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Bundles with Sharp Teeth: Effective product combinations.

By Rob Docters, Bert Schefers, Christine Durman and Martijn Gieskes

More than ever, businesses need to assemble multiple products combined into a single offer, a practice known as bundling. Technology and cost-cutting are creating a world in which many customers now prefer such integrated solutions and, to stay competitive, this demand must be met.

Take for example the advent of digital technologies, which in various markets have made possible the blending of formerly stand alone processes and devices. The resulting bundles are appealing and transform markets. We see such bundling in diverse arenas, for instance: in the convergence of cable and telephony services; the merger of customer call center phone systems and customer records data bases; and integrated architect, builder, and owner work flows in construction projects.

In this new world, finding effective ways to bundle your products and services is crucial. Yet pitfalls lurk because the more novel the bundle, the greater the danger of bundling mis-steps. This article will look at two dangers in particular: mismatching the various elements of a bundle, and mispricing the offer. If a bundle includes elements no one really wants, customers won't buy the bundle without a deep discount. Similarly, if a company attempts to combine products or services without enough thought as to price, the result is often gross overpricing or under pricing.

In helping clients with their bundles, we find there are four marketing mistakes which 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.

Sometimes mistakes are obvious, but often, the more successful the core product, the more its related bundles fall short of the optimum while appearing to be successful. We'll examine each category of mistake in turn, showing how things can go wrong and what to do about it.

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. We'll look at two special purposes in particular: bundles intended for attack, and bundles intended for defense.

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 percent switching cost for users to move from one company's service to another's. The task was to define an attack bundle—yet it was clear that an unadulterated 15 percent price cut 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 therefore 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 consumer and B2B customers to fully understand what they're buying. In the old days of standalone products they could rely on being able to kick the tires, but 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 they've 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, the 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, and 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 who were already splitting their 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 tieing a weaker product with *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.

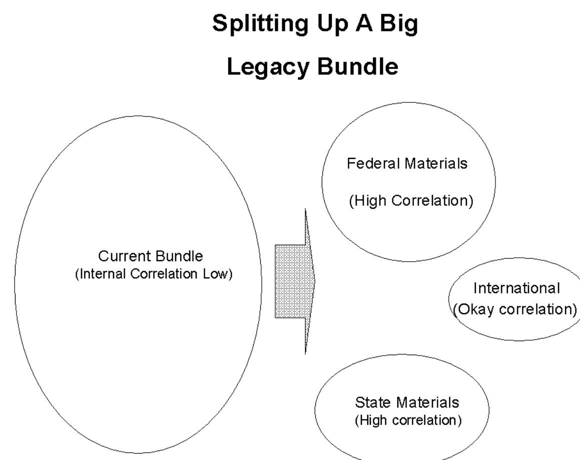
An example comes from the high technology arena, where a producer of optimization software for Server farms bundled in high priced support and maintenance charges as well. This worked well for a few years, but as soon as rivals matched the software, cancellations rose because the maintenance was overpriced 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.

Overbundling—Making bundles too big

An example of over bundling comes from a B2B online service which garnered a premium position in the early days of its market, pioneering the conversion of forms and print to online. It constructed its bundles around federal materials, and grew by adding such further legal jurisdictional categories 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.



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 almost no customer 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.

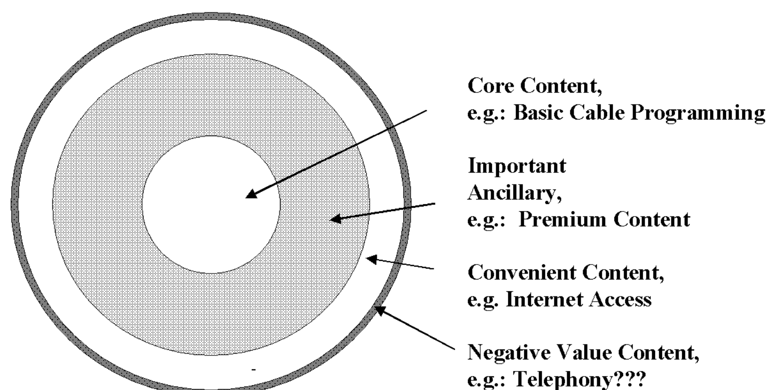
Sometimes operational costs can be minimized. We have found that in many cases there's no need to touch the product, and that limiting the breadth of the bundle is less important than narrowing the product's value message and price plans. In many cases, customers won't notice they're getting "more" than 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.

[SIDEBAR: Anatomy of a flabby bundle]

To diagnose the problems of a big bundle, a scalpel is required that can separate the components on paper and award them their proper value, from the point of view of potential customers. Fortunately, such a technique exists. It consists of a statistical examination of purchases, and we've found it effective across a wide range of markets.

In working with many different clients, this technique has helped us draw an interesting conclusion: most bundles—though not all—share a similar structure or taxonomy. This structure can be illustrated as follows:

Bundle Taxonomy



Essentially, a typical bundle marries four kinds of components. At the heart lies the core or anchor element; this is the product or service driving the purchase—for example, basic cable programming for cable television companies. Wrapped around that are those elements which strongly complement the core—for example, premium content. The next

layer consists of content seen as convenient for the core—in this case, new services such as internet access. This layer may be lower value than previous layers, but still carries its own weight.

The final layer of a bundle often turns out to be additions with *negative* value. These are either substitutes for other bundle components (buyers generally hate being forced to buy two redundant products), or components which have such low relevance to the core that they clutter the value message or cost more than the value they command.

This model can be very helpful in thinking about why different components are or aren't compatible. In our own work, we have often found that clients have bundled together substitutes rather than complements. For example, we helped a Telco analyze just why telephone bundles containing both Caller ID and the Return Call feature (*69) sold so poorly. It turned out that while the Telco had expected (*69) to appeal to customers as a convenience, customers viewed it as a security feature, using it to call back and scold harassing callers. This effectively made it a substitute for Caller ID. Substitutes within a bundle had destroyed value and undercut the market appeal of the bundle.

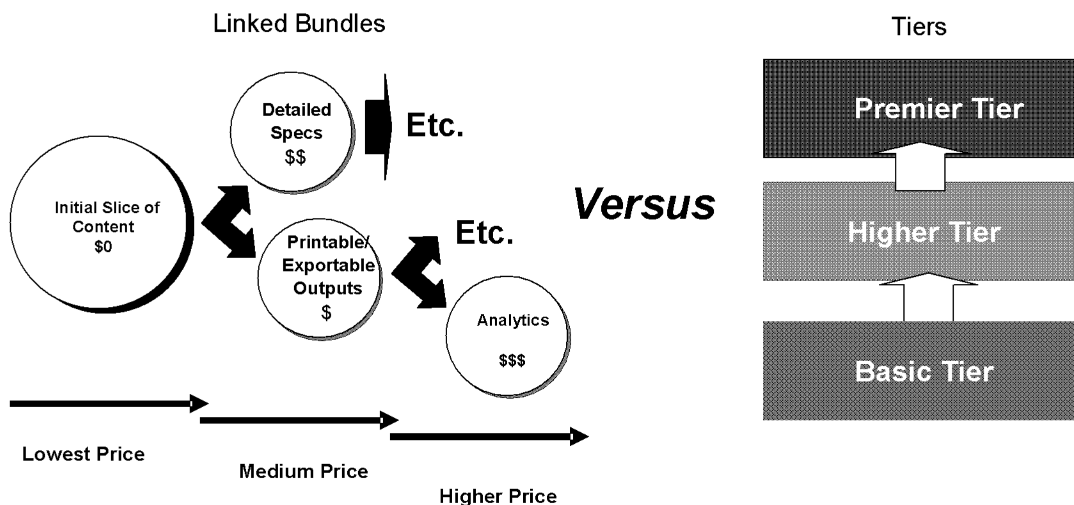
[END SIDEBAR]

Tiering rather than bundling

Tiering of offers is a popular pricing technique. It's actually a form of bundling, but differs from most bundling initiatives in this respect: rather than build from the ground up, tiering begins with an existing offer, then adds or strips out features to achieve the end result. Sadly, such additions or subtractions tend to be done blindly.

The value principles are the same as any bundle—try to build a compelling value price proposition. (Or at least the *context* for such a proposition, as sometimes the purpose of tiering is *not* to sell all the tiers, but to show consumers that one of the tiers is a good deal.) Tiering works quite well when consumers feel they have discretionary spending ability—that is, they can spend more on the features they find appealing. Tiering works less well with buyers faced with highly constrained budgets, who want the lowest price that meets their essential needs.

When customers are reluctant to spend more, a second technique is worth investigating: linking bundles, so that the purchase of one bundle *must* lead to the purchase of a second bundle. Up-tiering in this manner is a good way to increase revenues either at the time of the initial purchase, or later on. The underlying insights are twofold: First, customers will likely experience moments after the initial purchase when added features or bundle elements seem more appealing; and second, customers' price sensitivities will likewise vary over time. Linked bundles directly help sellers profit from the happy moment when needs are high, or price sensitivities low.



For this technique to work, what we call "hooks" are necessary to encourage customers to voluntarily upgrade. We have found this to be especially true in tough, mature markets. Here are some examples of hooks:

- LexisNexis sells legal libraries by geographic region—yet its search mechanism highlights relevant cases in the *total* legal database, not just by region. Even if an attorney steadfastly refuses to buy more than the library of his own state's decisions, he will keep seeing searches that show all cases, from any tribunal. On the eve of an important trial, if the search engine now shows a case outside his library which appears highly relevant, even a very stubborn buyer may decide at that moment to expand his purchase. This factor has led many users of LexisNexis to buy new libraries or to buy specific cases at several times the normal price.
- Basic bundles from a particular vendor of tax software include only tax law, annotations, and tables. Add-on bundles, on the other hand, include forms and calculation tools which can save critical time during tax season when practitioner are desperate for time.
- In the construction industry, many building contractors price their initial bids low, but charge high mark-ups for change orders in the midst of construction—when owner have little choice but to pay higher prices.

Migration paths prompted by customers' key needs—the hooks—can be far more effective than price structures founded only on a hierarchy of "good," "better," and "best."

Failure to innovate on bundle definitions-- Depth vs. breath

Back to incumbents: another common problem in the bundles of established players is that the bundle definitions no longer effectively communicate value, especially when compared to competitors' offerings: *everyone* is now claiming the same benefits. Worse yet, the market leader may even find that its definitions are being used against it.

For example, a company in the medical testing markets initially grew to prominence by offering services in more cities than did competitors. This claim was backed by well-equipped facilities in more than 40 states. When competitors arrived on the scene, however, through reciprocal agreements they laid claim to all 50 states! Even though the competitors' capabilities and quality were inconsistent, customers found the pitch convincing—after all, they had been trained by the incumbent itself to believe that geographic coverage was an important part of the buying decision.

The solution for the incumbent was to re-define its product, using service bundles and pricing to highlight its superior capabilities. This underscored the low value of mere geographic presence without appropriate equipment and quality.

One way of describing this idea is that it focuses on depth rather than breadth. Breadth is how customers assess the initial value of an offer; depth comprises the ineffable attributes which customers discover only after experience with the product. This notion applies to any industry: there are always attributes which can't be easily proven or sold up-front, but must instead be experienced to be believed.

As an example, one transportation concern buys only high-quality Peterbilt trucks, after having discovered that their drivers treat Peterbilts better, with subsequent lower operating costs. This would be tough to prove and quantify ahead of time, but is now factored into financial decisions. Similarly, television advertisers generally demand evidence or direct experience to assess the effectiveness of media with above-average advertising rates per thousand ("CPM"). It is the actual propensity of different audiences to buy that is the best evidence. After trial, or observing other's results, advertisers will pay premium CPM rates if warranted.

Depth vs. breadth is often key in fights between incumbents and challengers. Challengers are typically more innovative—partly because they need to be creative to succeed, and partly because they are unconstrained by contracts, tradition, or older computer systems. A classic example of depth vs. breadth was the fight between upstart MCI and incumbent AT&T during the 1980s. AT&T defined a minute of conversation as 60 seconds of talk time. MCI defined it as set-up time (ringing, etc.) *and* talk time. Effectively, this meant that MCI had a 57 second minute—and this helped it quote per minute rates lower than AT&T.

For challengers, the joy of re-defining "depth" includes the joy of causing competitor managements to throw temper tantrums—but most importantly, it places a big burden of explanation on the incumbent. Often this burden is insurmountable: for one thing, customers don't care about long technical explanations. It may be better for the incumbent not to acknowledge the upstart at all.

Why bundles matter—the tools are different

There are two reasons to understand and differentiate between different bundle strategies. The obvious one is that if the bundle is wrong, or if the wrong bundle price is presented to the market, the market won't buy. For example, customers have consistently shown that they exact a disproportionate penalty on bundles which contain substitutes rather than complements. They are similarly punitive if the bundle contains too many elements, making it too hard to understand the total value they're obtaining. Bundles must be razor-

sharp in purpose and pin-point targeted. To put it another way, markets have repeatedly shown that the bundles with the sharpest teeth take the biggest bites out of competitors.

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 that anyone with a typewriter can render the bill. Relatively inexpensive to implement.

By contrast, developing a set of linked bundles (in order to force the customer to upgrade over time) is a complex undertaking in all respects: bundling, guidance to the sales force, customer support systems, and billing. The building and launch of such a bundle may be quite expensive. Therefore, different market objectives and economics may make one bundle strategy feasible and another undesirable—it depends.

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.

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