help firms navigate the pricing challenges associated with both the incumbent and disruptor positions in markets undergoing disruptive innovation.

What is a disruptive competitor?

The Disruption Innovation Model developed by Harvard professor Clayton Christensen[1] in 1995 has become a dominant theory for how smaller firms can succeed in a market dominated by established competitors. According to the model, *established firms* focus on sustaining innovation (adding features that meet the needs of large profitable customers, but also adding to cost-to-serve). Over time offerings become feature-rich, but also expensive to produce and maintain. Making matters worse, many segments of customers do not value many of the features produced.

Disruptive competitors are those that enter the market by serving the least profitable customers with a simplified (or inferior) offering or creating entirely new markets, typically with a new core capacity or technology (the disruptive innovation itself). Because the initial markets served are perceived to be unprofitable and the offering inferior, the new entrant finds little opposition from established firms and grows. Over time, the new offering quickly improves in quality and the new disruptive entrant expands to serve new markets, eventually displacing the established firm (first through market share, then profitability).



Source: Clayton M. Christensen, Michael E. Raynor, and Rory McDonald
From: "What Is Disruptive Innovation?" December 2015

It is important to note that the largest and most profitable customers of large established firms have complex requirements that the disruptive innovation cannot initially serve.

For a fuller elaboration on the theory, read Christensen, C. M. (2016). The innovator's dilemma. Harvard Business Review Press. https://www.hbs.edu/faculty/Pages/item.aspx?num=46

Examples of Disruption

Industry	Disruption
Finance	Stripe has disrupted the online B2B payment processing world by simplifying the code required to securely process payments focusing initially on small eCommerce sites. Stripe incurs fixed payments (rather than a percentage of transactions) and has emphasized international accessibility with support for a wide range of currencies.
Healthcare	MHealth provides smartphone apps to aid in following up on patient care by providing a range of administrative and telemedicine features. By empowering patients to be more proactive in tracking their information the need for traditional doctor office visits—with associated co-pays—is reduced.
Technology	Nvidia's investment in AI chips (a niche less profitable market relative to CPU's) is allowing it to now dominate the chip maker segment and giant rival intel.
Entertainment	Netflix streaming service with low monthly subscription displaced expensive per-movie rentals with brick-and-mortar providers like Blockbuster.
Automotive	Kia and Hyundai invaded the US market by introducing low-cost models. Tesla is disrupting using a mid-market entry point for electric vehicles.

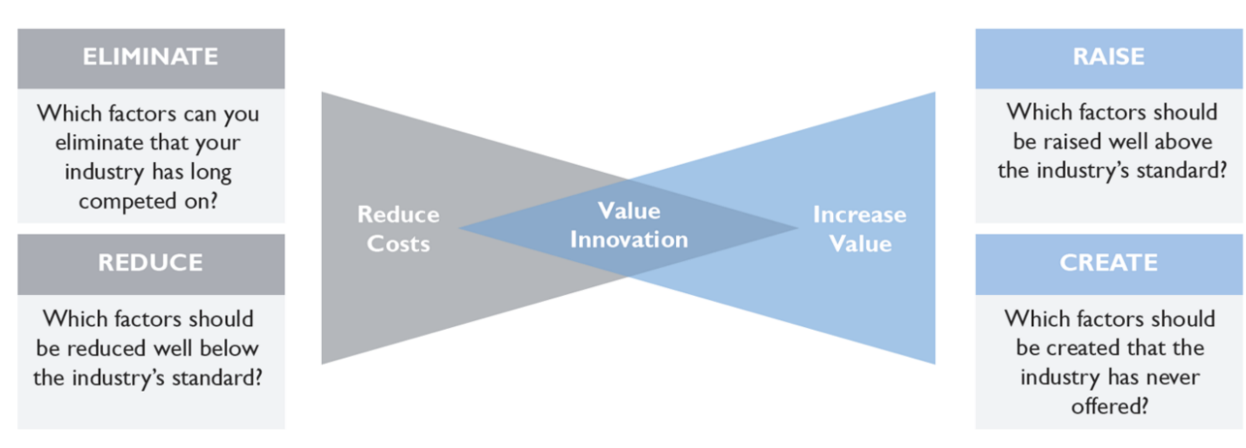
The fundamental opportunity is the alignment of customer needs, offers, and value proposition

The fundamental reason disruptive new entrants pull market share from established firms is that they possess a new technological or cost advantage, allowing them to serve previously undesirable customers profitably. This advantage provides the disruptive entrant unchallenged opportunities for the creation of value through renewed alignment of the customer, offering and price. Paying for features they will not use (or paying too much for features they do use) adds cost and reduces perceived value. Not all customers have the same demands for all features of an offering, so asking them to pay for what they will not use encourages them to look for alternatives.

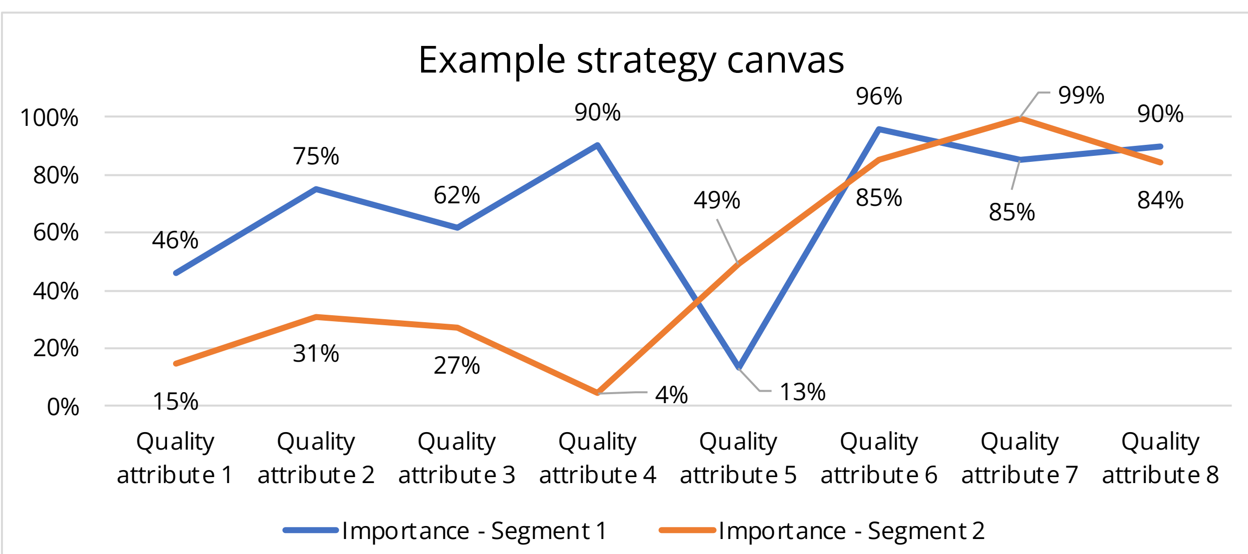
Instead of focusing on competition, leading firms focus on the alignment of offerings with customer needs to maximize value. In a process referred to as [Value Innovation] Kim and Mauborgne emphasize the use of a strategy canvas to map out factors by which industries compete and the priorities of differing customer segments.

The strategy canvas helps identify areas where the value to customers is increased by addressing their priorities and unnecessary components are reduced or eliminated thereby reducing the cost to serve.

Value Innovation; By W. Chan Kim & Renee Mauborgne



A strategy canvas is a mapping of quality attributes that drive the decision to purchase. In the below hypothetical example, there are two customer segments and eight quality attributes. Segment one has high expectations (indicated by a high importance score) of most quality attributes with the exception of quality attribute five. Segment two places high importance only on quality attributes six through eight, and therefore likely is uninterested in paying a premium for the added performance of quality attributes one to five.



Whether looking to design a disruptive innovation or defend your position from a disruptive competitor, having a clear understanding of what is important to your customers and how that varies between segments is *essential* to designing an effective strategy. Offerings should be designed to maximize the value provided and eliminate features that do not, thereby reducing the cost-to-serve.

If you have a disruptive competitor, how should you think about your price strategy?

Firms in the incumbent position must balance their commitment to the existing profitable customers of today with the needs of the market tomorrow, knowing that it takes time to make change.

Create a culture of value

The most effective defensive strategy that an incumbent can use to ward off a disruptor is a laser focus on customer value. There is a strong tendency to build offerings and add features over time. While at first some of the new features add great utility to the offerings, through the law of diminished returns there reaches a point where additional new features add mainly costs for maintenance but little relative utility to the general market. Using the value innovation concept to align features with specific customer segments:

- **Features can be prioritized for development.** Through the product development process, invest in excelling at the most important features while working to reduce or eliminate features considered unimportant for each segment (potentially as revealed through the strategy canvas analysis).

- **Offerings can be packaged through a variety of designs** (Good-Better-Best frameworks, Core offering + Add-on's) to target the value profile of specific customer segments. Such packaging designs allow 'fences' to be developed between offering packages based on value received and commensurately, a fair price is achieved.

- **Ensure the price-metric aligns with how your customer perceives value.** No one likes to feel like they are paying for something that is not useful. The strategy canvas may be instructive about disconnects between what we charge for and what customers value. Sometimes simply changing what we charge for can have a dramatic impact on how value is perceived.

While the notion of disruptive innovation is exciting, the reality is that most innovations by far are sustaining in nature. Even established firms that focus on customer value can be dynamic engines of innovation. With sustaining innovations, data is available for transaction analysis to ensure pricing can be optimized. Further, prices for new features customers may be familiar with can be evaluated via conjoint surveys.

Accept that value drivers are dynamic

At an established firm executive leadership is accustomed to the field of competitors shifting over time and the constant threat of low-cost providers. Seasoned leadership frequently dismisses disruptive threats due to the fact that most revenue is derived from larger accounts that the disruptive innovations cannot yet serve. The disruptive solution lacks features and is seen as inferior relative to the value proposition currently offered.

But technologies and business models can and do evolve. Therefore, the value propositions of your offerings will also change. Disruptive threats can be identified through year-over-year studies of the competitive set (built to be compared). Over time disruptive competitors will assume a consistently growing market share, frequently with more price-sensitive and lower-profit customers. When a consistently growing number of customers begin to reference a single low-cost competitor that uses a different approach, pay attention to what that competitor is doing! Even though the solution may be inferior today, it will likely improve thereby eroding the relative benefit of your offerings. Make no mistake, tomorrow's competitive field will not be that of yesterday or today. Monitoring your competitive environment is essential for understanding your true value and identifying threats.

Decide to cede market-share or manage cannibalization

Once your firm clearly identifies a disruptive competitive threat, the question quickly transitions to 'What should we do about it?'. At this moment three reactions are common:

- **Discount to match.** One knee-jerk reaction to a competitive threat is to reduce the price of existing offerings to match the lower-price disruptive threat. Break-even analysis reveals this is rarely a viable option. Full-service offerings are expensive to provide, and substantial discounts require disproportionately large volumes of growth to sustain revenue. In short, undisciplined, and poorly targeted discounts will weaken your ability to deal with the disruptive threat and you will find you are moving towards a price war from disadvantaged ground.

- **Cede the market share.** A second response is to ignore the threat. This response effectively pushes the decision down the road and allows the disruptive competitor to thrive unfettered by capturing more share. In the short term, this may be an effective strategy for ferreting out which disruptive competitors pose serious threats and are thus worth responding to. However, when your firm decides it will have to deal with the disruptor, it will likely then be a more serious threat with a larger market share and growing reputation. Your firm will be forced to react. When selecting this path, be clear to yourself how much market share you are willing to cede and in which markets. A proper exit price strategy should be planned to harvest the remaining value upon the determination to exit a market.

- **Develop a flanking product to match the disruption.** The third reaction is to proactively develop a flanking offering that imitates the disruptive innovation at a price lower than the traditional offering targeting specific customer segments. It is important to note that the flanking offerings you develop should be designed to match the (lower) level of value the disruptive threat currently represents and be priced competitively to that service level.

The third option is frequently the most viable of the three responses, but it remains a very difficult road. Firms must come to the painful realization that it is better to have controlled cannibalization within the firm than cede market share to external competitors.

Internally, executives who are rewarded for generating the high revenues associated with serving large complex, and profitable accounts will resist the development of lower-priced offerings for fear that customers will defect to these low-price offerings and cannibalize revenue. But if you have been monitoring the loss of market share, you can both quantify the value of what has been lost and demonstrate that the rate of loss is likely to accelerate as disruptive competitors enhance their offerings.

Build separate business units

Firms that successfully defend against disruption have found it helpful not only to segment customers by the job they wish to accomplish but also to build separate business units to address those segments. The needs of customers in large complex segments will drive a value proposition that demands a rich and complex feature set and commands a premium price. The needs of other customers may be far less demanding and profitable, yet still with a streamlined offering profits can be made. Unless you are organized to meet the needs of each segment, the team will only be incentivized to meet the needs of the large and more lucrative customers and ignore the lower-tier customers.

By reorganizing, each team is free to pursue profitable opportunities based on their respective value profiles. In time, both traditional and new offerings could be bundled in interesting ways.

In the case of ChatGPT from the beginning of this whitepaper, it is interesting to note Microsoft invested over $3B in OpenAI—an outside startup—to develop the ChatGPT technology rather than trying to develop it inhouse. While it is unusual to think of Microsoft as a new entrant into a market, remember that Bing has 2.8% of the search market and Google 93%. Investing in OpenAI and mainstreaming GPT through Bing gives Microsoft an opportunity to disrupt Google's hold on the lucrative search business.

Case Study: IBM enters cloud computing

IBM, an established leader in mainframe computing, observed the explosive growth of cloud computing that disruptive competitors like Amazon Web Services were having. Cloud computing provides opportunities for subscription pricing and pay-by-use models. In response, IBM acquired SoftLayer Technologies in 2013 to develop IBM Cloud rather than developing an in-house solution. IBM Cloud is now among the top 5 cloud providers in the world with 3% market share serving both small and large businesses.

Tips for established firms:

- Innovate based on customer value for customer segments with similar value profiles
- Monitor competitive field through time to identify disruptive threats
- Decide to cede market share or plan "controlled cannibalization" through a new offering
- If developing a new offering to counter a disruptive threat, strongly consider forming a new organizational structure with accountability for this offering and associated customer segments independent of traditional customer segments and goals
- Evaluate the value of sustaining innovations by employing transaction analysis, and conjoint or Economic Value Estimation per market size and familiarity with the solution
- Evaluate the value of disruptive innovations using price windows and Economic Value Estimation only
- Consider if a new price metric will help align offering to customer value
- In time evaluate if disruptive and traditional solutions can be combined in innovative ways

If you are a disruptor, how should you build a scalable price strategy?

Firms in the disruptor position need to be extremely strategic about which markets to enter in which order, while simultaneously determining how to set a balanced price. For a prices to be balanced, they should be low enough to profitably serve the initial target markets without forcing larger incumbents to react, but not so low that customers are anchored at levels that choke future profitability.

Culture of value: Build features incrementally to increase value

True innovation is born not simply from a technological advancement, but the realization of how value can be created for customers by leveraging the advancement. Technological advancement must be married to a new business application to become a disruptive innovation. The principles of value innovation as discussed previously demonstrate it is possible for disruptive innovations to occur without technological advancement at all.

For a firm that has identified an opportunity to apply a new business model as a new entrant into a model, the strategy canvas is an essential tool for prioritizing where and how to enter markets. In the start-up context, resources are constrained so the focus must be on excelling at the most important quality attributes and avoiding developing (or over-developing) features that have limited value.

One special challenge for the disruptive competitor as a new entrant is the lack of market information from which to set a price. A price window can be determined by establishing a floor (the cost for providing the new offering) and ceiling (total economic value the offering could provide relative to the performance of existing solutions). To narrow the window, qualitative interviews resulting in Economic Value Estimation (or EVE) can help more accurately ascertain the pricing window and preliminary estimates of a recommended capture rate.

Disruptive technologies frequently facilitate the introduction of new pricing metrics, the basis by which pricing units are agreed upon. Rolls Royce famously introduced the "Power by the Hour" model innovation in 1962 and expanded it in 2002 transforming the jet engine industry. Rather than paying to take ownership of jet engines, commercial aviation and government customers paid only for the time the engine was in use and providing value.

Targeted penetration pricing in niche underserved markets

According to the disruptive innovation model, customers with high price sensitivity and low service level requirements are frequently seen as unprofitable for an incumbent to serve. If the disruptive competitor can serve them profitably due to a new model, they will thrive in an uncontested space.

The strategy canvas can be used to illustrate which industries may be easier to enter than others. Industries that have high-performance requirements in multiple dimensions may not be the best to enter first. The customers will be demanding and the cost to serve is high.

Those with more specific demands or lower levels of performance requirements will cost less to serve and find simple lower-price offerings adequate.

Penetration pricing allows firms to enter a market at a low price to begin winning market share. To enact penetration pricing a firm will set a capture rate that biases value in favor of the customer. While for the short-term this feels like leaving money on the table for the customer, the superior value proposition will be appreciated by customers. Penetration pricing also requires the promotion of this favorable value proposition coupled with strong outcomes to allow all targeted customers to become aware an effective new way of doing business is available.

Land and expand with fenced value propositions

Once success is established in the initial market, qualitative research in adjacent markets should be conducted to develop refreshed and more detailed strategy canvases. Following the principles of value innovation select additional features could be created and offered in particularized forms to the next set of customers. As the offering moves to address the needs of adjacent segments, features can be removed to sustain tight value alignment.

Continue to foster a culture of value for the long-term

As disrupted markets mature, disruptive firms themselves can be exposed to the same risks as the established firms they disrupt. Walmart disrupted traditional retail chains with their mastery of discount retailing and supply chain management technologies in the early 2000's found themselves under a disruptive threat by Amazon in the decade of the 2010's and had to start an online division (Walmart.com).

Case Study: HubSpot creates inbound marketing

HubSpot was founded in 2006 to serve the underserved market of small companies that wanted to implement marketing campaigns. By focusing on social media and user engagement, the tool offered a new approach to launching campaigns. By focusing on small businesses, a segment the established players such as Salesforce and Oracle ignored as unprofitable, they were able to thrive in uncontested space. HubSpot's pricing plan allowed businesses with up to 1,000 contacts to have a free membership and begin to automate marketing campaigns. By 2010—only 5 years later—HubSpot revenues grew to $15.6M. By 2019, HubSpot's revenues grew to $670M.

Tips for disruptive firms:

- Don't mistake technological advancement with innovation (which implies a change in business model). Ask the question: Given the new capability, what unserved markets can we now serve?
- Innovate based on customer value for customer segments, especially segments with simple needs and those in markets considered unprofitable by established competitors
- Focus limited resources on high-value features
- Evaluate the value of disruptive innovations using price windows and EVE only, use penetration pricing to gain entry and generate a buzz
- Consider if a new price metric will help align offering to customer value
- After demonstrating results in the initial markets, identify the next markets that could be entered with limited modification. Fence the value created with additional features and versions.
- Don't forget, disruptors can themselves be disrupted. Frequently ask what features can be reduced and/or eliminated as well as added.

Resources

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