Pricing & Profitability Management

"Shelf-back pricing. Know your consumers in order to better price your customers!"

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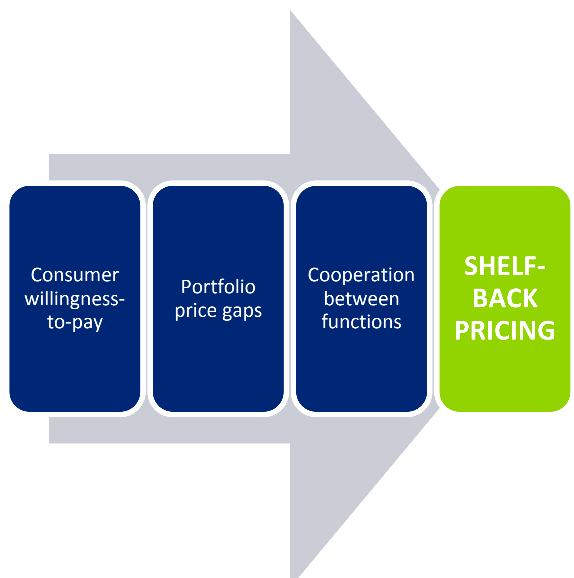
Welcome to the 2nd issue of the Pricing newsletter, annual volume 5, published by Deloitte. The purpose of this newsletter is to share some of our insights and experiences on specific topics related to Pricing. In this edition we share our insights on shelf-back pricing, a pricing strategy particularly suitable (but not limited) to the retail industry. We will discover the building blocks of shelf-back pricing and some successful examples from the market.



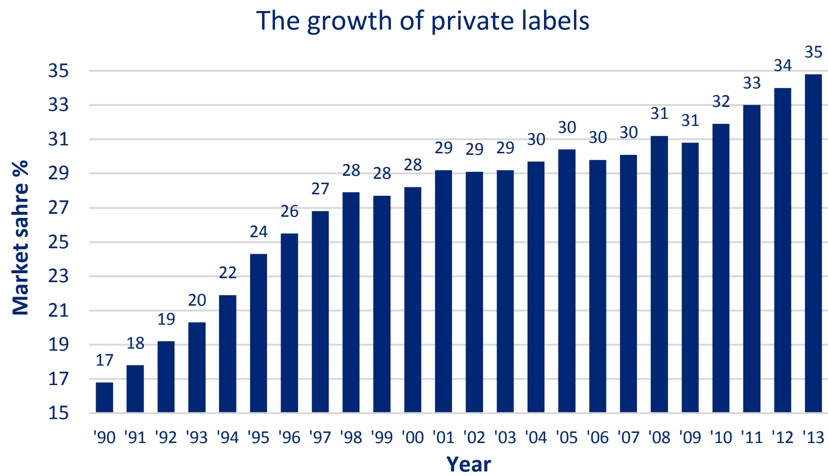
Companies operating at any stage of the value-chain towards the consumer agree on the importance of the shelf price in defining the success of a product in the marketplace. Marketing literature is densely populated with cases of suppliers and retailers whose success (or failure) has depended largely on their right (or wrong) shelf price positioning. Yet, it is surprising to notice how much time and effort B2C suppliers spend in managing prices towards their *customers* (retailers, wholesalers, etc.), and how little time and effort are spent in managing prices towards *consumers*. Having insights on the shelf price and the consumer willingness-to-pay allows suppliers to more effectively manage prices backwards along the value chain and ultimately towards retailers and wholesalers. Shelf-back pricing is based on three pillars: understanding consumer willingness-to-pay, maintaining portfolio price gaps in line with consumer values and ensuring a solid cooperation between organizational functions.

Understanding consumer willingness-to-pay

Understanding consumer willingness-to-pay is key for suppliers to develop products whose specifications are in line with market needs, avoiding costly over- and under-specification mistakes. It also allows to capture more value when a product is exceeding competition alternatives.

The strategic importance of consumer willingness-to-pay has been proven in very different markets. In launching its Pringles potato chips, Procter & Gamble understood that the unique value delivered by its innovative tube packaging and chip shape directly translated in a higher willingness-to-pay compared with other crisps. As a result, Pringles is sold at a 30%-higher shelf price than a comparable chip from another A-brand, while being still able to capture mass volumes.

The retail industry offers another interesting example of mastering the knowledge of consumer willingness-to-pay. For years retailers have been successful in selling products under their own private label. Through consumer intimacy they developed an understanding of the willingness-to-pay of the everyday shopper, who is willing to trade the brand name in exchange for a good product quality and (most of all) for prices that can be up to 50% lower than traditional brands. As a result, private label products are constantly growing in share and are nowadays an integral part of the commercial strategy of suppliers. The above chart shows this growing market share trend*.



But how can companies understand and quantify consumer willingness-to-pay? The most effective way is by conducting **consumer surveys**, although quite some effort is required in order to collect and process the results. Surveys are also affected by the natural tendency of consumers to declare a higher willingness-to-pay than they actually have.

A more scientific way of running a consumer survey is to add a **conjoint analysis**. In this case, respondents are repeatedly asked for their preference among a defined set of low- and high-valued product attributes. Based on consumer answers, implicit quantification of their willingness-to-pay can be performed.

A faster and easier, but often less rigorous way of collecting consumer willingness-to-pay is via the **expert opinion** of in-house specialists or industry subject-matter experts.

Maintaining portfolio price gaps in line with consumer values

Understanding consumer willingness-to-pay is only one side of the shelf-back pricing story. As suppliers' product portfolios are growing in size and the number of SKUs in retail shelves is increasing, it's becoming increasingly hard for companies to investigate consumer willingness-to-pay for each product they market. A way to simplify this is to have a clear understanding of consumer willingness-to-pay for some key reference products (typically, the best sellers) and build on those reference products the price gaps towards the rest of the portfolio. The example below clarifies this technique.

A leading global food company was marketing different versions of its coffee creamer at different prices, according to their flavours. Moreover, the price/kg gap between the 500g and the 1Kg bottle of the same coffee creamer flavour was set at 40%. However, the key value for which consumers were willing to pay was the availability of a small package, which was allowing them not to keep the product for too long in their shelves. Consumer valued this more than the 40% price gap set by the supplier. Differentiation between flavours, on the other hand, scored lower in the consumer willingness-to-pay ranking. As a result, the company aligned prices across flavours and increased the price/Kg gap between the 500g and the 1Kg

* Source: Nielsen Marketing Discovery Gondola, May 15th, 2014. The chart shows figures of the Belgian retail market, although several researches confirm the same trend on a global scale.

bottles. The two versions kept on selling in high volumes since they were now targeted to two clearly different market segments: families with children that were able to quickly consume the 1Kg bottle, and smaller families which were still purchasing the 500g version at a higher price. The supplier enjoyed a rise in profits thanks to an average higher price both in the 500g and in the 1Kg segment.

	Shelf price	Shelf price / Kg gap	New shelf price	New shelf price / Kg gap
500g seasonal-flavoured	2,53 €	0%	2,79 €	0%
500g standard-flavoured	2,53 €	+40%	2,79 €	+60%
1Kg standard-flavoured	3,57 €	+19%	3,49 €	0%
1Kg original	3,00 €		3,49 €	

Cooperation between organizational functions

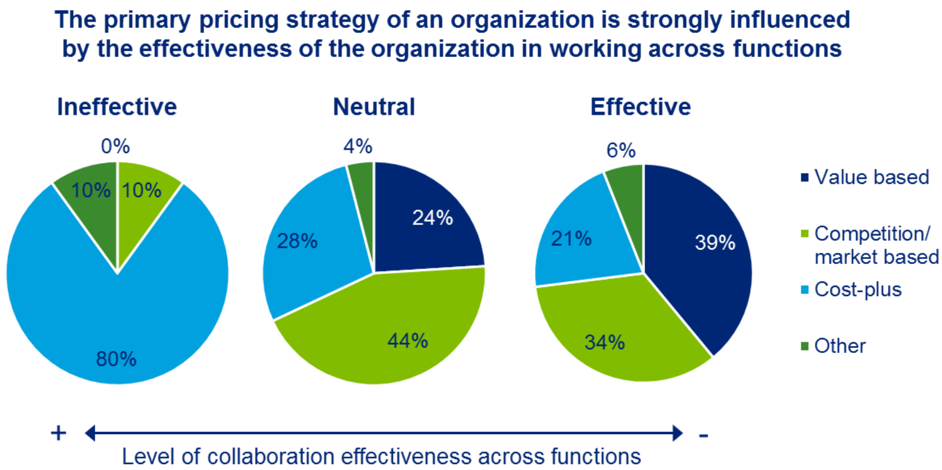
Applying shelf-back pricing means ultimately that a strong cooperation between the different organizational functions is needed. Marketing needs to gather consumer insights and translate them into clear price guidelines and tools that Sales can effectively put in practice with customers. Sales on the other hand should support Marketing, as sales people have a privileged access (through their customers) to consumer insights. The Finance department is also expected to work close to Marketing and Sales, measuring the results of pricing actions and report back the progress versus specific KPIs. Finally, the role of Management is to provide the whole team with strategic objectives, empower Marketing to take bold pricing decisions based on consumer insights and support Sales in the most strategic customer negotiations.

A recent research conducted by Deloitte in cooperation with Vlerick Business School (2014) confirms the importance of cooperation between departments in achieving pricing objectives (and thinking "shelf-back"). The research was directed at professionals of different functions (Marketing, General Management, Sales, Pricing, Finance, etc.), with the objective to gather information on financial performance of organizations, main factors of pricing effectiveness, pricing strategies, pricing tools as well as dynamics between sales and pricing functions.

"Please select 5 statements that you consider to be most crucial for effective pricing:"

Working together across functions to make sound pricing decisions	**65%**
Clearly defining ownership and roles within the pricing process	53%
Collecting information on competitors' pricing and market strategies	52%
Segmenting customers based on needs and buying behaviour	52%
Understanding customer cost-to-serve and profitability and adapting sales approach accordingly	40%
Documenting, communicating and enforcing pricing processes and policies	39%
Training and developing the pricing skills of staff	37%
Having IT systems in place to monitor pricing policy and processes	33%
Adjusting pricing in response to competitive threats	30%
Capacity to manage pricing at an international/regional level	30%
Measuring customer and transaction profitability and fixing price leakage points	27%
Clearly communicating prices and price changes to customers in a timely manner	24%
Using price communication tools to support discussions with customers	17%

When asked for the key factors for effective pricing, respondents mostly gave priority to the collaboration between different functions. Furthermore, in companies where the collaboration between functions is effective, it's easier to apply the value-based pricing methodology (which is at the heart of shelf-back pricing). When departments do not work with each other, consumer insights are not shared across the organization and prices cannot be set in other way than purely based on costs (cost-plus pricing).



In this context, the role of the Pricing Manager is key to bridge the gaps between organizational functions and to resolve eventual disputes that may arise. The research confirms indeed that organizations which have a dedicated pricing team or Pricing Manager position are proven to be more effective in collaboration between departments.

A whole new supplier-customer relationship

We have seen how shelf-back pricing allows suppliers to **price their products according to consumer willingness-to-pay** and **maintain healthy price gaps** across their portfolio. Exploiting consumer insights has also the benefit of pushing organizations towards a **better cooperation among functions** and employees.

A maybe less obvious but extremely powerful consequence of shelf-back pricing is the possibility for salesforce to increase the level of relationship with their customers. When salespeople are well equipped with consumer insights, they can share those with customers and act more as business advisors rather than just product sellers. They will be able to handle price-focused negotiations by bringing shelf price evidences to defend (or increase) their prices. The whole discussion between the salesperson and the customer can then be shifted away from price and centred more around value, which is the ultimate way to limit unnecessary price erosion and margin leakage.

Upcoming Events

- **Certified Pricing Manager Program 2 (Deloitte & EPP)**

  Date: 3rd until 7th of November 2014, Stuttgart, Germany

  More info: EPP Website

- **Spare parts pricing XXL**

  Date: 19th and 20th of November 2014, Bologna, Italy

  More info: EPP Website

- **PPS 10th Annual European & Global Pricing Workshops & Conference**

  Deloitte is proud to sponsor and partly host this conference organized by the Professional Pricing Society. Marc Abels and Cesar Bengoechea will elaborate on the following topics:

  Price Setting for New Products & Services - Marc Abels

  Setting the price of a new product or service is too often perceived as an unfounded process of speculation. Deloitte has developed a framework for pricing new products and services. The framework is built on a structured – 'validated learning' - approach to gradually solve these uncertainties and set your price in an optimal way.

  Pricing, At Your Service – Avoiding the Commodity Price Trap by Introducing Value Adding Services - Cesar Bengoechea

  When a product or service drifts toward the commodity category, customer focus gravitates towards price. Deloitte will share techniques and explore methods to take emphasis off price and keep commodity products profitable by introducing additional Value Added Services.

  Date: 26th until 28th of November 2014, Barcelona, Spain

  More info: PPS Website

- **Certified Pricing Manager Program 3 (Deloitte & EPP)**

  Date: 19rd until 23rd of January 2015, Venue to be announced

  More info: EPP Website

- **4th EPP Aftermarket and Manufacturing Industry Forum 2015**

  Date: 11th and 12th of March 2015, Venue to be announced

  More info: EPP Website

- **2nd Chemical Industry Forum 2015**

  Date: 25th and 26th of March 2015, Copenhagen, Denmark

  More info: EPP Website