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GETTING PRICING RIGHT

The value of a multifaceted approach

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GETTING PRICING RIGHT

The value of a multifaceted approach

BY LARRY MONTAN > TERRY KUESTER > JULIE MEEHAN > PHOTOGRAPHY BY DAVID CLUGSTON

Acme Consolidated spent over a million dollars to implement state-of-the-art pricing software that allows it to predict how customers will react to changes in price. The company used it to develop new prices that, according to the mathematical model, should add millions of dollars to the bottom line. Yet six months later, profits hadn't increased at all. An investigation reveals why: Acme's sales force had been giving discounts on more than 40 percent of the company's sales, canceling out the new prices' projected benefits. When asked why they offer so many discounts, the salespeople claimed that customers won't buy at the company's targeted price. The group that originally decided to implement the software doesn't have the authority to adjust sales force compensation or to offer sales training to help the salespeople sell at a higher price. Eventually, faced with a stalemate between the sales force and the pricing analytics team, Acme abandoned the price improvement effort – never having recovered its initial investment, let alone having improved profits.

Improbable? Not really. We've seen situations like this play out, with minor variations, at a number of companies where we've been called in to help them in their efforts to untangle the resulting issues. The common thread in these cases is the ineffectiveness of what looks like a foolproof pricing improvement effort because of unanticipated factors that work at cross-purposes to obtaining results. Adjusted prices don't reach stores because of weaknesses in the price-tagging process. Cumbersome technology hampers a company's attempts to improve its salespeople's negotiating position by giving them real-time profitability information. Or overlooked opportunities in accounting and tax structuring take a large bite out of a pricing initiative's improvement to margin.

Such situations are even more unfortunate because pricing done right can have a huge impact on a company's profitability. Research has suggested that price management initiatives can increase a company's margins by 2 to 7 percent in 12 months, yielding a return on investment of between 200 and 350 percent.[1] A 1 percent aggregate increase in price, assuming no change in volume, can boost a company's operating profits by 11.1 percent – much more than the profitability increase a company can expect from a 1 percent overall reduction in variable costs (7.8 percent), a 1 percent reduction in fixed costs (2.3 percent), or a 1 percent increase in volume (3.3 percent).[2]

The potential for results like these is a strong argument for treating pricing as a core competency rather than as a series of individual project-based efforts. Pricing excellence may well be the next step for businesses looking for a competitive edge, much as once-revolutionary principles such as Six Sigma and business process reengineering have become established among today's most profitable companies. A systematic approach to pricing can, in fact, offer opportunities for both top-line and bottom-line improvement, a broader base than cost-focused quality improvement efforts such as Six Sigma typically address.

There is also considerable room for improvement in how pricing is determined. At most companies we've seen, pricing activities are dispersed among far-flung areas of the business with little coordination or integration. The business functions that touch pricing often have different or even conflicting objectives: Sales focuses on boosting volume, Risk on mitigating losses, Marketing on growing market share, Product Management on differentiating products. Meanwhile, technology for helping salespeople make more profitable decisions is often rudimentary or nonexistent. Relatively few companies have installed advanced analytic tools that allow companies to "test drive" prices for their impact on margin before implementing them. No one may be thinking about the tax consequences of pricing decisions. And, many times, whoever sets pricing strategy has neither the information to make good decisions nor the authority to see them through.

In our experience, it's not enough for all these parts of the pricing puzzle—organization, analytics, technology, and so forth—to be working properly to realize significant benefits. Companies should also strive to integrate these capabilities so that pricing is addressed from multiple perspectives. Businesses that integrate their pricing efforts, we believe, can outperform those that don't. Supporting this view, a 2007 study found that companies that combined business process architecture, organization and governance, and technology in their pricing improvement initiatives boosted their stock prices by an average of 66

percent, outperforming the Standard & Poor's (S&P) 500 index by an average of 40 percent.[3]

THE SIX KEY PRICING COMPETENCIES

Effective pricing and profitability management depend on coordinated efforts within six areas of competency: pricing strategy, pricing execution, organizational management and governance, price analytics and optimization, pricing technology, and tax and regulatory considerations. Each of these areas, as described below, plays an important role in a company's ability to set and enforce profitable prices.

Strategy. A pricing strategy articulates the guiding principles behind a company's efforts to price its goods and services. At the highest level, for example, a company might adopt a sweeping pricing philosophy such as "We will not be undersold" or "Our products never go on sale." Pricing strategies may also be defined for a combination of specific products, channels, customer segments and geographies. These lower-level strategies typically focus on a well-defined marketplace goal, such as increasing market share for a certain type of product in a particular customer segment.

Execution. Pricing execution covers all of the processes by which a company delivers its prices to the marketplace. This can include everything from sales policies and procedures—for example, guidelines on how big a discount a salesperson can offer without checking with a manager—to the way products are tagged for sale at a retail store.

Organizational management and governance. This area deals with the people and culture factors that shape pricing behavior, including factors such as organizational structure, sales effectiveness, training, and talent management. Effective pricing management would include such things as enforcing sales policies and procedures, developing profitable sales compensation structures, and creating reporting relationships that help the company make and carry out pricing decisions.

Analytics and optimization. Pricing analytics involves looking at past transactions in order to understand profitability better. Data on product cost and prices paid—including cost-to-serve factors such as sales expenses and product packaging costs, as well as discounts and off-invoice price adjustments—are collected and studied. Using this information, companies can develop profit-boosting strategies such as discontinuing unprofitable products or customer relationships, changing pricing policies, or adjusting prices upward or downward. "Optimization" refers to the use of a mathematical model to determine the most profitable price for a good or service based on historical information on customers, marketplace and competitors. A price optimization model can not only help management select an appropriate price, but also estimate the probable outcome of any pricing changes.

Technology. With the pricing applications available now, there's no need to rely on spreadsheet tools for basic analyses and recordkeeping. These new applications can uncover customer, channel and product profitability patterns across millions of transaction records. They also can let salespeople access real-time customer and profitability information during sales negotiations, which can help

them to calculate a deal's profitability under a variety of price and product combinations before closing a sale.

Tax and regulatory considerations. Tax management can help a company plan and execute more profitable pricing, such as by evaluating the impact that recognizing profits in different countries would have on the company's global effective tax rate. Regulatory mandates affecting pricing include the Robinson-Patman Act of 1936, which prohibits companies from selling the same product to competing customers at different prices, and the Sarbanes-Oxley Act of 2002, whose requirement that companies assess the adequacy of internal controls over financial reporting can have significant implications for a company's pricing-related controls and documentation.

Below, we present several case studies that show how the interplay among these six competencies can help improve the outcome of a company's pricing efforts.

1. A Tale of Pricing Overrides

Analytics and optimization, execution and strategy

A large, publicly owned specialty retailer wanted to focus on pricing to quickly boost sales and profits during the upcoming holiday season. Management identified three areas for its holiday-season efforts: optimizing pricing for regular and promotional goods, decreasing price overrides at the point of sale, and improving price tag execution.

Historically, the retailer had set prices by following a set of guidelines that adjusted prices in response to changes in cost or competitors' prices. Merchants conducted competitive shopping research in different markets and combed the Internet to identify competitors' prices, and then they adjusted the company's own prices accordingly. Most pricing decisions were reactive, and there was little knowledge of customers' price sensitivity in certain product categories.

Additionally, the company was losing significant margin due to price overrides performed by sales associates in the stores. While the company recognized that store associates needed to be able to use price overrides in certain situations to uphold the retailer's price match guarantee and to address customer service issues, executive leadership believed that the current override rate was excessive and that overrides were often used beyond their intended purpose.

Finally, in-store audits revealed that, on average, only half of the products on store shelves were tagged correctly. Many price changes initiated at the corporate office were not reflected on the stores' price tags, and a number of items also had incorrect or missing tags. This exposed the company to the risk of potential attorney general lawsuits on behalf of customers who discovered that prices were higher at the register than was designated on the price tag. The company wanted to clear up this problem as quickly as possible to avoid negative publicity and customer dissatisfaction.

The company implemented several key improvements to quickly address these issues. It used price optimization analysis to set regular and sale prices for several important product categories. The resulting fact-based pricing, rooted in advanced analytics, helped the company achieve short-term margin and profit improvements. In addition, the company reduced the price override rate by educating store associates and management on proper markdown procedures and

instituting a method of clear accountability. Retail leadership implemented price override budgets and developed tools to track and report on override budget compliance and activity. To improve tagging execution, the retailer identified ways to reduce the number of price tags sent to stores and worked with field leadership to increase efficiency in store processes as well as improve management oversight and accountability. These strategic pricing efforts led to $9 million in additional margin for the retailer over a period of six months.

Encouraged by these results, the retailer is planning to further improve its pricing process over the course of the next year. The retailer plans to deploy optimization software that will perform predictive analyses on an ongoing basis for all product categories. In addition, the company will revamp its pricing strategy to support the overall financial objectives of the company and help build a stronger brand image. The company plans to use the insights delivered by the optimization analyses to set prices based on its customers' expected reactions to prices and price changes. It expects the end result to be a pricing strategy that supports the company's business strategy while creating a clear and consistent price message to the customer.

2. The Crucial Link

Analytics, technology, organizational management and governance and execution

After three pilot pricing projects in individual business units, a global chemicals manufacturer was finally ready to implement a transaction pricing analysis capability across its entire business. The pilot projects had yielded an average operating margin increase of one percent, and the company was eager to extend this benefit.

The company automated the labor-intensive analysis process. The new system helped account managers calculate the profitability of various product, price, volume and delivery configurations when negotiating with customers. The system also helped users explore profitability trends, forecast revenue streams, and analyze cost to serve, among other tasks. Executives expected these tools to help account managers make more profitable deals and help commercial managers better manage and monitor pricing in their market segments.

The company realized, however, that its new system would fail if people didn't use it. So the company is training account managers and finance staff on how to use the software, and creating policies on when analyses should be run and who is responsible for collecting and reporting the results. For example, business managers will now periodically analyze transaction-level data to uncover the causes of margin erosion, and they will be responsible for recommending and executing price changes in response.

As a result of these improvements, the company expects to increase annual profits by at least $45 million through a combination of reduced costs, enforced pricing policies and increased prices.

3. Getting Organized

Analytics and optimization, technology, organization and execution

A large diversified chemical company, facing commoditization of its products

BUSINESS UNITS
NEPOTISM DISCOUNTS
FAVORITE UNCLE
IN DARK
REGISTER OVERRIDE
WRONG PRICE TAGS
FREE PASS
RANDOM SALES DISCOUNTS
Right Discount
Right Customer

and under increasing competitive pressure, wanted to improve margins by pricing products based on customer-specific costs to serve. To do this, the company needed to understand its customers' buying behavior better. It also needed to know more about how its business units priced products.

The company decided to buy a software application to help pricing professionals perform advanced analytics and optimization as well as basic price management tasks such as price setting and deal management. But in order for the new system to work, management knew that they needed to change the way the company did its pricing.

First, they standardized pricing processes across the organization as much as possible. Standardization would not only make it easier to put in the new system, but also make pricing easier to measure and manage.

At the same time, the company added pricing analytics and execution tools and a customer relationship management capability to its new system, being sure to accommodate the business units' process similarities and differences. They also adopted new pricing policies and adjusted rewards and performance metrics. Oversight was centralized and strengthened. Roles were created and modified as necessary to carry out the changes, and the staff was educated on how to use the new tools.

In addition, the company created a formal organization to coordinate pricing activities. Each business unit now has a profitability manager who reports to the business unit president and who meets monthly with the other business units' profitability managers to review pricing policies, develop strategy and monitor profitability. The business unit presidents in turn report to the corporate COO, who has been made formally responsible for overall company profitability.

As a result of these efforts, the company expects to realize as much as $15 million in short- and medium-term profit, which would represent a net present value of $40 million and a greater-than-300 percent projected return on investment. The new analytical insights have also helped management modify pricing policies, including policies around price guardrails (minimum and maximum prices) and price exceptions, to encourage salespeople to adopt a value-based approach.

4. Spotlight on Parts

Execution, analytics and optimization, and organizational management and governance

A major manufacturer expected a sharp decline in new product sales during the coming year, when its prices would jump due to the cost of complying with new government regulations. The company would need to rely on its parts division for the bulk of its profits for at least that year and possibly beyond.

The parts division, however, had problems of its own. It was receiving numerous calls from salespeople complaining about errors, inconsistencies and omissions in its price book. Underlying these errors were a maze of fragmented pricing processes, inexperienced staff, poorly defined roles and responsibilities, and the challenges of using three different systems to manage pricing for more than two million parts. The issues were so severe that executives believed they were causing the company to lose sales and margin to its competitors.

Examining the price book production process, the company removed several

thousand obsolete or rarely sold parts from the list, reassigned responsibility for several key processes such as supplier cost data entry, reduced the number of data handoffs, and put in a formal quality assurance process.

At the same time, the company analyzed, by segment, the supplier cost and target margin data used to compile the price book. The analysis suggested that the company could increase profits by raising prices on some of its proprietary parts. These higher prices went into the new, more accurate price book – a move that resulted in tens of millions of dollars in additional margin.

The company next undertook a more comprehensive transaction price analysis using a broader set of data that included information about the cost to serve and other fixed and variable costs. This time, they found a number of revenue-losing areas in discounting, support and freight. They responded by reducing the cost to serve on certain items (such as by reducing unwarranted discounts) and making targeted price increases.

The company also addressed the staffing and organizational problems that had hampered its ability to execute basic pricing activities and, if left unsolved, would limit its ability to benefit from the new analytic insights. New policies, incentives and metrics encouraged the sales and marketing organizations to promote higher-margin items. The company established a pricing organization to take ownership of key pricing activities, educated employees from various functions on each other's roles, and filled several staffing roles. Finally, the company devised metrics to monitor business unit and process-specific control objectives, giving the corporate controller the responsibility for reviewing and approving any changes to the pricing process or controls.

As a result of these initiatives, the company expects to increase the parts division's annual margins by nearly $70 million.

PUTTING THE PIECES TOGETHER

If coordinating multiple pricing competencies can deliver such impressive results, why don't more companies do it? Sometimes, it's a shortage of time or money. Other times, the need to involve a competency isn't immediately clear; for instance, execution issues may not surface until after an initiative is underway. Absent an obvious need for improvement in a particular area, executives may be wary of expanding the scope of a project, especially if they aren't convinced that the investment will yield a commensurately bigger payoff.

Additionally, some pricing competencies sit in unexpected parts of the organization. A company's tax and regulatory specialists, for instance, may never cross paths with its pricing executives. As a result, it may never occur to a pricing executive to consult a tax specialist when planning a pricing initiative – or to a tax specialist to offer his or her insights to a pricing executive.

But the most common reason may be that management just doesn't know all of their options. For example, automated analytics and optimization tools have only come into broader use in the last decade or so. And they aren't just for pricing specialists anymore.

In spite of these difficulties, we believe companies can move toward a more integrated pricing approach if they develop all six competencies and connect the parts of the company where they typically reside. One way to do this is to

establish a formal pricing organization with specific roles and responsibilities for carrying out pricing activities. This organization doesn't necessarily need to be a self-contained department, but it does need to clearly own all of the company's pricing strategy and processes, no matter where individual pricing activities actually take place. At a highly decentralized company, each function might include several people with a designated pricing role as part of their job responsibilities. An integrated operating company, on the other hand, may find it more effective to set up a centralized pricing group.

Whether distributed or centralized, the role of a pricing organization is to help a company take a strategic view of pricing and smoothly carry out its day-to-day pricing activities. The organization should include people who perform predictive analyses to understand customer buying patterns, analyze levels of demand at various price points, investigate which customer segments are buying what products and features, and determine how to price for those products and features. Internally, the organization should define and execute consistent pricing processes, supervise the flow of price information through the company, measure and report on price performance, and set pricing strategy. Most importantly, the pricing organization should bring an integrated perspective to the company's pricing efforts, mobilizing the "right" pricing competencies to help increase profits while steering clear of unintended consequences.

A multifaceted approach to pricing may not be easy to pull off in an organization used to treating pricing as a one-time tactical fix. It may run counter to the instincts of people used to viewing pricing as all about strategy, all about price setting, or all about sales force compensation. But we believe companies that integrate the six key pricing competencies into a cohesive pricing and profitability management program can realize gains far beyond what can be achieved with a less comprehensive approach. By taking a comprehensive view of pricing, companies can position themselves to tap a vast source of shareholder value: the ability to set and enforce profitable prices, not just once, but again and again in response to marketplace changes and evolving business needs.

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Endnotes

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3 *Clear and Present Value*, Deloitte Development LLC, 2008