CFO

THE PRICE IS (MORE) RIGHT

Improved technology—and leadership from finance—may help companies optimize their margins.

BY RUSS BANHAM

After several years of cutting costs to the bone, many companies are reacting to today's soaring energy and commodity prices with trepidation: they would like to raise prices to maintain margins, but aren't sure when—or if—they can successfully pass along increased costs to customers. That may be good news for software vendors that make "price optimization" tools. While these applications are not cheap, they may win new converts as companies look for any source of insight that can help them improve and manage profitability, defend margins, and set a competitive price that markets will bear.

Although price-optimization software has been around since the dot-com days, the robust mid-2000s economy made it seem less than essential, and consequently limited the prospects of its original vendors. But with newer vendors debuting on the postrecessionary stage offering more-sophisticated, user-friendly, and intuitive tools, the market is reviving.

In the retail space, the tools are helping companies price some products to lure shoppers through the doors and others to maximize profit. In the B2B environment, the tools have a harder row to hoe, largely because the sales force essentially controls the customer relationship. The tools may spit out the optimal price to charge, but that doesn't mean the salesperson will charge it.

As Michael Dunne, research vice president for price-optimization and sales-automation technology at Gartner, says, "The skeleton in the closet is the sales force. No one trusts what they're doing, particularly the pricing desk. These guys are winging it based on a commission check. They're your chief obstacle [to getting] the prices you deserve."

Despite that barrier, Dunne notes that companies that deploy price optimization can gain a reliable two to five points in gross margin increases. The software, he says, represents a big step up from error-prone spreadsheets.

And just in time, too. "During the recession, companies did all they could to increase profits from the cost side, which was the only lever they had," says Rafi Mohammed, pricing expert at consultancy Culture of Profit, and author of The 1% Windfall. "Now, with the recession [supposedly] over, and demand rising, there's increased importance in getting the price right."

Getting the price right is on the minds of many CFOs, according to a recent survey from CFO Research Services and American Express. The study found that while 54% of respondents spent the past two years "controlling costs to maintain profitability," today two-thirds are more focused on top-line growth. As companies shift their focus from surviving to thriving, pricing becomes paramount. "If you get pricing right first," says Michael Simonetto, founder and global lead of Deloitte's pricing and profitability management practice, "the competition won't catch you."

How It Works

Today's price-optimization software is fundamentally different from what was offered in version 1.0. "The early tools were just consulting disguised as software," Dunne explains. "You needed smart, expensive people to interpret the data. Consequently, early vendors like Rapt, Metreo, and Revenue Technologies failed and were bought up by consultancies."

The new kids on the block came into the market from one or more of the three services that define the business today—price analytics, price optimization, and price execution—and then rolled them up into an integrated model backed by complex algorithms.

Price analytics is a way to cull insight from past transactions retrieved from point-of-sale data or from your sales force. With analytics, "you can learn which products are central from a margin standpoint," says Craig Zawada, a former partner and co-leader of McKinsey's pricing practice and currently senior vice president of pricing excellence at PROS. "We've developed 50 different variables—like share of invoice, volume trends, and customer total revenue—that can be analyzed based on the transaction data to provide indicators of opportunity."

After the analysis, price optimization generates models that draw upon market data to project realistic "best prices" or price bands for specific markets or sales situations. "This can pinpoint where you can get higher prices and margins from a customer and a product, inching higher here or dialing back a bit there," says Zawada, co-author of The Price Advantage.

Price execution focuses on conveying pricing details and enforcing approval processes to inform the sales forces and limit the risk of rogue discounting. "The rest," says Dunne, "is consulting work."

The tools also offer insight into the sales force, in terms of whether their deals are aligned with profit objectives. In other words, are they charging a particular (lower) price merely to close a deal? "Many companies have relied on sales reps that had the interests of the customer and themselves more in mind than the interests of their employers," says Tom Monheim, client-services manager at Kalypso, a consultancy specializing in price optimization.

Managing the Margin

However, leaning too hard on sales can be counterproductive. "Salespeople don't take kindly to software and consultants telling them what price they can charge," says Culture of Profit's Mohammed. But Deloitte's Simonetto insists that "without insight into each and every transaction made by the sales force, you can't manage the margin."

Consequently, price optimization becomes a concern for finance, which must determine whether the guidance it offers suits the company's culture and strategy. "Men and women still need to sit down and make these decisions," Simonetto says. "There has to be a smart person who understands the business to determine if the price is really right."

With that in mind, "The person best suited to manage the margin is the CFO," says Simonetto.

Sales-force resistance and related issues of corporate culture, however, are not impeding the growth of the price-optimization market. Most buyers are organizations with more than $500 million in revenue confronting complex pricing requirements. These include B2B verticals in the distribution, electronics, industrial manufacturing, high-tech manufacturing, and chemicals industries.

"We're also seeing growing interest from medical-device makers and consumer-goods companies," reports Dunne. Gartner estimates that price-optimization and -management software will become a $425 million market in the B2B space by 2013, up from $180 million in 2008.

Helping drive that market is the cash buyers have plowed into procurement software, making price optimization something of a defensive move for sellers. "McKinsey did a study last year indicating that B2B companies spent $3.2 billion on procurement software to get an edge on sellers," says Zawada. "If sellers haven't invested in price optimization, it's like bringing a knife to a gunfight."

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Dispatches From The Pricing Front

The average price PROS charges for enterprises with more than $500 million in annual revenues is a hefty $2 million, which includes the license, maintenance, and service. (PROS recently announced that it will offer the midmarket a cloud-based solution with a smaller price tag.) Zilliant and Vendavo, two other major players in this market, also offer solutions for large and midmarket clients.

Some organizations like McKesson Medical-Surgical didn't blanch at the cost. Three years ago, the medical-supplies and -equipment distribution unit of McKesson Corp. invested in PROS price-optimization software. "We had some margin pressures that weren't evident, and I wanted to know why it was happening," says Britt Vitalone, CFO of the unit. "We stepped back as a finance team to determine what tools the sales force needed to make better pricing decisions on a day-to-day basis, segmenting customers to drive pricing for different customer groupings."

Previously, McKesson salespeople based pricing on historical interactions with their customers. "When a new sales rep joined the force, he or she was told by veteran reps to charge x, because that's the way they'd been doing things for the past 25 years," Vitalone explains. "A ceiling mentality of what could be charged for different products took hold. We were passing on cost savings to customers that we should have retained as profit."

The company now uses PROS to segment customers and deliver recommended pricing. "For a particular customer or product, we will recommend a target price, a premium price, and a floor price," says Vitalone. "If it's a product we've never sold before, [the salespeople] at least have a price band that won't embarrass them. We still give sales the leeway to make the final decision. They know the competitive situation better than anyone else here."

While Vitalone won't disclose metrics on margin improvement, he says they have been "meaningful, going from a situation of declining and volatile margins to consistent margin expansion." As for the return on the investment, he says the payback was "very fast."

Despite the assertion of Gartner's Dunne that customers often need to retain an outside consultant to interpret the software's output, McKesson's beefed-up pricing department took on that role itself. "We have 12 people in the pricing department, up from 3 before we implemented the software," Vitalone says. "They work closely with the category management teams that provide data on product costs and their impact on pricing."

Westcon Group took a different approach. The network-technology distributor solicited outside guidance from consultancy AlixPartners, which taps its own software to assist clients with pricing and profitability. "Most of our pricing is driven by our key suppliers like Cisco, in terms of price lists they establish," says Chuck Thropp, Westcon's CFO of the Americas. "We then negotiated a discount with the customer off that price list. But we wanted a more refined way for determining the discount in order to maximize profitability."

AlixPartners segmented Westcon's customers primarily by individual customer profitability and what it cost Westcon to serve each customer. This allowed the company to better analyze pricing and its costs to serve and support those customers. While this may sound like an activity-based costing exercise, Thropp says the difference is that each customer was analyzed based on its unique level of cost to serve and specific value to the organization. "There were four or five products that really mattered from a margin standpoint, and many others that really didn't," the CFO explains.

As the software becomes mainstream, early adopters will lose their lead. "In 5 or 10 years, it will be a zero-sum game," predicts Simonetto. But today there is a window of opportunity for companies to not simply blunder their way toward a minimally adequate pricing system, but to develop a strategy that provides a true advantage. **CFO**

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