

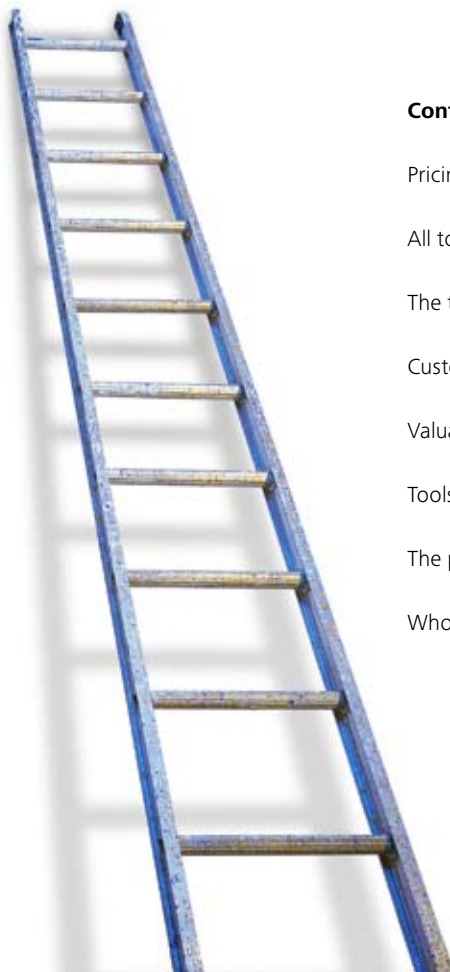
The problem
with pricing
(It's you)



What is a cynic?
A man who knows
the price of everything
and the value of
nothing.

— Oscar Wilde

Why CEOs should pay closer attention to pricing



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Pricing: where profit is captured or lost

If a business aims to create more value for its shareholders and customers through smarter pricing, the CEO must lead the way.

For all the moments that matter in business, there's only one point when money changes hands—the point of purchase. That's when the price you charge captures the profit you're in business to generate. Or fails to.

Our research has consistently shown that pricing has up to four times more impact on profitability than other investments. A 1 percent improvement in pricing can boost profit by more than 12 percent.¹ The return on an investment in pricing can easily top 300 percent in less than a year.²

With so much money at stake, it's hard to understand why so many companies neglect pricing, leave it to the sales force, or rely on lower-level analysts instead of moving it onto the CEO's agenda. If your company's view of pricing isn't high-level and cross-functional, we believe it's wrong.

As a business discipline, pricing has evolved far past the basic intersection of supply and demand taught in high school. Companies have more and better pricing capabilities at their disposal than ever before. Whether they're using them effectively is a different question.

Moving beyond traditional pricing methods takes courage. But so does every business decision that matters. If a business aims to create more value for its shareholders and customers through smarter pricing, the CEO must lead the way. Consider this guide as a good way to get started.

¹ Compustat, Deloitte Analysis

² Preslan, Laura, "Price Management: Conventional Wisdom is Wrong," AMR Research Outlook, February 2, 2004



What's new in pricing?

Pricing has evolved into a complex discipline that combines science and analytics with insight into human interactions. And it's still evolving.

Yesterday	Today	Tomorrow
No defined strategy—sales sets prices in the field	Marketing owns strategies for a few “high interest” products	Pricing is an independent function that aligns all prices with corporate objectives
Cost and profitability analyzed at the gross margin level	Targeted analytics that focus on profitability of specific customers and products	Integrated analytics drive profitability and market share objectives
Pricing capabilities “siloed” within an organization	Some integration of pricing capabilities	Seamless integration of pricing capabilities into a single approach
Prices based on cost-plus method	Some value-based pricing for differentiated products	Sophisticated segmentation and customer-awareness schemes
Limited use of technology to manage pricing	Specific pricing applications monitor profitability and manage prices with the sales force	Technology integrates demand-side factors into the pricing process
Manufacturers and retailers manage pricing independently	Advanced technologies open up communications between suppliers and retailers	Price and margin managed across the entire value chain

All together now

Before the downturn, companies everywhere had their eyes on market share. In the blink of an eye, they shifted into cost-reduction mode—at least those that managed to keep their doors open.

What's the target now? Growth? Margins? Survival?

Yes.

The marketplace forces companies to value different things at different times. But not all growth is profitable. Not all revenue is high-quality—which is to say, achieved at the right cost. There will never be a time when pricing doesn't matter.

Pricing has evolved from a blunt instrument to a laser-guided discipline. As much as almost any other function in business, it reflects the essence of strategy. Too bad so many companies miss that point.

One reason is that CEOs aren't involved. Many don't even give pricing a second thought, and those who do have their work cut out getting the rest of their organizations on the same bus. Sales wants to move units. Marketing has its eye on share. Finance cares about the balance sheet. All of which should make CEOs very nervous.

No matter where you're taking your business, pricing can help get you there—but only if you manage it effectively.

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Price check

Determine where your organization is out of alignment on pricing. Are you providing leadership? Is anyone following?

The evolving truths of pricing

Myth	Reality
We are making plenty of money from customer X—look at the sales!	You're barely breaking even on customer X when you consider the cost of selling and servicing.
Total annual revenue indicates a customer's value.	The true measure of a customer's value is more complex than that.
We win because of relationships but lose because of price.	You win because of the value you and your customer provide to each other.
Cost-plus pricing simplifies my pricing process.	The benefits are huge for those who learn to manage pricing complexity.
The market and competition determine the price I can charge.	You have more control of pricing in the market than you think.

The truth hurts

Somewhere at the intersection of data and insight lies the truth you need to make smart pricing choices. Each sale is more than a shotgun wedding of cost and markup—it's both a transaction and an anecdote. Through analytics, we believe you can combine the two and come up with knowledge worthy of action. Knowledge that should drive your business strategy.

It's the kind of truth that can give you the power to assess each customer relationship on its own merits, one transaction at a time. That's how you learn which customers are worth more investment—or perhaps no investment at all.

You may be surprised by what you learn. Many companies discover things they really don't want to know. And some don't act because it seems too hard.

So yes, you *should* be wondering whether you'll be ready to handle the truth. But don't let that stop you from finding it in the first place.

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Price check

Ask your sales and finance departments to evaluate the profitability of a key customer. Do you get the same answer?



Question time

It would take a pretty close relationship to ask some of these questions point-blank. But one way or another, you need to know the answers.

What a company should ask itself	What a company should ask customers
Do we understand customer profitability at the transaction level (by product, customer, and channel)?	Are you willing to buy our product in other ways (less expensive channels, different sizes and frequencies, different packaging)?
Who really buys our product and why?	Why do you purchase our products instead of our competitors'?
Which customers would we fire? Which customers should we be doing our best to keep?	Is there a more efficient way we—or our competitors—can serve your needs?
Do we scientifically measure pricing choices made by customers?	What are you truly willing to pay? What trade-offs are you willing to make?
What drives our customer segmentation? How do we approach our customers differently?	Do you use or value specific attributes of our product in a way others don't?

Customer questions

Cost-to-serve, competitiveness, and lost opportunities can all influence the profitability of every individual customer. A volume buyer might generate less value than five smaller customers. Bringing in a new customer—or a dozen—might cost more than winning incremental business from current buyers.

And the person you think of as a loyal customer might just be in a comfortable zone of indifference—a range within which price changes don't influence purchasing behavior. Where's the line? Too many sellers learn only by crossing it, and inadvertently knocking a customer out of the zone and into someone else's arms.

In response to all this, many companies focus on price harmonization. You may have heard that it's a tool to prevent arbitrage. Or that it streamlines administration. That may be true, but we believe mostly it's a system for leaving money on the table. There's a better way, a smarter way, that takes the long view of each customer's real value over the lifetime of the relationship.

Learn to listen to what customers are really telling you—both in words and in numbers. Develop a dispassionate view of what each is worth and why. Then use pricing as a tool to manage demand and concentrate your business on the most valuable relationships.

Learn to listen to what customers are really telling you—both in words and in numbers.

Price check

Try to articulate the value each customer creates for you. Find the “balance of value” for everyone you do business with.





Valuable versus visible

Your first instinct may be to approach pricing from an accounting perspective. Don't. Accounting is about aggregation—and aggregation masks the reality that can let you manage pricing effectively at the customer and transaction level.

Smart pricing requires a different perspective—an economic perspective—to measure whether a transaction has advanced the company toward its strategic objectives. Understanding that perspective and using it as a management guidepost requires a whole new set of metrics. It starts at the point of sale, where profit is built one sale at a time.

Understanding the economic profitability of individual transactions is essential for effective pricing. It can help clear the way for informed decisions about everything from channels and products to sales and advertising.

Is it time to unplug the accountants? Not at all. Their perspective is important—but it's only part of the view. Pricing is about managing profitability, for today and tomorrow.

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Price check

Ask finance to take the first step toward building a transactional model that maximizes sale-by-sale profit.



Which of these pricing capabilities are critical for your business today? Which will you need to master tomorrow?

Price Execution

Executing defined policies and processes that govern profitable decision making on a daily operational level

Pricing Strategy

Defines a pricing framework that supports business objectives by understanding and capturing the value of an offering relative to competitive alternatives and customer demands

Organizational Alignment and Governance

Effectively managing the people and cultural dimensions of an organization so that it can sustain pricing excellence

Advanced Analytics and Price Setting

Determining profit-maximizing prices for products and/or services by predicting impact at the customer level

Pricing Technology and Data Management

Designing and deploying pricing analytics, optimization, and execution tools to enable effective pricing decisions and to enhance quality and consistency of pricing processes

Tax and Regulatory Effectiveness

Proactively managing the tax, regulatory compliance, and governance issues related to pricing decisions

Tools *and* rules

If the goal were to set a company-wide pricing strategy, it would be natural simply to write down a set of rules. Natural, but counterproductive. Too much reliance on rules limits the value that informed people can bring to pricing.

Instead, strike a balance that enables people to make smart decisions. Install guardrails, not guidelines. The complexity of your product line and the capacity of your sales force can help determine how much freedom to build into your risk profile.

This kind of flexibility applies not only to pricing itself, but also to each of the internal capabilities that go into determining prices. This chart offers a glimpse of the pricing and profitability management toolbox.

A retail business may focus more on the price offering, for example, while a commodity supplier may benefit from a greater emphasis on price execution. No company can ignore any of these categories completely, though.

This isn't the classical approach to pricing, but it's critical. What's unfamiliar today will likely be table stakes tomorrow. Your competitors have access to these new tools already.

Too much reliance on rules limits the value that informed people can bring to pricing.

Price check

Determine which of the six key pricing capabilities are critical to your business today. Which ones are you taking care of? How will you address the missing components?



The people side of pricing

The focus on clearly defined capabilities makes pricing seem like a science. And to a large extent it is. But there are some elements of pricing that involve perception, relationships, and even emotion. It takes all of the above. This is the people side of pricing.

That's because every transaction is a human interaction, and vice versa. A keen understanding of pricing and profitability can help elevate the sales conversation from one based solely on price to one based on value and relationship—on both sides of the table.

So before you ask, "How much will they pay?" ask instead, "What are they really buying?" and "What value are they seeking?" It might be a particular product attribute, a relationship, or just peace of mind. The answers will affect your pricing strategies and how you execute them.

Your sales force should be finely tuned to make the most of every customer relationship. If share is the name of the game, cut them loose on volume. If profitability matters most, tighten up on discipline. If you want both—and who doesn't?—get really good at pricing.

How do you organize your pricing function? In most cases, a "center-led" team with accountability and authority can give business units the direction they need. Find the people in the business who like to take on new challenges and risks and make them part of your pricing team.

How can you focus everyone on the same goal? Celebrate wins, like you always do—but focus on margin, not volume. Then watch how fast the organization will take note and follow.

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Price check

Know who in your organization is ready and able to help you upgrade your approach to pricing.

Whose vision?

Pricing isn't simply an operational tactic. It's a strategic lever that both reflects the company's overall plans and helps make them happen. That means it's part of the leadership agenda. One of those vision things.

That's right: Another issue wants a seat at the big table.

If pricing is moving up on the CEO's agenda, what's going to drop off? Only you can answer that, but remember two important things: Pricing is something customers see first-hand with every purchase, and it's where the money comes from in the first place. In truth, pricing is already on your agenda, lurking deep inside almost every other item. You just need to pay attention.

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Price check

Demand a consistent pricing vision throughout the organization. Ask your department heads to develop their best thinking and then use your next major meeting to dive into competing visions.

Talk to us

We look forward to hearing from you and learning what you think about our ideas. Please contact us at usdeloittepricing@deloitte.com or visit us online at www.deloitte.com/us/pricing.

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