The price of pricing effectiveness:
Is the view worth the climb?

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As companies seek ways to increase profit margins and improve overall business performance, business leaders are increasingly turning to pricing as a discipline that can boost their bottom lines. A search of publicly available data reveals a significant number of blue-chip companies that acknowledge pricing improvement as a part of their earnings success. Yet many seem to make little progress in driving the kind of consistent pricing discipline that yields the results they need.
This dichotomy in the corporate world suggests several questions:

- What is the value of investing in pricing improvement? Is there a difference, attributable to pricing capabilities, between companies that expend significant effort to address pricing and those that do not?
- What does it mean to be good at pricing? Can’t we just raise our prices and see if our sales force can make them stick?
- What are the risks of embracing and investing in pricing improvement, and how can these be managed?

These are important questions in the face of many competing priorities and a challenging economic environment. However, a broad study of company performance and pricing reveals that, regardless of industry, geography or size, companies with effective pricing capabilities significantly outperformed industry peers across multiple financial metrics, including net margin, market valuation, return on assets and return on equity. This suggests a correlation worth exploring. Intriguingly, even the diverse population of companies studied has identifiable commonalities in the capabilities they have built. These commonalities, as well as identifiable strategies and the risks the companies faced in building pricing capabilities, are worth a closer look.

**PRICING AND PERFORMANCE**

Great companies do pricing very well. Whether these companies simply have more sophisticated pricing capabilities, or pricing prowess has bolstered their performance, the link between pricing and profitability recurs both anecdotally and in more detailed analysis. One study suggests that pricing has two to four times the potential to influence profitability relative to other business levers. Companies that actively pursue pricing as an important part of their strategy typically outperform industry peers on several financial metrics. Even companies that may not have achieved full maturity in their pricing capabilities but have placed a greater degree of importance on pricing than their peers and are actively pursuing pricing improvement benefit significantly (see figure 1).

In general, then, it’s not a stretch to say that pricing is an area worthy of focus—and likely worthy of developing beyond the table-stakes level. When many executives think of improving pricing, they envision being able to set more market-relevant prices for their products to drive greater volumes at higher prices, thereby increasing revenue. While price setting is an essential piece
of the pricing puzzle, the overall discipline of effective price management concerns itself with managing transaction-level profitability, which requires capabilities in pricing strategy, execution, analytics and governance. The discipline also requires coordination across many functions including sales, marketing, finance, product development and customer service.

The complexity associated with this coordination is daunting, but there are a number of commonalities associated with enhanced performance in pricing. A closer look at high-performing companies suggests some useful points of consistency.

Clearly defined ownership and roles within the pricing process

Companies that exhibit effective pricing are 30 percent more likely to exhibit clearly defined ownership and accountability within the pricing process. They also have pricing job roles that are clearly documented, including an executive owner who is accountable for results. Often, they have dedicated pricing organizations that help govern the process. Regardless of the structure, though, leading companies included in our analysis have consistent accountability for pricing control and transaction profitability embedded in their organizations.

Without clearly defined roles, a company’s accountability for pricing is limited to functional reporting lines. This root issue can manifest itself in a number of ways.
For one large publishing company, the pricing process was so fragmented that accountability was quite simply absent. While sales was responsible for the customer interface and primary negotiations, an account management team was responsible for packaging advertising opportunities, and finance set the rate card and pricing guidance. These roles may appear well defined but, upon closer review, no stakeholder was ultimately responsible for pricing and profitability at the transaction level. Even if the initial package proposal met all required pricing hurdles, sales was the sole arbiter of final pricing—and sales was measured on pure revenue, not profitability. The details of why sales assigned a price—perhaps due to value of inventory, customer segment or cost-to-serve for the proposal—were not transparent, so the set price often disappeared in the course of negotiation. Essentially, each function was attempting to optimize its own performance according to its local measures, which did not align with corporate needs.

**Understanding customer cost-to-serve and using these costs to manage profitability**

Companies that are pricing leaders are 26 percent better at managing true profitability. They have an advanced understanding of customer and product portfolios, and efforts are directed toward growing profitable product and customer combinations. They have a full understanding of channel costs based on promotional and distribution activities. Sales personnel can use cost-to-serve in negotiations, and use forward-looking analyses to drive decision-making.

A large consumer goods organization serves as an example. Historically, the company measured its sales force on production of gross margin dollars. Leaders felt this provided a good balance of measuring revenue and pricing, which should correlate to profits. However, the company managed its trade spending at a local level with little governance. This essentially gave the sales force carte blanche to invest at will to ensure that it maintained and grew sales volume—a situation that resulted in wildly varying returns on the trade spend dollars. As a result of a growing disparity between gross margin growth and net profit growth, the company invested in reporting and tools that created a new level of visibility for management and for the sales force. This reporting provided visibility into the effect of trade spending on the profitability of each salesperson’s book of business. With this new system, and by simply redefining profitability targets instead of implementing draconian control measures, the company saw an 88 percent improvement in quarter-over-quarter profitability within a year.

Companies that underutilize pricing as a driver of profitability tend to have a limited understanding of product profitability beyond gross margin.
Similarly, they have limited visibility into the costs associated with each distribution channel and no real understanding of customer service costs beyond gross selling and administrative costs. This lack of information handicaps decision-making on deal management and approval. It also hinders development of quality revenue metrics for the sales force.

**Segmenting customers based on needs and buying behavior**

Companies with leading pricing practices are more likely to use segmentation techniques to fine-tune pricing. They have a full understanding of what customers value and why, and include customer needs and requirements in product development decisions. They differentiate their marketing to appeal to particular dimensions of competition in each segment, and they use clearly defined channel strategies that are largely driven by differences in cost-to-serve. Customer lifetime value is used effectively when making customer portfolio and relationship decisions and is input for decisions regarding segments to target or drop.

For example, a leading medical device company recently used conjoint analysis to differentiate customers by their willingness to pay for its service plan offerings. The findings from the study helped the company define which services to include in silver, gold and platinum service plans. As a result, the company now specifically targets its service value proposition to customer segments based on their relative preference for features such as parts cost coverage, labor cost coverage, response time and uptime guarantee.

Companies with less sophisticated pricing capabilities tend to rely on different internal assumptions: They track customer needs for product development but follow only sales volume for segmentation. They often experience significant leakage of customers between channels and have no real understanding or use of cost-to-serve information to drive channel separation. They don’t understand customer value well, and they base metrics largely on unit or dollar volume, not profitability. These segmentation “shortcuts” hinder effective price discrimination and, thus, profit realization.

At a global chemicals manufacturer, the marketing department employed a customer segmentation scheme comprising four segments: small, medium, large and national accounts. The customers were categorized based on their annual purchase volume alone, and they received discounts commensurate with their segment. The large and national accounts received virtually all of the sales force’s attention because they were the company’s “best” customers. When overall company performance started to stagnate, it decided to take a closer look at customer profitability. It discovered that its biggest customers were actually its
least profitable ones once cost-to-serve was included in the margin calculations. One of the biggest culprits was the shipping and handling costs incurred by the manufacturer—not because of the large volume of product they had to ship, but because of its customers’ purchasing behavior. They would place relatively small orders nearly every day, and the products would be shipped as soon as the orders were received because its best customers deserved its best service. The manufacturer incurred significant expense in less-than-truckload (LTL) fees, and its customers virtually eliminated its inventory carrying costs. Armed with this new view of profitability, the manufacturer traded its old volume-based segmentation scheme for a new one based on customer value and purchasing behavior, and then put its best sales people on the newly-defined “best” customers.

Pricing is rarely perceived as an urgent problem or opportunity. Employees may lack the capabilities needed for making the required changes. Poor data may limit visibility into transaction profitability.

While it seems intuitive that effective price management can lead to improved financial performance, many companies remain unable to improve their pricing capabilities. Establishing or broadening these capabilities can be a very complex, risky and sometimes costly investment that requires specific skills and a good reserve of commitment on the part of leadership.

Changing pricing management is complex in part because pricing manifests itself in just about every function within a company. Product management, sales, marketing, finance and even operations either affect or are affected by any price change. Aligning diverse constituencies to drive a change in this system is no small feat. Organizational and process inertia can complicate things further. Specific pricing-related processes may have been in place for a long time, and undoing or adjusting them would force people across all these functions to learn a new way to do specific things or reduce the autonomy of certain stakeholders. In particular, the sales organization may view broad-based changes to pricing practices as a reduction in its influence.

Amid this complexity and inertia, the risk of making a mistake is high. It’s easy to find case studies that spell out the unintended consequences of
misguided pricing tactics and strategies. No one wants to tinker with something that may damage the company’s bottom line.

Finally, a company’s own characteristics may present many obstacles. Other priorities and initiatives may have momentum and take precedence, especially because pricing is rarely perceived as an urgent problem or opportunity. Employees may lack the capabilities needed for making the required changes. Poor data may limit visibility into transaction profitability. And of course, the company’s performance or an economic downturn may limit investment resources to the point where paying for a project is impossible.

Even when these companies overcome the reluctance and inertia and embark on a program, there are the usual risks associated with any project: many stall, get overwhelmed, or lose their focus.

OVERCOMING THE HURDLES

Of course, if it was easy, everyone would do it. What we have observed is that proficiency in pricing is not a bolt-on capability, but one that requires a series of changes in data collection and design, as well as analytically based decision processes. Moreover, organizational changes are often required
to support processes based on a newly acquired arsenal of data—and more importantly, the insights derived from it.

Start by building a transaction-level fact base. Good decisions begin with a quantitative understanding of transaction profitability at the most granular level. This will be the source of truth as well as of ideas for improvement. Once an organization has built its fact base, qualitative information gathered from all pricing stakeholders should provide the fodder for hypothesis-driven analysis and opportunity identification. With this approach, the business case is built into the process of analysis. Key actions and considerations include:

- Identifying all components of a transaction that add or subtract value from the business on a marginal basis. Each component represents a lever that can be used to affect profitability. For example, costs to serve such as expedited shipping, special packaging, the cost of capital included in payment terms and technical service costs are often overlooked in traditional margin calculations. Tying these costs to specific transactions instead of aggregating them across all transactions will demonstrate the true profitability of each transaction. They can then be aggregated along any dimension—customer/product/region—to aid decision-making.

- Gathering data at the most granular level possible. More detail equals better and more flexible analysis. The cost of gathering, storing and processing these data has plummeted, so the assumptions about what was knowable back when original pricing practices were put in place are probably no longer useful.

- Being judicious with allocations. Fixed costs that are not marginally affected by the transaction should not be included in the analysis. This is an economic exercise, not a restatement of accounting performance. Therefore, costs such as corporate overhead and taxes do not need to be assigned to individual transactions; an arbitrary allocation would be misleading in pricing decisions.

Strengthen processes and information tools to enable rapid, fact-based decisions. The best analyses and strategies are of limited use without an efficient and effective pricing process. The ability to manage information flow, make rapid pricing decisions, escalate pricing exceptions and control market execution of pricing is critical to any effective pricing improvement. Companies can use data analytics to identify process weaknesses. If data analytics highlight a customer
that is getting a discount that he doesn't qualify for, it indicates a weakness in the pricing process tied to discounting.

QUANTIFYING THE VALUE OF INVESTING IN PRICING

In June 2011, Deloitte Consulting LLP and Deloitte’s Global Benchmarking Center (GBC) hosted an online survey to benchmark pricing competencies, performance and investment of respondents across industries, geographies and competitive markets. This study was also designed to shed light on the relationship between company performance and effective pricing capabilities. More than 40 respondents completed the online survey and self-reported their performance.

The responses were analyzed along two dimensions. The first approach was based on developing comparison groups within the respondent set driven by the responses related to the financial performance and the effectiveness of pricing processes. The second approach was based on comparing survey respondents who represented public companies with a broader set of peers within their industry sectors.

Companies that were identified as “high performers” based on analysis of the survey responses showed a number of traits in common:

- They are more likely to understand the importance of key pricing competencies and effectively support them.
- They have a more centralized pricing function, with solid support from the top layers of management.
- They spend about as much as others on technology, but they are seeing a much higher return on their investments.
- They look beyond gross profit to measure the profitability of each transaction.
- They have a consistent focus on pricing across all phases of the economic life cycle.
- They are nearly twice as likely as low performers to have a C-level executive involved in pricing.
- They give their sales forces slightly less discretion than others when it comes to negotiating prices.
- They appear to be the leaders in adopting price management software.
- Nearly two-thirds of high performers are using a value-based pricing strategy.

Characteristics of strong pricing processes include the following:

- Complete closed-loop flow of activity and information to drive continuous improvement. Pricing is, at its core, a series of judgment calls based on guidelines set according to market information and corporate objectives. In an ongoing business, market information is consistently flowing in. The process must be able to incorporate and use it on a continuous basis.
• Clearly defined, communicated and enforced roles and authority.
• A concise framework and structure for exception escalation.
• Balanced measurement of activity and outcomes.

**Identify specific risk areas and the red flags that will trigger predefined response plans and actions.** Pricing is a high-leverage game. Small changes in the marketplace can require significant changes to a pricing strategy. Red flags (such as margins, volume dropping below certain thresholds, rising salesperson turnover or new competitors entering the market) can alert executives to a new risk that requires corrective action. Organizations should plan in advance how they will react to potential threats—and they will arise. The escalation hierarchy for pricing exceptions should have a top strategic level within which significant structural pricing issues can be addressed quickly and effectively.

Early-warning triggers and the responses to defined scenarios will be specific to each business and its strategy. The key lesson is that pricing should be a primary consideration and weapon of response, not a reactionary afterthought.

**Design compensation and incentives to promote compliance.** Very few disciplines draw as direct a line between action and incentives as pricing, especially for a sales force. Pricing is often the primary lever that closes a sale. Process and governance may be able to largely control pricing compliance. But incentives that align with pricing objectives provide the structure that allows the sales force to operate with autonomy, as the touch point with the customer, without running afoul of corporate financial needs.

• Compensation and performance measurement should motivate proper use and protection of key levers in the transaction, as identified in the pricing analytics.
• Revenue and even gross-margin-based compensation plans are often insufficient to align sales behavior with corporate objectives.
• Stakeholders (in this case, the sales force in particular) should have direct influence and control over elements of performance measures.

Be thorough but not overly complex in performance management design. Partial measures invite loopholes. Complex measures invite lack of focus, which leads to the use of proxies for practical decision-making. Some companies, for example, have turned to discount rate (or “price realization”) as a proxy for profitability, mainly because it is simple to understand, already captured in existing systems, and easy to measure.
at the transaction level. However, this metric ignores all of the costs to serve that the sales reps often use during a negotiation that ultimately affect profitability.

**Keep the focus on the customer.** Organizations can create value only by addressing the needs and goals of buyers. They should design pricing processes that reflect the client’s perspective and make the most of the entire value chain, regardless of organizational boundaries. For example, a consumer business company sells to a retailer that finally sells to the end consumer. Thinking of profit improvement strategies for the first transaction in the value chain without understanding the ramifications on the downstream demand may suboptimize overall value created. In another setting, for large business-to-business companies, one customer may purchase products from multiple business units, which are often managed as separate organizations with different leaders, different objectives, and different pricing metrics and strategies. As these companies begin to use data for advanced analytics that suggest increasingly sophisticated and targeted pricing changes specific to their business unit, it can be easy to lose sight of the cumulative, customer-level impact of these multiple pricing actions across BUs.

Executives contemplating an investment in pricing effectiveness often ask whether the view is worth the climb. There’s no shortage of risks to mitigate and challenges to overcome, even beyond those listed here. However, with the right approach—one that focuses on developing the organizational and process aspects of pricing, improving analytics and understanding the customer—a company can direct its investment toward those efforts with the highest return. DR

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**Endnotes**

2. Based on the 2011 Shift Index (Deloitte Development LLP) of Compustat data; Impact estimated based on the average Fortune 1000 company.  
4. Ibid.
5. Ibid.