GORDON STUDER

Bringing **discipline** to pricing

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Different local market environments create quite different opportunities for pricing. You must understand these environments to set prices optimally.

Many otherwise rigorously run companies are disconcertingly lax about pricing. Although a 1 percent improvement in price yields bigger gains in operating profit than a similar improvement in variable costs, fixed costs, or volumes—almost 8 percent on average across the S&P 1000—companies often base prices on the anecdotal observations of a few vocal salespeople or product managers. A lot of companies therefore end up with pricing policies that leave money on the table by failing to differentiate markets on the basis of their competitive dynamics and supply-and-demand economics. But there is a straightforward way to gauge supply and demand in individual markets. Companies can use it to decide whether their prices are too low or too high and, if so, by how much. (*See* sidebar, "Pricing in the e-channel," on the next page.)

Compare apples with apples

Consider a hypothetical company competing in many locations and market segments. Sales branches forced to discount heavily are making little or no profit, but those that can sell near or above list price are doing quite well. Perplexingly, the high and low performers are not concentrated in particular geographic areas and don't focus on particular product lines. The efforts of sales managers to explain the performance of their branches are as diverse as their results.

But if the company sorted sales branches by locations and product lines, it may not have grouped like with like. These time-honored classifications, along with others such as size or type of average customer, often fail to account for the market environments of individual branches. And it is the market environment—the level of competitiveness (a key driver of supply) and the scope of the opportunity (a key driver of demand)—that expands or limits a company's

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Pricing in the e-channel

One of the toughest challenges an organization faces in its efforts to craft smart pricing strategies is the coordination of its standard channel-pricing strategy and its e-commerce channel strategy. The Internet and similar digital networks appear to be great price equalizers because of their price transparency. But an e-channel can do more than undersell competitors; it can also conflict with and undermine its owner's standard channel. There are two ways of avoiding this problem.

First, limit your customers' ability to play arbitrage games—purchasing identical products or services, or packaged combinations of both, through more than one channel. In other words, a supplier's value proposition comprises much more than simple unit product and service pricing, so customers shouldn't be able to "back into" a package cheaply by, for instance, assembling a data network from components purchased over the Internet rather than buying custom-designed and -installed solutions.

Second, look for opportunities to target customer segments that have not so far been addressed. An e-channel might be an ideal way to offer nonstandard packages that are uneconomical through standard channels. A full-service provider, for example, might use the e-channel to offer uninstalled, minimally serviced controls for heating, ventilation, and air-conditioning equipment.

ability to set prices. Without first sorting sales branches by their market environments, a company can't make meaningful distinctions among them.

As a rule, sales branches in similar competitive environments can command similar pricing levels. If the prices of those branches, and thus the profits they generate, are lower than those of their true peers, the local branches' sales and marketing skills, service or logistics practices, or other capabilities are probably at fault.[1] Of course, that may not be true; in some cases, for instance, corporate pricing policies might have been poorly communicated to the branch sales force; in others, branches may have logistics, service delivery, or even local product-quality problems that are not within sales management's control.

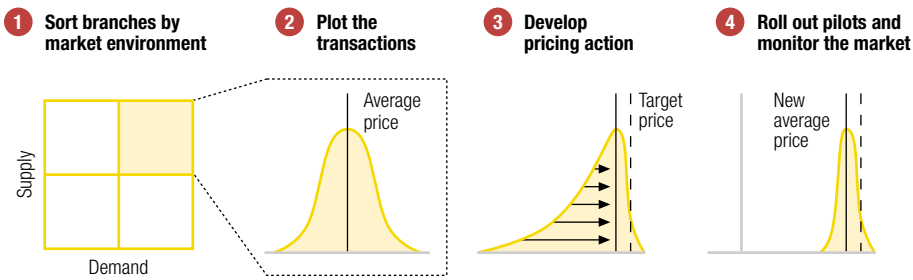
A new pricing process

By grouping sales branches together in a meaningful way, a company takes the first step toward developing the ability to price its goods and services optimally. It can then plot the historical pricing transactions of sales

[1] Companies must take care not to compare apples with oranges at the sales-branch level. Take, for instance, a company that has different competitors in each region of a country yet defines itself the same way in all regions—by customer size or type, say, or by vertical industry served. If the prices of such a company's branches vary a good deal within similar competitive environments, the company will be hard-pressed to understand the causes.

EXHIBIT 1

A new pricing process



branches in similar competitive environments, develop a way to reduce the variations between high and low pricing performers within each of them, and launch the new organization-wide pricing discipline (Exhibit 1).

The first step in the new pricing process is to develop a supply-and-demand framework by understanding the supply-and-demand characteristics of a specific market or line of business. For some products, forecasting demand can be as simple as collecting information about the installed base and projecting the size of the market for add-ons. For other products, companies might have to weigh—singly or in combination—the influence on prices of such factors as population growth by age category or preferences, the growth rate of businesses of a certain size or type, and product-to-product migration patterns. Products too new to have histories can be compared with existing products, in similar market segments, that have similar characteristics. Established products entering new markets should be priced and positioned on the basis of their performance in existing markets.

Sizing up the competition

Most companies tend to rely on surveys or word of mouth to gauge the extent of the competition they face on the supply side. But the fact that an isolated bit of bad news—to give just one example—can warp the judgment of senior sales managers makes such methods, though useful, less than ideal. A more authoritative approach would be to track pricing trends and competitors' actions within and across branches by collecting raw, quantifiable data from every sales branch. The data should include the following:

- The number of significant competitors across all accounts in a sales branch
- The average number of serious, reputable companies competing against a given sales branch for specific deals
- Annual revenue growth per sales branch over the past two or three years

- The percentage of bids that customers reject after being quoted an initial price
- The average difference between the initial quoted price and the final invoice price

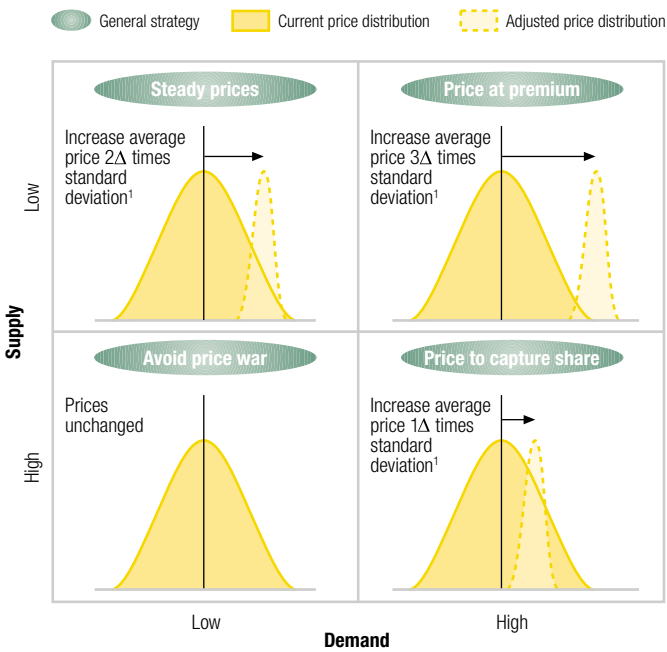
Most companies find it fairly easy to collect accurate data for the first three categories; for the rest, they will have to accept the best data they can get.

Plot the transactions

Equipped with supply-and-demand information, a company can segment its markets into four quadrants according to their competitiveness and the size of the opportunities they afford (Exhibit 2). Sales branches are placed in the quadrant with appropriate supply-and-demand characteristics—a segmentation that permits the company to plot the way prices charged to customers of the sales branches in each quadrant have changed over time.

EXHIBIT 2

Plotting the transactions



[1]Pilots will define Δ and Δ multiple; the Δ multiple in this exhibit reflects the general strategies depicted here and should be changed according to the specific strategy a company chooses.

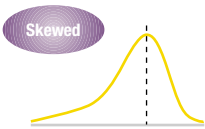
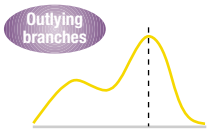
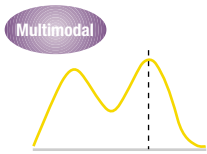
Typically, the pricing of transactions varies widely from one branch to the next. Any deviation among branches in the same quadrant reflects variations in the effectiveness of local marketing efforts or local sales forces, or in the level of service they provide.

Develop a pricing action for each quadrant

Management should next develop a systematic approach to reduce the variations between high- and low-price performers within the same quadrant or between quadrants and to improve the overall pricing performance within quadrants. A high-demand, limited-supply quadrant, for example, offers an opportunity to price at a premium.

EXHIBIT 3

Reading the curves

Situation	Explanation	Action
	• Flattening of the right side of the distribution indicates that the target price is close to the upper limit of the market price. • Moving the average higher requires an enhancement to the value proposition (for example, to services offered, service level, or sales force effectiveness).	• Concentrate less on increasing the target price and more on decreasing the spread.
	• Local targets and incentives (for example, aggressive quotas) may drive predictable branching behavior. • Some branches may have unique, overlooked circumstances (for example, product and customer mix, operational problems, or management constraints).	• Verify data accuracy and investigate unique circumstances affecting branch performance. • Isolate lagging branches. • Take situation-specific corrective action.
	• Natural product or customer segmentations are present (for example, institutional vs. small-business customers). • Market conditions may have changed over time or in specific regions. • Systemic internal factors have changed (for example, deployment of a new technical services capability).	• Find out if situation is localized or generalized. • If generalized, verify or adjust factors and weightings used in segmenting the market. • If localized, identify root cause and take corrective action.

As Exhibit 3 shows, the shape of a quadrant's histogram is a good indication of the closeness of the current target prices and margins to the highest levels the market will bear, for these shapes vary according to market conditions. Thus it is important to make inferences from asymmetrical curves and from curves with a broad spread. Price changes for each quadrant should be based on the shape of histogram bands, conclusions drawn from the first three or four pilot projects, industry experience, and segment-specific strategies.

Actually making price changes stick, of course, requires parallel efforts to support the branches in question. The methodology proposed here is an analytical tool that senior management can use to identify problem branches; management must still evaluate the particulars of each situation and act accordingly. In some cases, this might mean replacing sales managers, in others, arranging for an infusion of marketing and sales expertise or field training and support. Closely monitoring the impact of pricing recommendations will permit a company to calculate price elasticity over time and thus to make the next set of price-change recommendations.

Roll out the pilots

Management is now almost ready to act on what it has learned. First, though, a note of caution about the difficulty of quantifying customer churn, or the rate at which a company loses customers. At the retail level, it is hard to identify buyers lost to competitors and especially hard to spot those who continue to place orders while at the same time placing larger ones with competitors.

Customer "elasticity" presents similar problems: a client wrestling with a new information technology system, for example, might delay purchases for reasons unrelated to a supplier's pricing or performance.

Given the difficulty of taking accurate measurements in such situations, it is wise to move carefully—for example, by conducting a pilot program over several months to test a given market segment's price points in a controlled fashion. Thus armed with a better understanding of customer churn, management can decide how to roll out new prices across additional sales units. With prices and margins optimized and variations within quadrants reduced, the focus can shift to monitoring market conditions and costs.

Optimize profits, not prices

The pricing procedure described here doesn't end when optimal pricing has been achieved and variability brought under control. These are only the first two milestones in a continuing process of pricing for maximum profitability. Next, companies must identify products that are no longer profitable and monitor customer churn for signs that prices are higher than the value provided in return.

Any product's value proposition changes as the market evolves. The number of competitors might swell or shrink; new products or versions of products could be launched; competitors might start or stop giving rebates. Thus, every time market information is collected, it is vital to measure the customer and sales churn of every product—even if prices haven't changed recently. It may be necessary to change prices as a result (Exhibit 4).

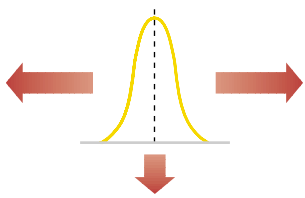
Since net or "final" prices are always moving, a product's total cost and its impact on profits should also be monitored. Products that don't meet

EXHIBIT 4

Assessing the market and adjusting to it

Prices too low
- Decreased customer churn
- Increased win-loss ratio
- Decreased fixed cost per unit sold
- Higher volume growth than comparable competition

Corrective mechanism
- Assess competitive value position
- Selectively increase prices (if value confers an advantage)



Optimal prices
- Stable market share
- Lack of quick pricing or volume swings
- Positive field pricing

Things to watch for
- Unique, niche repricing opportunities
- New entrants and offerings

Prices too high
- Increased customer churn
- Decreased win-loss ratio
- Increased fixed cost per unit sold
- Lower volume growth than comparable competition

Corrective mechanism
- Selectively reduce prices to align them with customer expectations
- Selectively enhance benefits and provide additional value-added services

management's minimum profit requirements may have to be discontinued. Of course, a product that in itself is losing money may be worth keeping for strategic reasons, such as rounding out a comprehensive product line or serving as a mechanism for appealing to big customers.

New prices, new organization

The analytical rigor and unbiased nature of this approach make considerable organizational demands on the companies that use it. A change in pricing is a major enterprise for any organization; it cannot be achieved overnight. Companies accustomed to anecdotal approaches may resist.

For these reasons, it might be wise to form a specific group to make pricing recommendations and monitor the impact of price changes. With the support of the sales organization and senior management, the group could put forward pricing suggestions even in the face of opposition. By closely monitoring the impact of price changes, the group would be alert to the need for midstream adjustments. To the extent that the organization must evolve over time from a sales-and-technology orientation to a focus on pricing and the bottom line, the pricing group could be the agent of that transformation.

Of course, the leader of the group shouldn't report to anyone directly affected by its recommendations, even if that person—for example, the vice president of marketing or finance—would otherwise be a logical choice. Moreover, a clear succession plan should be developed to get high-caliber people, especially from sales, to work in a somewhat isolated pricing group. They ought to understand that there will be no negative political repercussions if they want to return to sales or move up the corporate ladder, for by necessity such a group will often irritate the senior people in a company.

Finally, to alleviate some of the fears of both sales representatives and customers, management needs an effective communications plan. Rebates to selected customers, the promotion of key salespeople, and improved employee compensation would be likely to smooth the way.

Pricing can be a key lever of profitability. The system outlined here permits businesses to price across markets for maximum profit. But since this approach presents a mass of data to analyze, cross-organizational issues to tackle, and difficult metrics to track, it requires investment in systems and resources as well as strong management backing. In the end, that kind of commitment will be a small price to pay. MQ