

Spare Parts Pricing

Gain profits by sailing round common pitfalls



Summary

Several spare parts manufacturers are wasting their money – even in tough economic environments spare parts are a good source of continuous profits. Do not be worried by typical pitfalls that could be holding you back from realizing those returns.

Today, OEMs in various manufacturing industries, from automotive to aerospace, from tool manufacturing to large engine manufacturing, suffer from declining margins in their original product business. At the same time buyers think twice before signing contracts for large equipment orders. In such a market environment, spare parts come to the fore as more customers seek to repair their old products rather than replacing them with new ones. For manufacturers of spare parts, this is a good driver to investigate more sophisticated ways of pricing their products.

However, many spare parts manufacturers fail to utilize the power of efficient pricing mechanisms to optimize their returns.

Their pricing strategy is neither consistent nor well-founded since they have become entangled in common pitfalls that constrain effective price management of spare parts. Sailing round those 6 typical pricing pitfalls can significantly contribute to improved business performance.

Pitfall 1: Staff are unable to spend sufficient time on managing prices for every single part.

The spare parts business is known for its complexity. Manufacturers typically produce multiple models of products which change over the years and sell hundreds of thousands of spare parts to support those products. Given these volumes, it's hardly surprising that companies focus on pricing the 'best' spare parts, those fast movers with the highest revenues, and leave all the others to be priced with an easy broad-brush approach. While it seems logical on the surface, this practice grossly sub-optimizes the pricing of most of the parts (even the 'best' ones). Our experience suggests that in many companies at least 60-80 per cent of parts are not priced adequately to match market conditions and company strategies.

The solution – managing prices at an individual part-number level – sounds daunting, especially when adding headcount is impossible. How can it be done? By organizing parts into segments and by continuously applying strategies and tools to analyze and act upon large data sets.

Segmentation is the grouping of parts based on common characteristics such as market dynamics, life-cycle position, customer value, and sales volume. Pricing strategies can then be determined for each segment,

and pricing can be managed at a segment level. For example, parts that are extremely competitive could be grouped into a commodities (or hyper-competitive) segment. The strategy for this segment should be to price parts at market prices. Another potential segment could contain captive parts that could be priced higher because there are no substitute competitive products in the market. Finer segments might mark pricing to meet or beat a specific competitor for a specific set of parts.

By using segmentation, companies can adjust prices for several hundred thousand parts, which is already good practice for certain manufacturing companies. Relevant attributes used to segment parts for those companies may include the position of the part in its lifecycle, the part's market share, the intensity of competition, as well as the part's perceived value and price elasticity (Figure 1). Segmentation could be tailored to each product portfolio to take account of the factors that drive business for parts in their portfolio – it may be quite different across different groups. An analysis of

the parts in each segment helps the pricing teams to develop segment-specific pricing strategies.

This process of applying defined pricing strategies to individual parts within a segment can be automated and updated as conditions change. With the right tools, on-going analysis of segments can validate that price and margin while performance remains in line with the intended strategy for the segments.

Pitfall 2: Gross margin is a good indicator of profitability.

Most businesses manage their profitability by gross margin targets. Experience shows that while gross margin is an accurate measure of profitability, it may not be the most effective one for two reasons: 1) it does not take into account all the cost-to-serve elements for the part, which together are frequently higher than the cost-to-buy (used to compute gross margin) and 2) it does not reflect the value of the part to the customer, which should affect the selling price.

Fig. 1 – Pricing strategy by segment

Competitive Position	Captive	Target margin: profit before tax 50%	Target margin: profit before tax 50%	Target margin: profit before tax 50%	Target margin: profit before tax 65%	Target margin: profit before tax 65%
	Competitive	10% premium on competitor A list price	10% premium on competitor A list price	Competitive price: Match competitor A list price	20% premium on competitor A list price	20% premium on competitor A list price
	Commodity	Match average market list price	Match average market list price	Match average market list price	10% premium on competitor A list price	10% premium on competitor A list price
	Warranty	Target margin: profit before tax 0%	Target margin: profit before tax 0%	Target margin: profit before tax 0%	Target margin: profit before tax 0%	Target margin: profit before tax 0%
		Early	Growth	Peak	Declining	End
		Lifecycle Stage				

Figure 2 depicts one specific part number and the many other costs that chip away at a part's 'profitability' beyond total actual part costs. While total actual part cost measures the acquisition cost of the product, it does not include the costs of marketing, promotions, discounts, incentives, rebates, storage, transportation, and shipping, just to name a few. When these costs are included, the true profitability of the part in this example is 38 percent. While a 38 percent true profitability might be great for this product, for other parts, the result could be negative profitability. Consequently, manufacturers are able to focus on parts with negative profitability and price them accordingly.

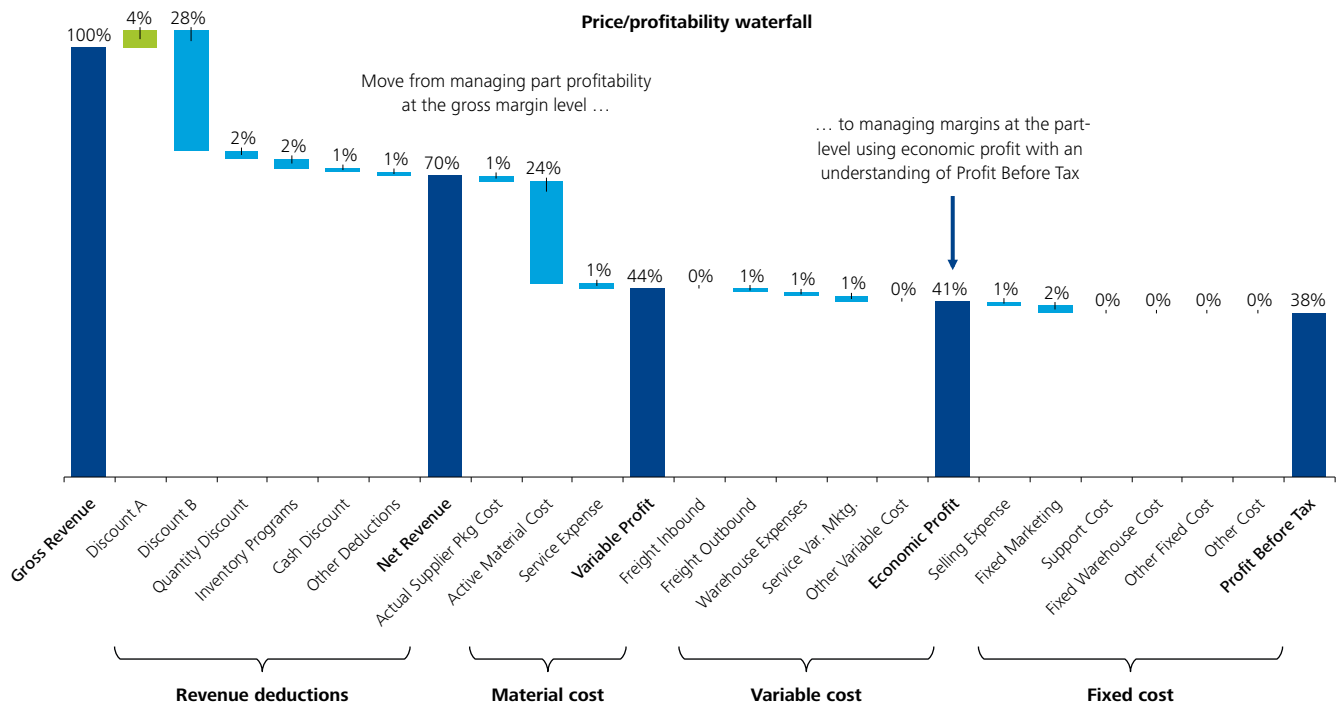
Chart 2 is called a waterfall as it helps companies identify where profit is 'leaking' by displaying all 'cost-to-serve' elements and where certain actions (including price increases) would be effective. A total cost-to-serve view demonstrates that actual profitability is always less than the gross margin indicates. While some of these

costs can be controlled (for example, marketing spend), others cannot. This also highlights parts where vendor concessions are essential and give companies guidance for holding those negotiations. Manufacturers can expose and execute opportunities for improving profit by understanding cost drivers better.

One manufacturer, making pricing decisions based on gross margin, frequently decided to reduce parts prices to increase sales volume. At the same time, marketing ran promotions on the same parts, in effect reducing prices even more over a six-month period. Essentially, the company discounts the parts twice, thereby causing rampant margin erosion. This could have been avoided by including promotion costs in the margin metrics.

Instead of using gross margin as an indicator of profitability, a spare parts manufacturers should consider other metrics that take into account all the cost-to-serve elements for the part.

Fig. 2 – A total cost perspective makes true profit apparent



Pitfall 3: Historically, the finance department has ownership of our pricing policy.

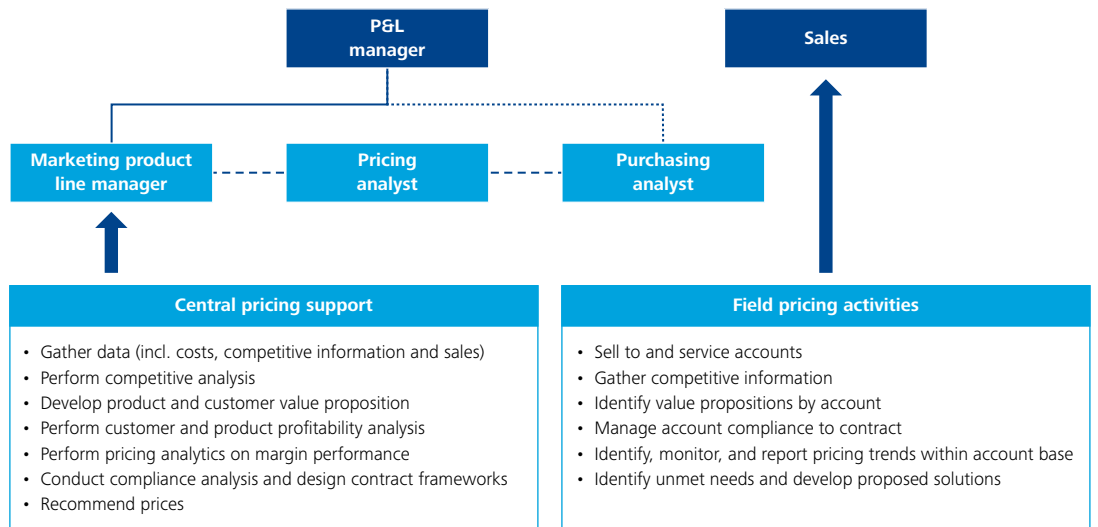
An effective pricing approach is impossible without cross-functional collaboration and organizational alignment, but in many manufacturing companies, the functions that touch the part – finance, sales, purchasing and marketing – have different goals and performance metrics. Finance may focus on profit before tax for the entire business unit or product family; marketing may focus on gross revenue and gross margin by commodity group; and sales may focus on gross volume and gross revenue by region or representative. Frequently, they do not communicate effectively about parts pricing.

The establishment of high-performance pricing teams can help companies to align goals and metrics from several functional areas. The team can gather cross-functional data in order to perform a thorough analysis of revenue and margin performance before recommending prices. The process for achieving alignment begins by answering tough questions: What are the roles of each function? What is the ideal pricing process? Who has responsibility and accountability for each individual step in the pricing process? Who do team members report to? How do they work together? What metrics work most effectively for the company overall? How do we resolve disagreements on strategy?

Figure 3 shows how a pricing team could be structured. The marketing manager reports directly to the P&L manager (marketing); a dotted line connects the pricing analyst and purchasing analyst (the same analyst can work for multiple portfolio managers; hence, his or her knowledge and experience can be leveraged effectively across many part segments). The team is virtual, working together as needed to develop pricing recommendations. Each function has a well-defined role; the sales organization provides competitive information to marketing, in addition to collecting competitive data through external sources. Finance gathers data, performs the analyses, and determines the part’s true profitability. Marketing contributes an understanding of the value that customers place in the product, determines product strategy, and recommends prices based on the analysis from finance.

This type of alignment is relatively simple to achieve and execute; with a clear definition of roles and responsibilities, the project team knows what to do and how to do it. The P&L manager defines revenue and profitability goals for the team and enables the team to reach consensus about pricing actions. The different business functions are focused on the same metrics – revenue and profitability – and work towards achieving these goals.

Fig. 3 – A functional structure integrates cross-functional pricing activities



The same metrics (such as economic profit, variable margin, and/or profit before tax) can be used by all parts of the organization to drive toward an integrated pricing strategy and process.

Pitfall 4: Competition in the spares business is severe for every item! – hence, we price conservatively.

This misconception has two assumptions, both of which companies need to test: 1) “we have lots of competition for every part” and 2) “if we have competition, we must price conservatively”.

We will start with the first assumption.

When considering the marketplace, many manufacturers talk about ‘gut feeling’ and an inherent ‘feel for the market’. Rather than following a disciplined approach to collecting data and using it to set prices, they use proxies, such as volume or customer feedback, for the level of competition, saying in effect, “we sell a lot of part A, so there must be a lot of competition” or “we don’t sell much of part B, so there’s probably not much competition.” In other scenarios, a manufacturer might assume that similar parts are equally subject to competition or that a part coming off warranty automatically faces stiff competition. All these gut feelings must be tested by integrating competitor data and performing competition analysis as a step within the pricing process. A variety of sources of competitive data are available in the marketplace, and manufacturers could consider using a combination of third-party research firms, such as catalog subscription services, ‘mystery shoppers,’

and ‘web scrapers’ to conduct this research. Companies don’t need to buy data on every part, but should rather pick a subset that provides sufficient market insight. Competitive data provides perspective on a part’s relative position in the marketplace and should be integrated into the process of pricing analytics and price setting.

As for the second hypothesis – having competition automatically means conservative pricing – the problem is that it implies a ‘one size fits all’ pricing strategy. A more effective strategy is to know when and how to position prices in relation to the competition. An analysis of competitive data over time can provide some key insights about price positioning. For example, how does a part’s competitive position change during its lifecycle? Is the manufacturer a price leader in the ‘early’ stages and a price follower in the ‘peak’ stages? If so, in the ‘early’ stages, a manufacturer could command a higher price to capitalize on the absence of competition or could set a lower price to deter the competition from entering the market space. What premium would the market pay for original equipment parts? How has pricing affected volume of competitive products in the past? How quickly will competitors respond to our price changes? The answers to all these questions will vary, product by product, and will be discovered by analyzing competitive prices.



Pitfall 5: We are lacking resources and data quality to effectively implement lifecycle pricing.

The concept of lifecycle pricing is simple enough: The price of a part changes over the part's lifecycle phases in line with changes for their competitors' situation, and each lifecycle phase has an associated optimal pricing strategy. By identifying the current lifecycle phase for a given part, a manufacturer can make decisions that will optimize profit over time (Figure 4).

Given the increasing availability of data through ERP systems, other external sources or pricing tool sets, it is possible to collate all the needed data to arrive at a lifecycle pricing strategy that is practical and executable. However, lifecycle pricing certainly requires integrated processes and robust systems for tracking performance as parts move through different stages over time. Given the large number of SKUs (stock keeping units) in a typical parts manufacturing company, the potential complexity of lifecycle pricing quickly becomes

apparent. Among the questions that routinely need to be answered are:

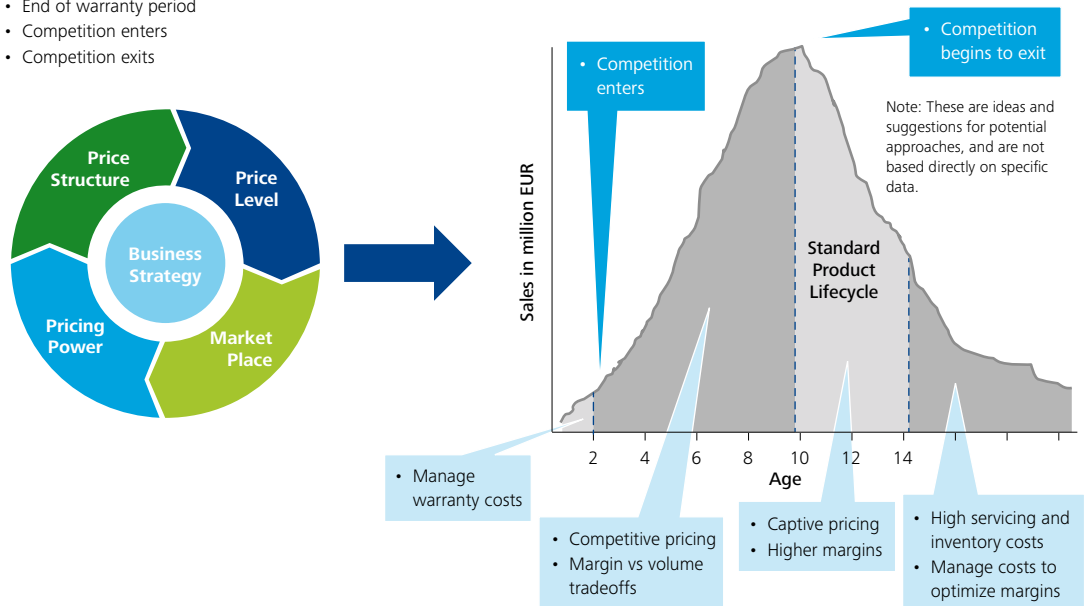
- Do we need to price every part according to its lifecycle stage?
- How can we define and capture the triggers for various lifecycle events? For example, how do we keep track of competition entering or exiting the field?
- How do we obtain supersession data and determine true lifecycle stage of a part? How do we manage lifecycle pricing if there are multiple parts in a supersession chain?
- How do we determine lifecycle when a single part has multiple applications?

While these are all big issues, manufacturers who have tackled them systematically not only improved their profitability significantly but also eased the burden of their day-to-day pricing work.

Fig. 4 – Different lifecycle events should affect pricing

Different lifecycle events and pricing triggers should be tracked closely at a product level, such as:

- End of warranty period
- Competition enters
- Competition exits



Pitfall 6: We cannot afford to invest in pricing tools.

In today's economic environment, manufacturers may be reluctant to make large investments in just about anything, including pricing technology. Even with a strong business case, it's tough to get approval for big projects. In addition to those hurdles, other concerns can be intimidating: Is the company's data good enough? How much will a data source cost? Are the other requirements in place (people, capabilities, skills, processes, and policies) without which the data could be (or already is) useless? It can also be difficult to convince internal executives as they are tempted to say, "We've gotten by for years. Why not just keep doing what we've always done?"

There's a single answer to all those objections: Return on investment (ROI)!

The ROI from better pricing is significant – so significant in fact that, in many cases, an investment in pricing technology will pay for itself in a single pricing action. By implementing a solution incrementally, a manufacturer can use immediate gains to fund future expansion of capabilities and tools.

Having real-time data to make pricing decisions will rapidly improve margins in a significant way. Also, many pricing tools bring best practices and consistency to the processes surrounding pricing – a form of process reengineering embedded in the technology solution that many parts manufacturers urgently need. And finally, market experience indicates that many companies are currently striving to build their parts pricing capabilities. If your competitors become more sophisticated in pricing, they'll gain a true and meaningful advantage.

Given the pressure to reduce headcount, just about every manufacturer of parts needs truly useful pricing processes and tools. What company can afford not to find a better way to become profitable?

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