





# Covert Pricing

## *Expanding Profitable Business Behind Enemy Lines*

Holding your cards close is not only smart when playing poker but also when developing Internet pricing strategies. As more people scour price-friendly sites such as Expedia, Orbitz and LendingTree to get the best deals for the money, more companies are getting caught in costly Internet price wars—reducing prices to unsustainable levels. A new Internet pricing strategy can help you avoid such wars while increasing market share—in some cases by as much as 75 percent.

LAST YEAR, WE IMPLEMENTED A NEW approach to Internet pricing as part of a project for a leading company in the global travel industry. Our goal was to help the company capture profitable market share in its online travel agency (OTA) business, but to do so without starting a costly price war. The results have been remarkable: In just three months, the company increased its OTA revenue market share by 4 points—from 8 to 12 percent. Even more remarkable is that the increase was not a one-time blip: The gains have been sustained over the past six months as profits have continued to roll in.

These results are attributed to a new Internet pricing strategy we call *covert pricing*. It is an unconventional pricing methodology that borrows tactics from guerrilla warfare to ambush competitors, launch early morning raids and don camouflage to prevent detection by price-canvassing “robots”—all in an effort to tempt vulnerable micro-segments of customers away from a competitor’s online territory.

With covert pricing, companies can increase market share and profits by surreptitiously offering short-lived promotional prices that undercut competitors’ prices. For example, offering a reduced price to customers who shop between 7 and 8 on a Monday morning can increase market share in this micro-segment from 50 to 75 percent.

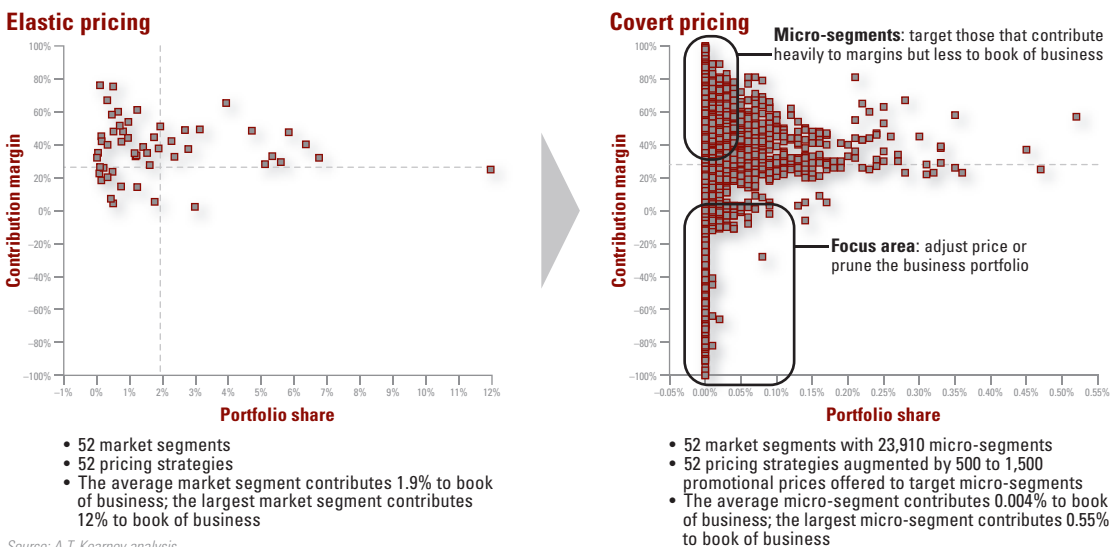
To ensure wins are not one-time events, the promotional prices change constantly—as do the targeted micro-segments of customers. The before-and-after numbers have been phenomenal. A meager 5 to 8 percent market share in targeted micro-segments before implementation rose to 63 percent market share after.

## Winning by 1,000 Micro-Segments

Differential pricing and customer micro-segmentation are not new concepts. The same ideas drive every company that floods the

FIGURE 1

Elastic pricing strategy versus covert pricing approach



market with a plethora of unique offers tailored to meet the exclusive needs of thousands of customers. Capital One is famous for such pricing strategies. The credit card company has more than 10,000 price points for credit cards, offering distinct fees, interest rates and services. Of course, the Internet has allowed companies to turbocharge their pricing strategies: Agile companies can reach more people faster, targeting consumers electronically with new offers and observing responses almost in real time. The result is a widening gap between fast and slow competitors.

Covert pricing, however, can help turn this gap into a gulf by taking micro-segmentation to the next level and using the full stealth power of the Internet. The key is to target profitable micro-segments by undercutting competitive prices with short-lived promotional prices. It is not uncommon for companies pursuing this strategy to increase the number of market segments by a factor of 100 or even 1,000. Ideal targets for covert promotions are small, high-profit, micro-segments, as the rewards are large and competitors' ability to detect the promotional activity is small.

Figure 1 compares the market segmentation used by an elasticity-driven pricing strategy with the micro-segmentation strategy employed by the covert pricing approach. As you can see, the first chart has 52 market segments and 52 prices, while the covert pricing chart has the same 52 market segments but an additional 24,000 micro-segments. The 52 pricing strategies are augmented by anywhere from 500 to 1,500 promotional prices for these targeted micro-segments.

Micro-segmentation has an additional benefit—it provides a deeper understanding of customer profitability, which can trigger price adjustments, or portfolio pruning that further improves the profitability of the overall business.

We have found that taking corrective actions in underperforming micro-segments can increase margins by 2 to 3 percent.

## Covert Pricing and Virtual Raids

The element of surprise is essential not only to the success of a covert pricing strategy but also to its longevity. Prices have to be published at the last minute and available only for a limited period of time. Virgin Blue, for example, publishes its online-only promotional fares to select destinations during a “happy hour” from 12 to 1 p.m. daily. Budget Rent A Car releases its “think fast” discount rates every Monday to subscribers of its weekly email newsletter; prices are available for just seven days.

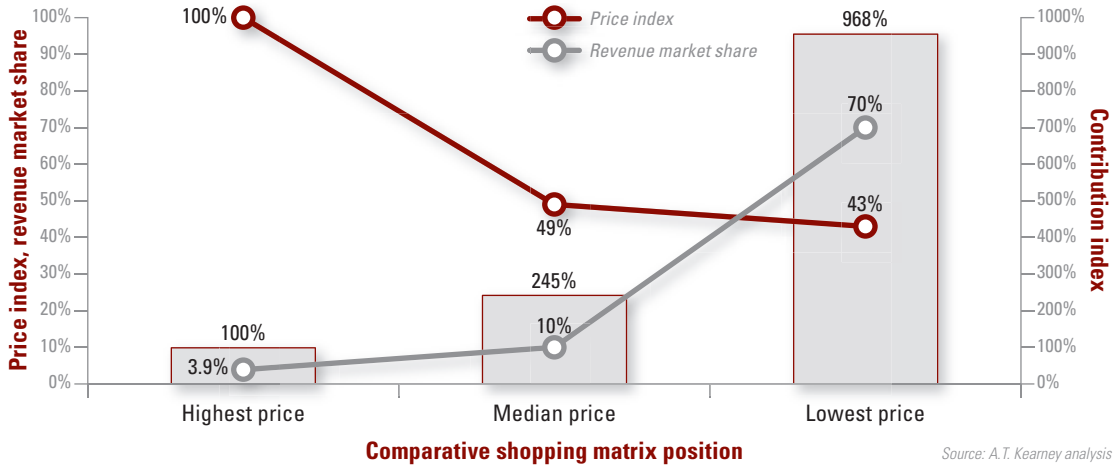
The strategy is based on three principles:

- Competitors do not have time to detect the new prices, decide a potential price response and publish new prices
- Shoppers feel pressured to act and make a purchase decision because the deal will quickly disappear and might not return in the future
- The promotion brings in buyers and the “bandwagon effect” increases sales for products that are not part of the promotion

In certain cases, the promotional program is not actively advertised in order to increase the stealth of the attack. Instead, companies opt for a passive distribution of the promotional product as certain shopper characteristics or requested products unlock the more favorable prices. To explain this, consider companies that review patterns of website visits to identify price-sensitive shoppers. Anyone who spends time on or purchases products from websites such as overstock.com, eBay or other easy-on-the-pocketbook sites is flagged as price sensitive. During subsequent visits, shoppers flagged as price sensitive will receive a better price than those who have not been flagged. Therefore

**FIGURE 2**

Rewards grow exponentially with the potency of the stealth attack



price discounting is not advertised; the lower price is offered based on shopping history. This is an efficient way to conceal prices from shopping robots.

From our research of comparison shoppers on online travel agencies, we found that the rewards to the company grow exponentially with the potency of the stealth attack. For example, although any improvement in shopping-matrix positioning resulted in an incremental rise in revenue, the full potential of the promotional price was revealed only after the company acquired the top position—in our case example, revenues increased 17-fold for a contribution of just under nine-fold (see figure 2).

We estimate that 40 to 60 percent of comparison shoppers are brand-agnostic—they will automatically select the lowest price even if there is just one penny difference. This is sometimes counterintuitive to pricing managers who are used to thinking in the continuum of price elasticity—how can one penny shift the market?

Although all comparison shoppers are looking for a deal, not all comparison shoppers define a deal the same way (see sidebar: *Am I Really Getting a Deal?* on page 20).

Applying covert pricing principles, companies can reach market share that might otherwise seem beyond the realm of possibility: Our client increased its current 5 to 8 percent market share in target micro-segments to an amazing 50 to 75 percent.

## Detecting Spies

As part of our work, we researched price-canvassing computerized robots. Equipped with the technology to convert any website with pricing information into a price database, they are also timed to work during periods of high demand, such as early in the morning when potential customers are most likely to shop for flights, hotels or car rentals.

The robots continue grabbing competitor prices at frantic speeds as they collect, store and analyze millions of prices a day. In fact, roughly 61 percent of all price requests from online travel agencies are the result of price canvassing.

With armies of price-canvassing robots scouring cyberspace, one brand's attempt to lower a price often sparks a price war. We found that one discounted price can quickly trigger

ripples of discounts, causing industry-wide revenue losses of up to 65 percent in a matter of days. Automated pricing systems further exacerbate the problem by making it difficult to recover even after competitors bring their prices back up to normal levels.

Figure 3 illustrates this with a hypothetical example. WidgeTron drops its price for widgets by 20 percent. Two days later, GimmickTrek notices and drops its widget price by 30 percent. Every online widget maker quickly follows suit and begins adjusting prices to the new market dynamics. On day five, WidgeTron begins to bring its price back up to its prewar price level. Will the market follow? Will companies be able to recover lost profits?

detection from competitors. Taking a page from Peter Senge’s popular book *The Fifth Discipline*, we can illustrate this by modeling a business environment in which interactions occur dynamically rather than in linear cause-and-effect relationships. When viewed as a dynamic time-sensitive system, aggressive and overtly visible pricing initiatives eventually become self-limiting and even self-destructive, especially in the absence of advanced counter-intelligence. Within these dynamics are two predominant circles of behavior, shown in figure 4 on page 21.

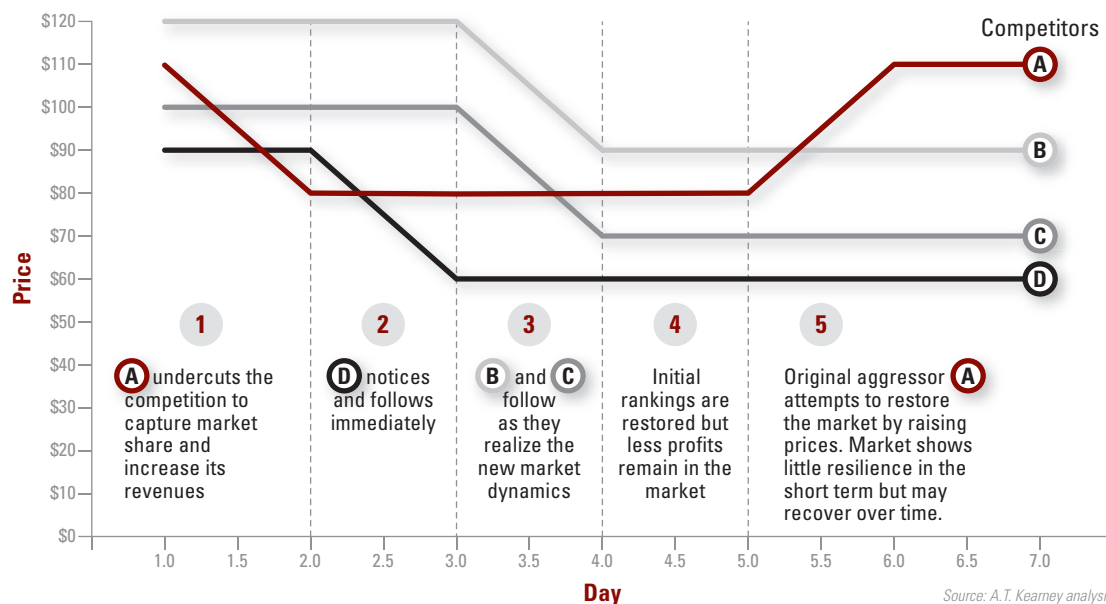
Again, we can use our widget maker to help illustrate this. At first, WidgeTron begins to realize gains from its aggressive but openly visible tactics of undercutting the competition’s prices. Initial success wins over top managers who become champions of the approach. What’s not to like as the profits roll in? Urged on by top managers, the strategies become more

## Don’t Get Caught

Gains from covert pricing strategies can be sustained indefinitely if cloaked properly against

**FIGURE 3**

Aggressive pricing leads to price wars that diminish profits in a matter of days



aggressive—creating what is known as a “self-reinforcing loop,” in which all behaviors are geared toward fueling the flames of profits.

After a few days—or weeks, depending on the industry—competitors have had enough and come onto the battlefield. GimmickTrek, the first on the field, might launch counter-pricing moves, followed by the other competitors, thus neutralizing the initial advantage and diminishing WidgeTron’s benefits. Now we have a “limiting loop,” whereby the competition checks the aggressor’s pricing initiative, grinding its growth to a halt and possibly even causing a large portion of the profits for the entire market to evaporate.

The best way to surmount limits to growth is to remove the limiting factor. In this case, the lesson is simple: If you want to continue growing, do not let your competitors catch you.

Our covert pricing concept avoids the limiting loop scenario with pricing counter-

intelligence: a collection of analytical techniques to detect and avoid competitors’ automated detection systems. We begin by identifying and compiling shopping patterns of legitimate buyers into a reusable set of customer profiles. When combined with creative visual analytics and a database of after-the-fact price requests, these profiles can single out patches of unexpected behavior and the presence of canvassing robots.

## The Three-Minute Decision

Mounting covert attacks on competitive-pricing positions relies on capturing millions of prices, processing the information, and publishing the promotional prices quickly to targeted customer micro-segments. Speed is of the essence, both to initiate the attack and to withdraw avoiding detection. The lethal attack requires quick decision-making and thus perfect coordi-

## Am I Really Getting a Deal?

A few years ago, amazon.com outraged some customers when it became clear that Amazon was selling the same DVDs to different customers at discounts of 30, 35 or 40 percent off the manufacturer’s suggested retail price. Amazon insisted that its discounts were part of a random “price test” and not based on customer profiling. Although Amazon had done nothing illegal, the firm acquiesced after weeks of customer criticism and offered to refund the difference to those who had paid the higher prices.

We can learn two things from this example: First, customers must know they are getting a deal; and second, thanks to the media, it is

impossible to hide a differential pricing strategy. Therefore pricing options must be communicated as a positive thing for the consumer. If lower prices exist, the consumer should be made aware of them prior to the purchase.

Research further substantiates this lesson. Findings in a study by International Communication Research for the Annenberg Public Policy Center of the University of Pennsylvania reveals that online consumers overwhelmingly object to most forms of behavioral targeting and all forms of price discrimination<sup>2</sup>:

- 87 percent say it is never okay for an online store to charge people different prices for the

same products during the same hour

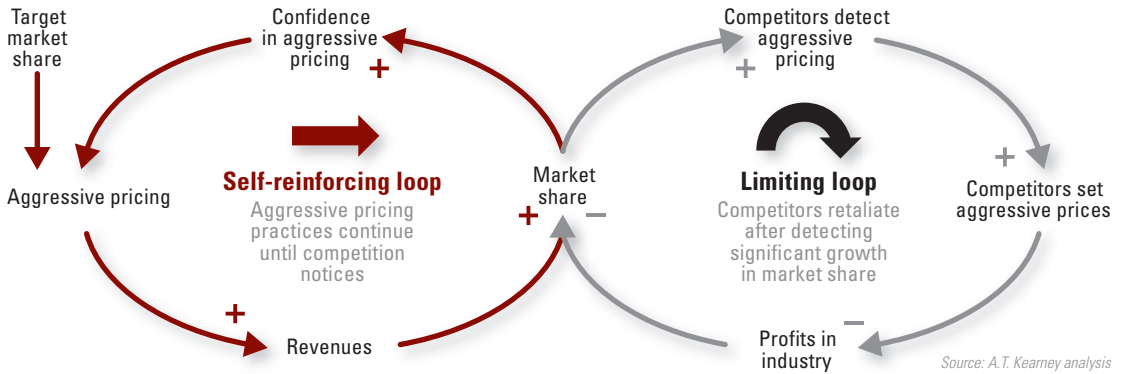
- 76 percent say it would bother them to learn that other people pay less for the same product
- 68 percent believe (mistakenly) that sites such as Expedia, which compare airline prices, must have the lowest prices

A differential pricing strategy will not work if it cannot work in favor of the consumers’ side. This means that long-term considerations are equally as important as those in the short term. Increasing sales or number of new customers has little worth if the brand value is undermined or existing customers are lost.

<sup>2</sup> Joseph Turow, Lauren Feldman, Kimberly Meltzer, “Open to Exploitation: American Shoppers Online and Offline,” *annenbergpublicpolicycenter.org*, June 1, 2005.

**FIGURE 4**

Covert pricing sparks two circles of behavior




nation among the key components of the pricing supply chain: shopping agents, automated pricing algorithms, price management and updated systems and Web analytics.

The problem for most companies is that the various elements of the pricing supply chain are spread throughout the entire organization and have different owners: The pricing organization owns price management and shopping agents, IT controls price changes and systems updates and marketing owns Web analytics. This fragmentation impairs the quick decision-making that is essential for success.

By consolidating all systems under one umbrella—a single pricing powerhouse—reac-

tion speed and data visibility increase significantly. Indeed, for our client, decision time went from two to three days to less than three minutes.

## Winner Takes All

Covert pricing is an effective strategy that should become part of the pricing arsenal of any company operating in highly price-competitive markets. While the primary benefit of the strategy is capturing profitable market share, ancillary benefits cannot be ignored: The micro-segmentation analysis leads to a healthier portfolio of customers, and pricing counter-intelligence defends market position against rogue competitors. 

### Consulting Authors

**DAN OXYER** is a partner in the North America automotive practice. Based in the Detroit office, he can be reached at [dan.oxyer@atkearney.com](mailto:dan.oxyer@atkearney.com).

**RASVAN DIRLEA** is a principal in the North America automotive practice. Based in the Detroit office, he can be reached at [rasvan.dirlea@atkearney.com](mailto:rasvan.dirlea@atkearney.com).

**TUVAN SENCALIS** is a consultant in the Atlanta office. He can be reached at [tuvan.sencalis@atkearney.com](mailto:tuvan.sencalis@atkearney.com).

**OZGUN ATAMAN** is a consultant in the Chicago office. He can be reached at [ozgun.ataman@atkearney.com](mailto:ozgun.ataman@atkearney.com).

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**PUBLISHING ADVISER**  
Wayne Boley

**EDITOR**  
Patricia Sibo

**DESIGN**  
Kevin Peschke

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