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Rebuilding Profits in the Manufacturing Sector: How to Manage Profits and Pricing

BY LISA S. THOMPSON AND JOSEPH ZALE

Executives at manufacturing companies face constant pressure to lower costs, irrespective of the economic conditions. The manufacturers who succeed (as opposed to simply survive) will likely be the ones who focus as aggressively on the other side of the profit equation—driving revenues. Managing the revenue side of the profit equation can be easier and more beneficial than most manufacturers realize. Price leverage on profits is substantial; for many manufacturing firms, a 1 percent improvement in price can add substantially to the bottom line. Managers can capture this potential profit opportunity by focusing on two areas:

- Pricing based on differential economic value.
- Proactively managing aggressive customer negotiations.

Pricing for Value

Key to managing value-based processes is the creation and communication of offering differentiation. Many manufacturing firms are aggressively adding services or bundling products in an attempt to make their total offering different. Different is not differentiation.

Differentiation comes only from differences that create unique economic impact in a customer's business. These economic impacts are the result of benefits the customer receives when they use a supplier's products and services. Economic benefits may result from reducing the customer's costs or increasing the customer's revenue. In some cases it may even be about reducing risk. For example, a company in the 3D print technology space is redefining how manufacturers develop and test new products. Their new technology is on the way to helping manufacturers dramatically decrease the cost of trial production. The technology (when fully functioning) will enable the cost of an individual customized component to be the same as that of a mass-produced one. Shipping costs and inventorying costs for manufacturers using their technology are projected to drop significantly in the future. Manufacturing firms that add services or create new product bundles to make their offerings different may find customers willing to buy more volume but not at higher prices. Adding services or increasing complexity with new product bundles drives higher costs. If higher costs do not drive higher prices, this creates challenging profit problems—the kind of problems that sap profits.

Another approach some manufacturing firms are pursuing is to generate "solution offerings."

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Solution offerings are intended to create a complete package that solves a specific customer problem. Think IBM, for example. The computer hardware and software maker famously built a large consulting services business to tailor their technology offerings to meet customer needs. The challenge with solutions is that customers may find solving the problem themselves is cheaper. At a minimum, solution offerings are much more difficult to sell—they require selling at senior management levels (not just purchasing), and have much longer selling cycles. Sales people should be skilled in diagnosing customer needs and fitting solutions to these needs—often a lengthy and expensive process. Manufacturing firms attempting the solution offering approach are increasingly finding the costs high, cash flow slow, and anticipated profits elusive.

There are several reasons why customers may refuse to pay higher prices for added services, product bundles or solution offerings. First, while the services, bundles and solutions may make the offering different, they do not necessarily create differentiation value for customers. Creating differentiation value is the first step in getting higher prices; when customers do not receive more value from a supplier's services than they get from competitors, they won't pay for them.

Second, services, bundles and solutions may create value for some customers but not for all.

Customers who receive no value from the services won't likely pay more for them, and may insist suppliers charge competitive (lower) prices. Even customers who do benefit from the added services will be more price sensitive when they know that others are paying less for the same offering.

The key to getting paid for services, bundles, or solutions is to tailor offerings to specific customers, and not to provide differentiated services to customers who won't pay for them.

This means there will be more offering variations to manage; our experience is that tailoring to provide unique benefits and value often results in price premiums that readily justify the cost of multiple offerings.

Finally, customers will not likely pay for services, product bundles and solution offerings when they do not understand the benefits and value they receive from them. And they won't pay for these benefits and value until they are forced to make decisions about not receiving them. The first task for managers in manufacturing firms is to communicate value to target customers in terms the customers can understand. It's not the customer's job to understand value; it's the supplier's responsibility to quantify and communicate it.

Then managers should consider instituting policies to compel customers to acknowledge the value delivered. This may be done by understanding all offering components and encouraging customers to give up value-creating components in order to get lower prices. For example, start charging for rush orders or requests for order changes beyond what is typically supplied in your market.

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Here are some managerial tasks to help implement value-based pricing:

1. **Make sure you understand how your target customers use your products and services—how your customers make money in their business.** This is the essence of the sales and marketing functions: to comprehend what drives customer businesses. At the same time, make sure you understand what benefits customers can get from competitors. Avoid adding offering elements that might make you different without driving differential value. Take GE aircraft engines for example. GE developed its "Power by the Hour" program for leasing based on usage (rather than selling) its engines, knowing that the value of uptime varied greatly between airlines that flew long-haul versus short-haul routes.
2. **Unbundle differentiated offering elements from your core product offering.** You can provide competitive offers for your core products and services while offering the opportunity to purchase superior offerings at premium prices. For example, if your ability to deliver on rush orders is superior to competition, then be sure to withhold rush service from customers who are beating you up for lower prices. Save your valuable services, product bundles and solutions for those who will pay for it.
3. **Drive market communication that emphasizes your differentiation—the rationale for customers to do business with you and not with competitors.** Make sure your differentiation story is widely known across your customers' organizations—build allies to help you get your value message out. You can search on line to see the companies that offer tools for customers to allow them to compare the economic value of their offerings to competitors – there are many of them! Market communication includes everything from advertisements to CEO statements to selling scripts to invoices; all should work together to communicate that the business is focused on delivering value to target customers.

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Proactively Manage Negotiations

Customers resist price levels for several reasons:

- They are aware that there are lower market prices available.
- They do not understand the economic impact of using a supplier's offerings.
- They benefit by creating an arena of intense competitive bidding.
- They have never been forced to choose between value delivery and lower prices.

Customers in virtually all industries have gotten much better at negotiating. Purchasing has become a strategic focus for many firms, and it is often used exclusively to drive price concessions from suppliers. Customers insist suppliers provide the best products and services, but at lower prices. At the same time, managers in manufacturing have been reducing their offering line—they have controlled costs by reducing offering variations and system complexity. Of course there are economies of scale available here; if only a limited number of offerings are available, the fixed costs involved in providing these are spread over larger volumes, resulting in lower unit cost. But there's a problem: not all customers benefit from the offering elements that are now part of a smaller offering set, and they won't pay for them. As word gets out—and it typically does—that some customers are paying lower prices, general market price sensitivity goes up; even customers who benefit and would likely pay for the offering know there are lower prices available and insist they pay less.

Customers also are price resistant when they don't understand the value they receive from a supplier's offering. Much of the manufacturing sector's advertising and selling scripts remain focused on product features and not economic value. Myopic advertising and selling practices assume customers completely understand why they should buy the product and how they will benefit economically using the product. Our experience is that even when customers really understand the economic benefits of a supplier's offerings, that knowledge rarely enters the purchasing discussion. Product myopia makes it easy for customers to see suppliers as delivering commodities, facilitating price negotiations in the purchasing agent's office. When manufacturing firms don't force customers to acknowledge value delivery, the purchasing discussion becomes price-focused.

Customers may resist supplier price positioning because in the past they've been rewarded for creating an atmosphere of intense competitive pricing activity. If purchasing agents can succeed in using competitive deals to negotiate lower prices, you can expect them to demand lower prices in every sales call. Even subtle suggestions of competitive activity may work ("you're higher than all the competition" or "I'd like to give you this order, but you'll have to sharpen the pencil") if you demonstrate you are willing to chase every order. The problem: if they're playing this game with you, they're most likely playing it with all your competitors, which may mean that purchasing agents are starting an unintended pricing war in your industry.

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Customers are price resistant when they don't have to make value tradeoffs to get lower prices. Customers will not accept higher prices if they can get all of what they want at lower prices. Sales policies that are focused on driving volume often result in large, but unprofitable deals. Customers who are not forced to make value tradeoffs in exchange for lower prices are rewarded for their price aggression. Worse, these price-aggressive customers become trained to ask for more while offering to pay less.

So what can managers do to help deal with aggressive customer price resistance? Here are some key managerial tasks:

1. **Understand your customers: those who gain a unique advantage from your offerings, and more important, those who do not.** Create offerings that are specifically suited to specific customer groups, and target customer groups for which you can provide differentiation at competitive advantage. Avoid customers where you have no advantage. For example, a manufacturing company with nationwide plants targets nationwide manufacturers to which it can offer a consistent-quality product where there is a high level of need for service support.

2. **Talk about economic value at every stage of the selling process.** All customer communication should be founded on the customer's business and how the customer can benefit economically from your offerings, avoiding "product myopia." Instead of talking about the characteristics of your product, contrast the economic benefits (such as less waste, improved production processes, ability for the customer to achieve price premiums) the customer receives from your products with the consequences of using competitive alternatives. Of course, this means you should understand how customers benefit from your products.

3. **Negotiate aggressively with price-aggressive customers.** Make sure you have good intelligence about competitors' prices. Start negotiations with a "walk away" point and don't compromise this end point in the heat of negotiations. Be careful about the orders you pursue—the only winner in a price negotiation is the price-aggressive customer. For example, your walk-away position for aggressive price negotiators should be your "fighter" brand—a stripped down, basic offering that will allow the customer to receive the product at a low price without valuable services (the means for you to control costs).

4. **Institute sales policies that force customers to accept lower levels of value delivery in exchange for a lower price.** Avoid rewarding customers for price aggression by giving them both lower price and valuable offering elements. This means you should understand the customer's business well enough to determine your economic impact on their business, and you've engaged in conscientious market communication about this value delivery. For example, tell a price-sensitive customer that you will meet their demand for lower prices if all orders are "must take" deals in truck-load quantities with minimum two week order lead times.

Managers in the manufacturing sector who institute value-based practices have seen dramatic increases in both revenue and profits. While the task is challenging, manufacturers who are disciplined, focused and committed to profitable organic growth can reap the rewards.

About the Authors

LISA S. THOMPSON is a principal with Deloitte Consulting LLP in the Monitor Deloitte Strategy and Operations practice.

JOSEPH ZALE is a principal with Deloitte Consulting LLP in the Monitor Deloitte Strategy and Operations practice.

For more information, contact:

Lisa S. Thompson
Principal
Deloitte Consulting LLP
+1.617.449.5028
lisathompson@deloitte.com

Joseph Zale
Principal
Deloitte Consulting LLP
+1.203.905.2802
jzale@deloitte.com