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Pricing in an Economic Downturn

Effective strategies to achieve sustainable growth

October, 2009

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What is this POV about?

- Presents a point of view that a effective pricing tactics could be used in a downturn to gain competitive advantage
- Illustrates why price slashing may not be the most effective path to a sustainable business model
- Provides examples of companies that price effectively to outperform market and peers
- Identifies a set of key pricing strategies that businesses may employ to proactively manage profits in an economic downturn
- Identifies key levers that can be influenced

Contents

- The Current Economic Scenario
- Price pressure due to the economic conditions
- Adverse reaction of companies
- Challenges faced and how to effectively implement New Pricing Strategies
- Conclusion

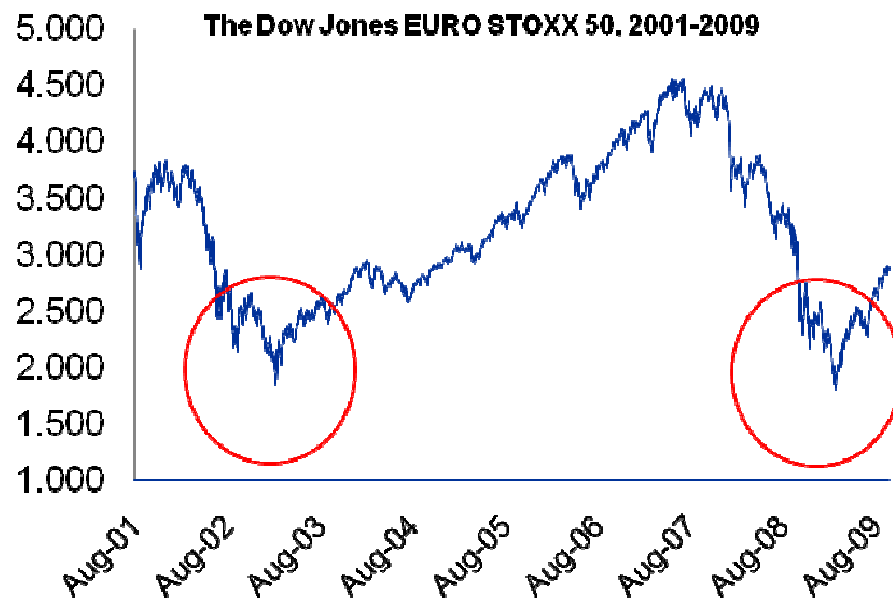
The current downturn in the economy

The world economy is now mired in the most severe financial crisis since the Great Depression, with a credit crunch driving debt dependent industries into recession

Highlights of the economic scenario

- According to the United Nations baseline forecast, world gross product (WGP) is expected to slow to a meager 1.0 per cent in 2009, a sharp deceleration from the 2.5 per cent growth estimated for 2008
- In the US, credit card debt is now in the excess of one trillion dollars
- Retail sales continue to decline, resulting in more bankruptcies and liquidations
- The unprecedented extent and speed of the fall in commodity and gas prices is having an effect on commodity producers as well as is making investment in exploration projects unprofitable
- Given credit market conditions, trade finance has become more expensive, leading to downward pressure on economic activity

A scenario comparable to 2001?



- Current economic conditions, (crash in the stock market, high unemployment, and the slowdown in GDP growth) are similar to previous economic downturns (1991, 2001)

Current economic conditions are exerting a downward pressure on prices

“UK set for three-way iPhone price war” – *CNN, Sep 29, 2009*

“Target joins in price war on expected best sellers” – *Business Week, Oct 19, 2008*

“Audi slashes 10pc off its new car prices” – *The Independent, Sep 30, 2009*

“Ryanair launches price war as sales slump” – *The Guardian, Aug 8, 2008*

“Petrol prices slashed by 5pc in supermarket forecourt battle” – *The Daily Mail, Jul 23, 2008*

Most companies panic during a recession and react badly

In a recession, companies panic, hastily implementing short-sighted policies without better understanding the market and what drives profitability.

Driven by market pressure, companies tend to find themselves facing the following challenges:

Typical challenges faced by companies in a downturn economy

1. Implementing a new pricing strategy without understanding of internal cost structure
2. Trying to retain all customers without evaluating individual customer profitability
3. Sub-optimal pricing without understanding what customers value
4. Engaging in price-wars against competitors
5. Inaccurate forecasting of impact on individual buyers
6. Sacrificing Brand in an attempt to survive
7. Choosing the right signal when implementing price changes

We will now look at each one of the above and discuss strategies to effectively deal with each challenge

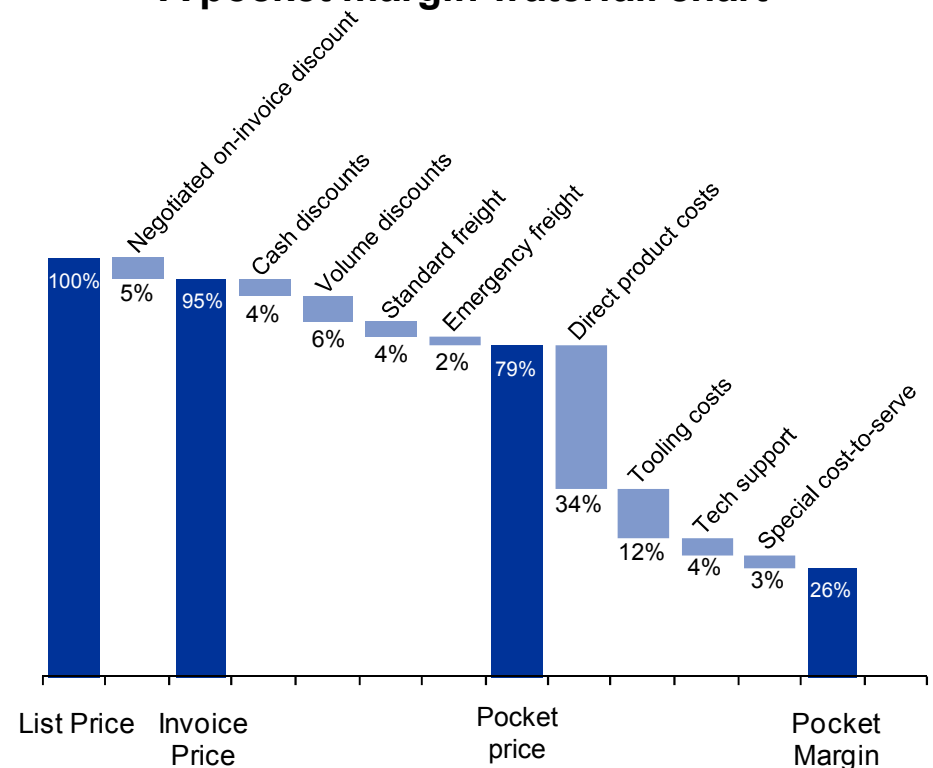
1. A company needs to understand its own cost structure before implementing a new price strategy

A company needs to clearly understand its own business and cost structure, in order to correctly estimate the effects of a change in pricing strategy

Typical reaction of companies

- The initial reaction of firms in such an economy is to cut costs instead of playing with price because management perceive costs as more “controllable” business levers
- Many businesses choose to manage recession-related risk by focusing on core competencies
- Cutting costs has a finite end, indiscriminant cuts can erode value, and most companies don’t understand costs enough to know the impact of the cut

A pocket margin waterfall chart



Understanding the cost structure

- Perform a transaction-level analysis of each cost element, assign SG&A burden to the appropriate transaction
- This “new picture” into the company’s cost structure can help a company discern which areas of business are most profitable and which areas don’t add value, or worse, are a financial drain.

2. Understanding individual client profitability is crucial to effective pricing

Typical reaction of companies

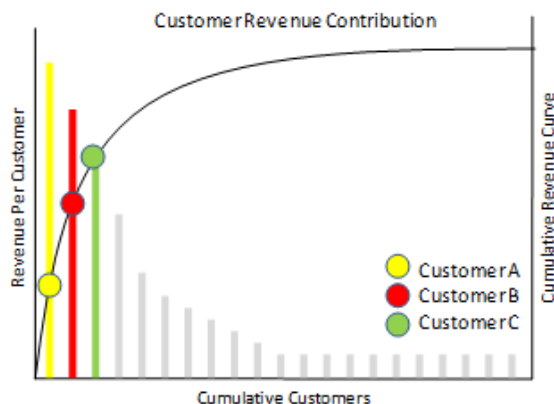
- Hold onto all current customers - often this means increasing incentives for the promise of revenue.
- Companies often lower prices to their “best” customers in an attempt to increase customer loyalty
- Sales teams offer unreasonable discounts in an attempt to boost sales
- Inaccurate, oversimplified metrics often lead to disastrous pricing strategies - in many cases allowing good customers to subsidize the bad ones.

Understanding customer value

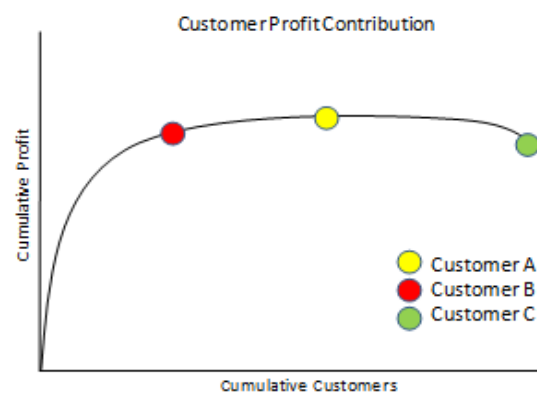
- Obtain true Costs to Serve for different customers, align prices and discount levels to ensure profits
- Identify the true value of each customer, and focus on increasing sales with those customers through incentives
- Identify existing customers who represent more potential value than previously realized - and drive programs to capture this business

Identifying truly profitable customers

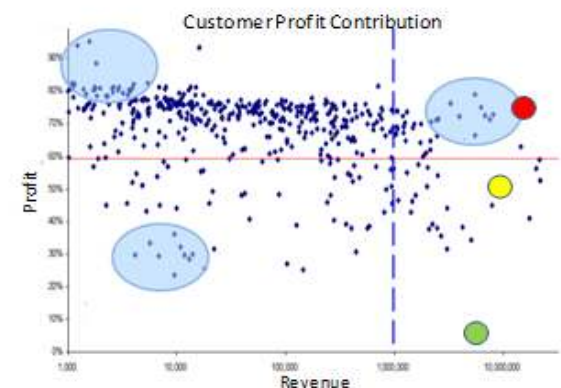
You think these are your best customers?



Are you still sure?



Focusing here will have more impact



3. Understanding what customers value most is critical in determining optimum prices

Key Questions	Illustrative Strategies
What pressures are top of mind for customers in the current state?	<ul style="list-style-type: none"> ▪ Suppliers selling very minor or very critical products to a customer may raise prices without much protest
How much do customers value each feature of a product offering and what trade-offs do they make in the purchasing decision?	<ul style="list-style-type: none"> ▪ Performing conjoint analysis to estimate the value your target customer segment attributes to each feature of the product ▪ Investigate availability of alternatives or substitutes and how easy it is for customers to switch
Are there clear pricing strategies for products/services during a downturn?	<ul style="list-style-type: none"> ▪ Develop downturn-specific pricing strategies for products and services ▪ Revisit segmentation of customers and evaluate pricing processes and criteria
Are there ways to differentiate customer experience?	<ul style="list-style-type: none"> ▪ Segment customers based on customer needs and what they are really willing to pay for ▪ Innovate to differentiate customer experience by segment
How does a price increase for one product impact bundles?	<ul style="list-style-type: none"> ▪ Evaluate the change in value proposition of a bundle due to the change in price of one product

4. Engaging in a price war can be detrimental to all concerned

A race-to-the-bottom price war can substantially erode profits long after the economic turbulence has subsided

Risks of a price war

- Consumers will assume that the quality of your products is below that of the higher-priced competitors and, consequently, choose not to buy your products.
- Low prices buy market share, but not customer loyalty. Customers become conditioned to switch to the next low-price firm that comes along.
- Higher-priced competitors may cut their prices and may have longer staying power because of deeper cash reserves.
- While a recession may only last a year or two, the impact of recession driven price cutting is extremely difficult to overcome for many years

Examples

- European Hypermarket operator and retailer engaged in a price war with competitors Casino and Metro, resulting in an operating profit margin of 3.9%, one of the lowest in the sector
- Dropping prices of luxury goods will result in consumers becoming unwilling to spend more for the same goods in better times
- Companies like Carrefour have deeper pockets and can survive longer in a price war.
- Devastated by the success of Dacia in Western Europe, Peugeot and Citroën are planning to start their own budget brand. In order not to damage their market reputation, they are considering to create a new brand.

Instead, pricing organizations should seize the opportunity to secure sales and retain customers

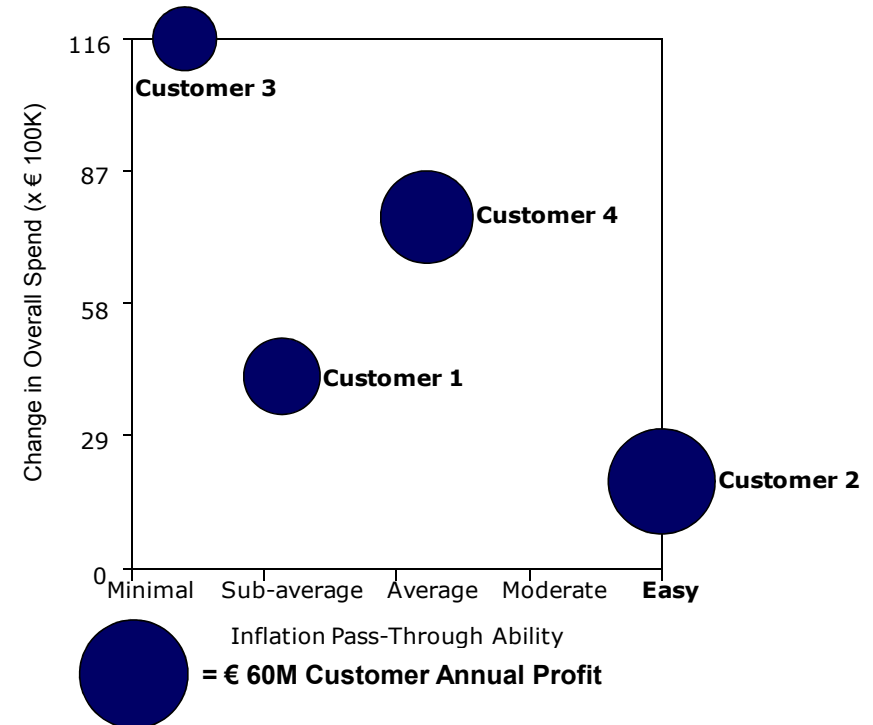
5. It is important to understand the impact of the new pricing strategy on individual customers

Failure to forecast a buyer's capacity to absorb a price increase or pass it further along the value chain may result in unanticipated customer fall-out

Typical reaction of companies

- Many companies do a holistic analysis of how inflation impacts their profitability, and what results a price increase will have on financial statements
- However, minimizing customer fallout and achieving anticipated financial results requires understanding how each buyer will be impacted
- More resistance will be met from customers who play in highly competitive markets, and who face a larger increase in overall spend due to a price change

Customer Impact & Risk Assessment Matrix



How to accurately evaluate impact by Individual Buyers

- Understand a buyer's ability to pass costs along the value chain (Inflation Pass-Through Ability)
- Use historical purchase data or contractual commitments and apply price change to that data to anticipate the reaction of the customer (Change in Overall Spend)
- Use profit information to identify high-profit customers who should be given greater priority in addressing inflationary price increase concerns

6. Should Brand be sacrificed to succeed in a tough economy?

While a recession may only last a couple of years, the impact of recession driven price cutting is extremely difficult to overcome for many years

Examples

“LVMH in the recession: The substance of style”

The Economist, Sep 17, 2009

- Louis Vuitton, LVMH’s star company with profit margins of around 40-45%, is the only leather-goods firm which never puts its products on sale at a discount.
- They destroy stock instead, keeping a close eye on the proportion it ends up scrapping (“destruction margin”)

Immediate results:

- In the first half of 2009, Vuitton’s revenue rose by a double digit percentage compared to last year, registering gains in every market.
- They were not affected by the panicked price-slashing of up to 80% by American luxury department stores in the run-up to Christmas in 2008

Long-term effects:

- Unlike some competitors, Louis Vuitton reinforces its exclusive image in the market
- Gaining market share by acquiring new assets at attractive prices, as a result of outperforming competitors

“Apple Bests Downturn,”

WSJ, Jan 22, 2009

- Apple Inc. defied the recession and did not slash product prices in an attempt to increase sales

Immediate results:

- Apple reported its best quarterly revenue and earnings in history
- A 5.8% rise in revenue and a 1.5% gain in profit, sending its quarterly sales past \$10 billion for the first time.

Long-term effects:

- Consolidation of Apple’s position as a premium Brand
- Allows Apple to continue charging a premium price for its products

7. Choosing the right signal is important when changing price

Price changes can be structured to take two forms, a base price adjustment or an additional surcharge, depending upon what a company wishes to signal

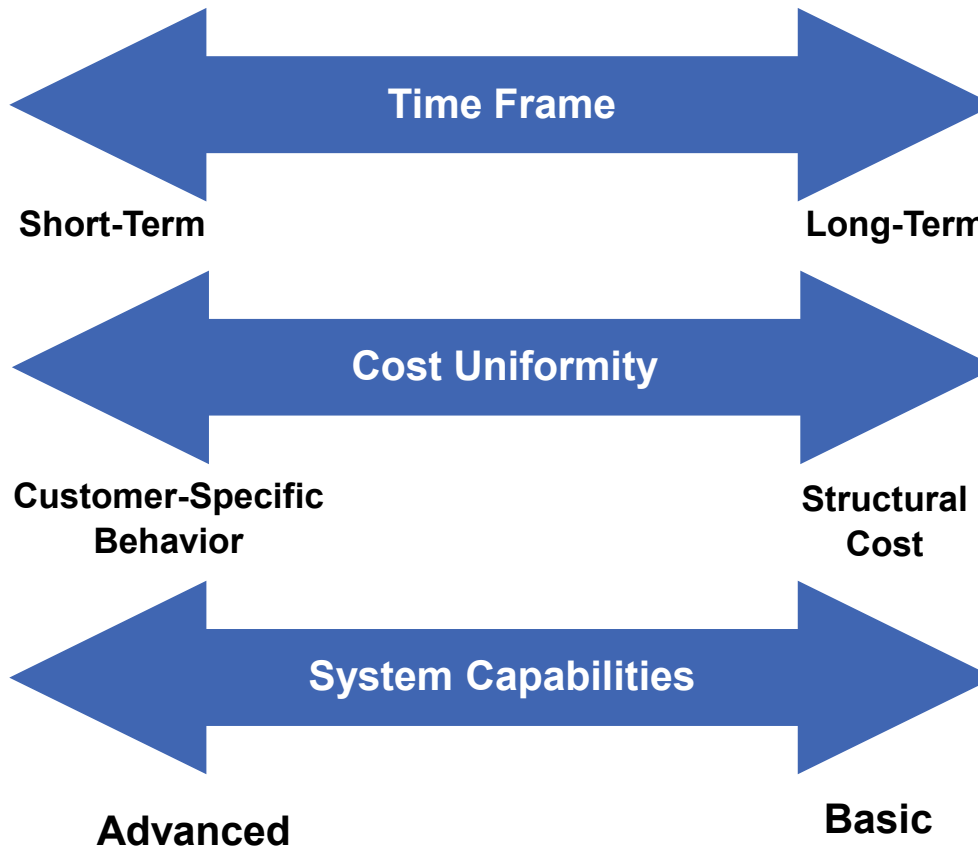
Base Price Adjustments vs. Additional Surcharges

Surcharge

Temporary ad-hoc fee can be removed after a certain period of time

Business efficiencies or additional costs can be avoided by modifying customer behavior

Systems have capability to determine when surcharges logically apply



Base Increase

Price increase is expected to remain; change is built into base price

Price increase is expected to remain; change is built into base price

Difficult to write custom logic into systems, easier to modify base price

Conclusion: Effective pricing strategies are critical in a downturn

What companies in a downturn need to understand

1. Their own cost structure at a transactional level
2. Individual client profitability and which ones are truly profitable
 3. What customers value
 4. Engaging in a price war is detrimental to all involved
 5. Impact of new pricing strategy on customers
6. The risks associated with sacrificing Brand in an attempt to attain short-term monetary gain
 7. Choosing the right signal is important when changing price

Companies who focus on price and profitability management deliver higher than average shareholder returns

Contacts

Deloitte.

Koen De Staercke
Partner

Tel: + 32 2 749 59 12
Fax: + 32 2 749 56 70
Mobile: + 32 497 59 62 12
E-mail: kdestaercke@deloitte.com

Deloitte.

Stefan Van Thienen
Partner

Tel: + 32 2 749 57 31
Fax: + 32 2 749 56 70
Mobile: + 32 476 22 01 03
E-mail: svanthienen@deloitte.com

Deloitte.

Marc Abels
Director

Tel: + 32 2 749 57 80
Fax: + 32 2 749 56 70
Mobile: + 32 497 05 10 37
E-mail: kdestaercke@deloitte.com

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