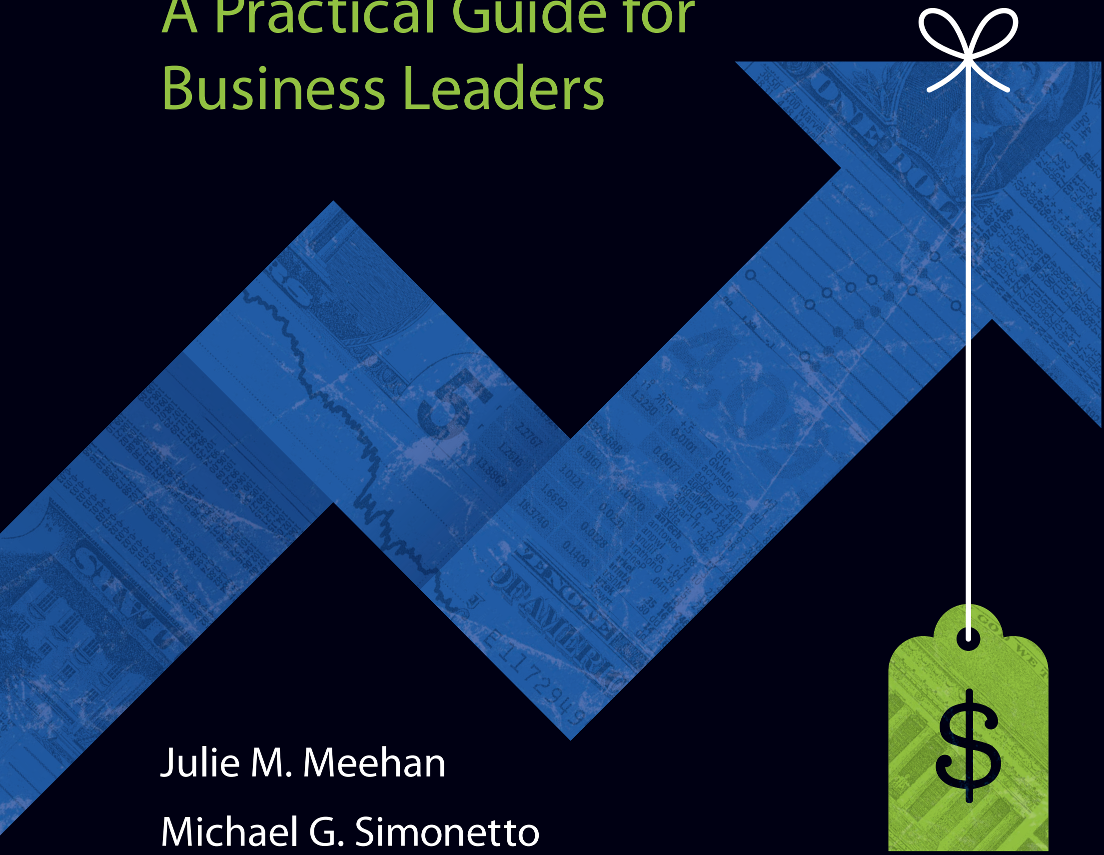
Pricing and Profitability Management

A Practical Guide for Business Leaders



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CHAPTER 1

Introduction to Pricing and Profitability Management

The moment you make a mistake in pricing, you're eating into your reputation or your profits.

—Katie Paine, founder and CEO of KDPaine & Partners

There is an old joke about a businessman who loses margin every time he sells his products. A customer asks, ''How do you make money?'' The businessman answers, ''I make it up in volume.''

A company that routinely sells products below its margins would hardly seem likely to remain in business for long. Nonetheless, many firms follow this approach today. In some cases, this approach is an unintentional move, which results in the company's losing money on every transaction. In other cases, it reflects a carefully considered decision to maximize profitability across a portfolio of product offerings. However, in other instances, this approach is adopted by business leaders who simply misunderstand which of their products and customers are actually generating margin and the factors that truly determine their company's profitability.

The field of pricing management has been growing steadily in recent years. If you mention the subject in a group, many people will assume the ensuing discussion will be limited to price setting. But the discipline involves much more than just prices themselves. Pricing management is a strategic competency that involves people, processes, technology, and information. Its reach extends into virtually every corner of an organization (i.e., marketing, sales, IT, operations, finance, accounting, and executive leadership). Effective pricing management is capable of changing the way a company views and operates its entire business; it helps ensure the overall profitability of an enterprise and it can impact the bottom line profoundly. This book is intended to serve as a comprehensive introduction to the discipline and a reference work for business leaders, managers, and students who want to deepen their understanding of and sharpen their capabilities in this critical function.

Pricing: The Critical Lever for Raising Performance

Why make pricing improvement a focus for an organization? The answer is simple: the benefits are enormous. A study has shown that 90 percent of pricing investment meets or exceeds return on investment (ROI) expectations.[1] Put another way, *for any dollar invested in performance improvement, the greatest return comes when it is invested in pricing.*

Figure 1.1 reflects one version of an often-replicated analysis.[2] All versions lead to the same conclusion: pricing is the most powerful lever available to raise performance. Despite this, the evolution of pricing management has, until recently, been slow. Although it has long been recognized as one of the traditional *four P's* of marketing, a number of systemic and structural challenges prevented pricing management from achieving the same level of sophistication or having the same capacity to improve performance as it has now. In its early days, practitioners focused on revenue/yield management and operated almost exclusively in the airline and hospitality industries. But recent developments have led companies to appreciate the breadth and critical importance of the discipline. We discuss three of these developments briefly below.

The Search for Improved Data Management Solutions

The widespread adoption of enterprise resource planning (ERP), particularly over the past 10 years, has enabled firms to collect, process, and store

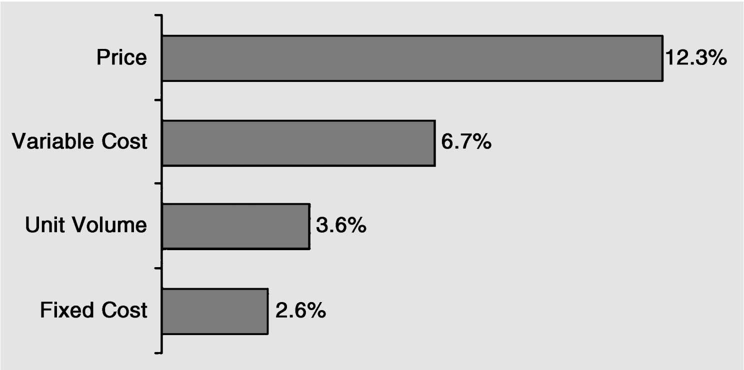

Figure 1.1 Profit Improvement Initiatives and Return on Investment (ROI)

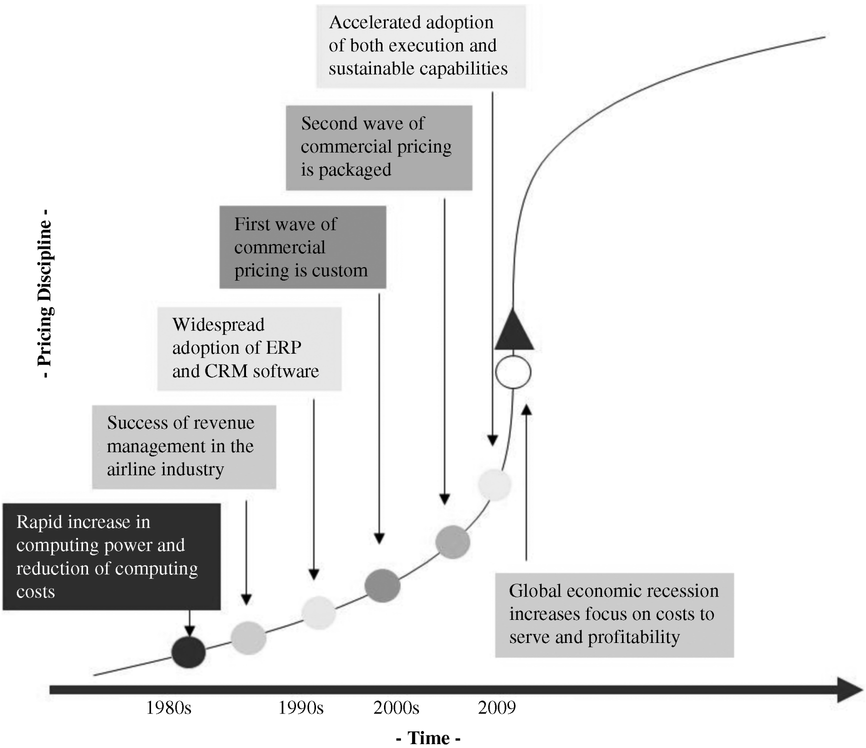

Figure 1.2 Causes of Historical Growth of the Pricing Discipline

more transaction-level data than ever before—a prerequisite for effective pricing management. However, management of this information has lagged behind. Data mining, transaction-level price analyses, demand-elasticity curves, price waterfalls, price-band analysis, customer segmentation, and transaction-level profitability measurement are all tools that require large amounts of clean, available data. Companies have aggressively sought new ways to manage this data, which, in turn, has led to an explosion in price optimization software (Fig. 1.2).

Traditionally, pricing software addressed demand curves, price optimization, and, at the highest level of sophistication, revenue/yield management. In the past five to seven years, however, the need for software to address price execution has been recognized and addressed. The software continues to evolve in response to market needs, as various packages leapfrog each other with improved capabilities. Overall, vendors have moved from offering purely custom solutions to providing true ‘‘off-the-shelf’’ functionality that can be implemented in months, not years. In addition, these vendors aggressively pursue the integration of stand-alone pricing software and core ERP systems.

The response to these software developments has been striking. Every single competitor in the ERP space has bought or built software, or partnered with other vendors who have software, to bring advanced pricing capabilities to the market. This is true for both the business-to-business and the business-to-consumer markets.

As this book was going to press in 2010, the pricing software industry was well into a consolidation phase. A number of the small niche players had gone out of business or been absorbed by larger firms who coveted the specific capabilities they could add to their existing application portfolio. A few key players had emerged, but the true winners had not yet achieved dominance.

However, despite its obvious importance, software alone will not provide a competitive price advantage; good data can only serve as a basis for developing an effective strategy. In fact, if software is positioned as the ''silver bullet,'' it can actually decrease a company's ability to set and manage prices because sales personnel will likely resist using the tool without careful preparation. For example, an advanced software application can help calculate customer-specific pricing, but if sales incentives are not aligned with the new prices, then discounting practices may arise that undermine them and make the new price list suboptimal. For this reason and many others, software must be part of a comprehensive strategy that can meet the demands of an increasingly complex world.

The Growing Challenges of Global Markets

Globalization (and the expansion of cross-border arbitrage and gray market activity) has increased the need for multinational companies to create worldwide pricing strategies. If not addressed effectively, gray markets will cannibalize sales for manufacturers and jeopardize relationships with distributors who own contractual rights within a region. The need to address these issues strategically in international markets will continue to grow as companies realize other profitability initiatives have ceased to work.

Reaching the Limits of Cost-Cutting

An organization can only undertake so many cost-reduction initiatives without diminishing its ability to serve its customers effectively. For example, a manufacturing company can consolidate plants to slash expenses only so long as its production capacity is still able to meet demand. Similarly, a retailer cannot continue eliminating sales personnel if this strategy interferes with the running of the store, causing revenue to drop. Companies can never ''cut'' their way to prosperity. Pricing, in contrast, is a constant means to profitable growth.

The emergence of these three trends—improved data management solutions, the challenges of global markets, and the limits of cost-cutting—

has helped companies see the tremendous opportunities that pricing management can produce. The benefits are both sizeable and quickly realized. (There is also a first mover advantage: the earlier a firm addresses pricing, the further along its learning curve and ahead of the competition it will be.) Yet while companies have more and more tools available to help them develop an improved pricing capability, many still have failed to act. Why?

Common Obstacles to Pricing and Profitability Management

In a 2004 study, AMR Research found that fewer than 3 percent of companies effectively managed, communicated, and enforced prices.[3] Why? Because pricing, done correctly, is an extremely complex undertaking that requires a group of trained practitioners to view the business through a unique lens.

While executives may understand the benefits of improving their organizations' capabilities, the obstacles they face may seem insurmountable and can create institutional inertia. Many apparent barriers simply reflect the demands of pricing management itself. Other barriers reflect the natural confusion of an organization that lacks the structure and the personnel to handle the new strategic approach. A few of the common impediments follow.

Daunting Complexity

Pricing is an intricate and interdependent competency that impacts all levels of an organization and the market it serves (including customers and competitors). At any given time, an organization must ask itself and address a multitude of questions:

- How can price be used as a competitive advantage, and how can we achieve results as quickly as possible?
- How do we position a price with our customers, and how do we differentiate our offering?
- What should our value propositions be for each customer segment?
- How does our product portfolio match the needs of our customers?
- What do we have to do to meet the promises made by our executives and our sales force, while still delivering the required margin?
- Can we use price to influence demand (and can we build that into our production and supply chain thinking)?
- What should our price be?
- Once we have the right price in place, how do we execute it effectively, and what will be the likely customer and competitor responses?

Internal Resistance

Pricing data collection and cleansing can be a challenging and time-consuming task that requires specialized technical skills and a cross-functional and multisystem understanding of the data. Winning cooperation between the different functional groups involved may prove difficult. Initial improvement efforts are often viewed skeptically by organizations simply because they reflect a new approach. In addition, individual units may rely on different data sets to form their assessments of the organization's needs and market position, which can lead to strategic disagreements. Thus, many pricing initiatives fail before they truly begin because managers find various reasons to resist changing the status quo and are unwilling to adopt a fresh, objective view of the business at a transaction level.

Fear of High Stakes

Besides being costly, pricing errors can produce long-term (if not permanent) consequences for an organization. Any organization that has engaged in a price war with a competitor can attest that the brand (and/or the price levels) never fully recovers. Many firms fear the negative consequences of poor decisions and conclude that maintaining the status quo with acceptable margins is a safer path than trying to achieve better margins and risking a catastrophic mistake.

Unavailable, Inaccessible, or Unclean Data

If data are missing or otherwise unusable then companies lack the basic information they need to formulate a plan. For example, a company will have trouble performing a profitability analysis by customer segment if it lacks organized transaction-level data and customer-level, cost-to-serve information. This problem will remain if effective modeling or sampling techniques cannot be developed to address the issues.

Human Resource Constraints

Engaging the right people for pricing improvement (i.e., those with the appropriate authority, political connections, and skills) can be challenging as many managers are already too busy executing their day-to-day activities to take on additional responsibilities. Many organizations struggle to dedicate the necessary personnel required to mount an initiative as ambitious as pricing improvement.

Hidden Problems

Many weaknesses in a company's existing pricing strategy can be masked or obscured by the complexities of overlapping functions. Uncovering the trouble spots can be a challenging exercise. Table 1.1 identifies some of the major pricing issues and their common indicators.

Table 1.1 Common Indicators of Major Pricing Issues

Symptom	Description of the Problem	Impact
Maverick Selling	• More than 30% of all deals are closed below the established discount guidelines or policies	• Unwarranted discounts are issued
Price Erosion	• Lack of visibility into historical pricing of comparable deals (or into historical trends) causes deeper than necessary discounting	• Unwarranted discounts are issued
Margin Erosion	• Below-the-line transactional expenses and incentives are not considered during deal negotiations or not recovered after deals close	• Revenue leakage and lost profits
Slow Response Time	• The time to respond to a customer's pricing request is relatively long	• Lost deals
Unsegmented Pricing or Discounts	• Prices are not set at a level granular enough to capture the maximum profit from a transaction	• Unwarranted discounts are issued to unprofitable customers • Revenue leakage and lost profits for price-insensitive customers
Price Agreement Compliance	• A single customer has multiple agreements for the same product, but consistently makes purchases at the lowest price	• Unwarranted discounts are issued
Customer Volume Compliance	• Customers have an established agreement with volume commitments, but do not buy to their full potential	• Unwarranted discounts are issued • Unrealized revenue
Less Productive Pricing Team	• The team does not have the ability to prioritize and analyze special pricing requests properly to have the maximum impact	• Unwarranted discounts are issued

Cross-Functional Chaos

''Pricing touches everything, and everything touches pricing.'' This simple truism is recognized by pricing professionals, but it is not often recognized across an organization. In a typical organization, Marketing sets list (or market) prices and gathers customer and competitive pricing information; Sales negotiates prices with customers; IT provides data and maintains the systems that support pricing decisions; Finance shares costs and ''profitability'' data; Operations offers input regarding capacity; Order Fulfillment determines how best to process purchase requests (and generates the costs that flow from these decisions); and Executive Leadership monitors pricing and profitability, while reporting key metrics to external stakeholders. Lack of coordination and conflict between these functions (which have different agendas) can make it nearly impossible to set up a dynamic, informed, and integrated pricing competency.

Organizations that lived through the wave of reengineering in the 1990s still bore the scars, more than a decade later, of attempting to manage processes across functional boundaries. The results were impossible to quantify and simply set various functional groups against each other. The good news is that pricing, unlike other options, drives immediate and recurring results and produces measurable improvements to the bottom line. Effective pricing gives a place at the table to all the internal groups affecting, or affected by, its policies. Unlike many cross-functional initiatives, pricing does not require one function to win and others to lose. In fact, the balancing of each group's' objectives creates a natural tension that, when used effectively, actually improves pricing performance by ensuring that the various functions' needs and goals are addressed.

Differing Organizational Pricing Perspectives

The internal debates on pricing are endless. The level of real insight into customer buying behavior is limited; value propositions are non-existent (or worse, come from an internal perspective); and the real margins by customer, product, or salesperson are poorly understood and difficult, if not impossible, to calculate. Thus, there are several distinct perspectives, which generally follow functional lines:

- *It's all about the numbers.* According to this school of thought, deep analysis of the numbers (derived either algorithmically or by regression) will produce profound insights into customer behavior; the product or service value proposition; and, ultimately, what the optimal price offering should be.
- *The sales force should be given complete freedom.* Advocates of the sales team believe that the sales team, because of its daily interaction with buyers and direct insight into customer behavior, should be the sole determiner of price. One senior vice president once summed up this perspective nicely: ''My sales force needs total flexibility at the point of contact with the

customer.'' Is this ever really true? And, if it is, at what cost? Getting pricing right inherently requires the ability to make fully informed trade-offs.

• *Get your costs right, and price will take care of itself.* Seasoned managers who have built successful careers on cost management believe too much effort is spent on the ''soft side'' (i.e., attempting to understand customer behavior). The real answer to any pricing issue, they believe, is to move further down the cost-experience curve, using production efficiencies and statistical process controls to produce goods more cheaply than the competition. This group tends to favor a cost-plus pricing approach, which determines margin (and ultimately selling price) by taking the cost to produce and adding a ''fair'' or ''reasonable'' markup.

• *Customers will pay us a premium if we create a better product.* Little emphasis is placed on pricing during the new product development process; innovation for the sake of innovation is valued. Yet while many products are high function and top quality, manufacturers are generally unable to recoup a margin that warrants their investments in development.

• *Better information systems are the silver bullet.* The failure to meet pricing challenges is often framed as the result of a lack of relevant information. If the IT systems delivered the right information, advocates believe, then setting and negotiating price would be easy, and deals would almost close themselves. (Of course, good data can serve as only the basis for developing a strategy—this should not be confused with actually having a plan.)

• *The customer rules.* For some in the organization, the voice of the customer represents the final word on what prices should be. Little or no effort is made to evaluate the value a product creates for buyers, let alone to determine if the offered price takes into account the value the customers create for the organization. Focus groups, surveys, and, above all, anecdotal insights from the sales force are used as the basis for determining what to charge and what a customer is willing to pay.

Each of the perspectives listed above is a key indicator of a corporate culture dominated by a certain function: the first by finance; the second, sales; the third, manufacturing; the fourth, innovation or engineering; the fifth, IT; and the final, marketing. Each perspective can produce important insights but offers only a fragmentary view of pricing. In this case partial answers will yield only partial results. The more one view predominates, the less effective pricing will be.

Why is it that a book on pricing begins with a discussion of corporate culture? Because the human factors are so significant that they can make or break the entire process.

Understanding—and Leveraging—the Human Side of Pricing

Price lies at the heart of the buyer-seller interaction, and an inherent conflict exists between a company's desire for long-term customer relationships and its effort to get fair value for its products and services. Most organizations encourage their sales teams to build strong relationships and to know their customers on a personal as well as a professional basis. Unfortunately, these bonds often become ends unto themselves, obscuring their original purpose, which was to establish profitable, long-term customers. Companies must continually analyze customer interactions at the transaction level and determine the value to both them and their customers. By understanding the worth of a product to buyers, a manufacturer can better differentiate its offerings from the competition. Similarly, by quantifying the buyer's value to the company, the company can decide which relationships warrant investment and which should be treated as opportunistic transactions. Both analyses contribute to a balanced, healthy customer portfolio.

A key driver of the buyer-seller relationship is sales force compensation, because poorly aligned incentives result in weak margin performance.

Consider the experience of a medical device manufacturer that compensated its sales team by unit volume. The products were new and evolving rapidly, so the company pushed for high rates of market penetration. Competition was fierce, and, for the sales team, getting buying groups to choose the products carried nearly as much weight as physician preference. Critically, compensation was entirely volume driven with no cap placed on sales earnings. The more you sold, the more you earned. The results were predictable: the sales team constantly pushed for prices to be reduced to challenge the competition.

At one point, as prices continued to fall, senior management actually believed a competitor had discovered a cost or manufacturing advantage. In reality, the company (the marker leader) should have looked at the behavior of its sales team: it, not a competitor, was driving the perceived price war. Eventually, a careful analysis of the situation led to an important policy change. Margin was included, for the first time, as a key compensation metric. This single change quickly altered sales behavior, and the decline in price began to level off almost overnight. Unfortunately, two other consequences of the volume-driven compensation policies were not so easily remedied. First, customers, taking advantage of every new price discount, had purchased supplies to last for years. Future sales had been pulled forward, skewing demand elasticities. Worse, buyers had been conditioned to expect that every sales visit would result in fresh price reductions. The situation took years to reverse. New products were impacted by the effects of the earlier price war, while the existing product set suffered from chronic low profitability. The unintended consequences of a misguided focus on volume were far reaching, long lasting, and severe.

Another human challenge for pricing involves countering the tactics customers use to drive down price. *Strategic sourcing* is a practice that has been in existence for decades. Today, every well-performing company follows this approach to achieve the best possible price when purchasing goods and services. If you are a manufacturer, it is likely your sales force has been subjected to painful interactions with procurement agents who know and have quantified every aspect of their relationship with you as a supplier. Consider how often a member of your team has been hit with a variation of the following comment: ''I know we don't buy large volumes of this particular product, but our aggregated spend across your portfolio is well over $100 million. We therefore expect a 5 percent price reduction across the portfolio for this, and every subsequent, year. After all, our volume is helping you move down the cost-experience curve, and we should reap some of those benefits.''

The flip side of strategic sourcing is understanding what drives profitability at the transaction level with a particular customer. Firms need to arm their sales force with the information that lets them counter the traditional procurement approach. In many cases, they may still be able to provide that 5 percent discount while actually improving margin performance.

In general, successful pricing management requires a company to build the right sales team and to provide it with the correct training and tools, while aligning compensation with the desired outcomes. Once again, the need to take an integrated approach to pricing is obvious. A company can create the best, most optimally priced offering in the world, but if its sales force cannot execute it (or worse, the company's compensation structure incentivizes its salespeople to negotiate outside established guidelines), then the company's investment in price-setting capabilities has been wasted.

An Integrated Approach to Pricing: The Six Core Competencies

To meet the pricing challenge, companies cannot rely on any single internal or external perspective. Rather, all views must be combined in a way to maximize each of their strengths and to minimize each of their weaknesses. The following six organizational competencies are needed to achieve this (Fig. 1.3).

1. Price Execution

Price Execution refers to all of the processes and policies by which a company delivers its prices to the marketplace. These 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. Execution is the ability to

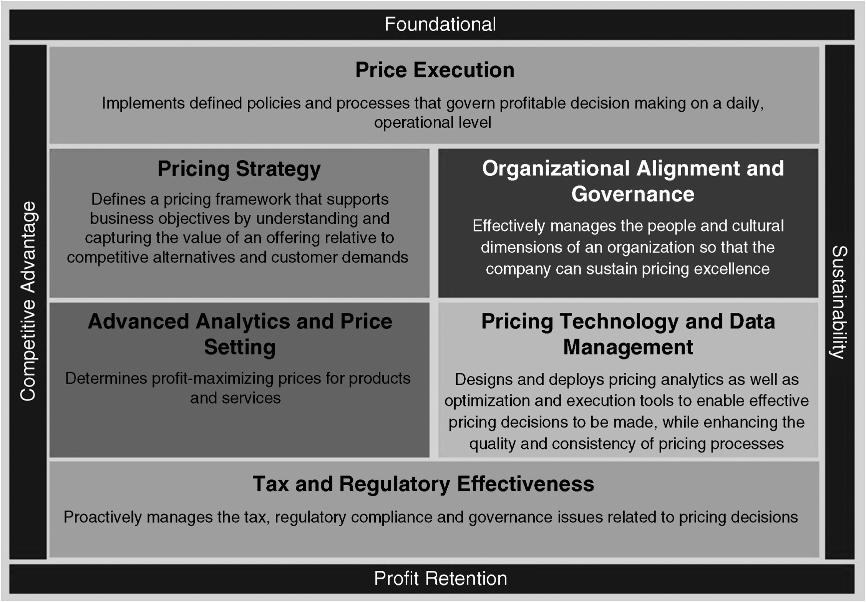

Figure 1.3 The Integrated Pricing and Profitability Management Model (The Six Core Competencies)

meet strategic goals efficiently, effectively, and consistently. If even one process operates poorly, then overall performance will suffer. An organization can have world-class capabilities in the remaining five competencies, but price and margin will be lost if execution fails (which is why Price Execution falls on the foundational axis of Fig. 1.3). Put another way, the best salesperson can be armed with the optimal price derived from the best technology, but he or she still needs to get the price to the right customer at the right time with the right message about value to be successful. This is why firms should start by understanding, at the transaction level, what truly drives sales and profits. This understanding will enable them to develop the strategies they will need for their specific markets, products, and competitors (while improving other pricing capabilities).

2. Pricing Strategy

Pricing Strategy articulates the guiding principles behind a company's efforts to price its goods and services. At the highest level the strategy must be aligned with the overall business plan. Pricing leaders may assume, for instance, that prices should be set to maximize profitability when the company has, in fact, made increasing market share its priority. An effective strategy should be focused, nuanced, and dynamic. It should be regularly reviewed and revised, as needed, so it can meet evolving corporate goals.

More targeted pricing plans may focus on combinations of products, channels, customer segments, and geographies. These lower-level strategies typically focus on a well-defined goal, such as increasing market share for a certain type of product in a particular customer segment. These plans also address price positioning (setting prices for goods and services to reinforce a particular *price impression*; in other words, what a company wants to communicate about its brand, quality, and style) and pricing structure (how the company configures prices for its offerings). An effective structure allows elements of the product to be removed or added to meet the variations in value that different customers place on specific components relative to similar competitive offerings.

In general, the pricing strategy shows a company where it is headed, why it is going there, and what it can expect when it gets there. It should also provide actionable insights and expectations about markets, channels, products, competitors, and customers. Without an effective plan, an organization is governed by the pricing issue of the minute, losing sight of long-term goals.

3. Advanced Analytics and Price Setting

Advanced Analytics and Price Setting cover the use of data and specific analyses to view the business both retrospectively and proactively. Pricing analytics enables firms to review past transactions to understand profitability better. This historical analysis creates a unique pricing lens through which to view the business, and often redefines true profitability for a company. Data on product costs and prices paid (e.g., cost-to-serve elements, including sales expenses, product packaging costs, discounts, and off-invoice price adjustments) are collected and studied. Using this information, companies can develop profit-boosting strategies such as discontinuing unprofitable offerings or customer relationships and raising or lowering prices. *Optimization* refers to the use of mathematical models to determine the optimal price for a good or service calculated from historical information on customers, the marketplace, competitors, and a given set of constraints. A price optimization model can not only help management select an appropriate price, but also estimate the probable outcome of any changes.

Organizations must recognize and use the science of pricing. Transaction-level analyses, effective behavioral segmentation, and advanced logarithmic or regression-based price optimization all demand advanced skills. But data are blind; they should be combined with qualitative analyses to produce actionable insights. The effective use of pricing science does not mean the wisdom and experience of the sales force is devalued. Only the combination of analytic and qualitative perspectives will yield sound pricing actions that can work effectively in varying market and competitive environments.

* * *

Pricing Strategy and Advanced Analytics and Price Setting fall on the competitive advantage axis of our model because, when done well, they both enable companies to outperform market competitors.

4. Organizational Alignment and Governance

Organizational Alignment and Governance deals with the people and cultural factors that shape pricing behavior, including organizational structure, sales effectiveness, training, and talent management. It answers questions such as:

- How centralized or decentralized should the pricing process be?
- What are the roles and responsibilities, goals, and incentives for everyone who is involved in pricing, and are they aligned?
- How do we expect salespeople to spend their time, and do they have the right skills and tools to manage price effectively?
- Most important, are compensation metrics aligned with both our strategies and our execution capabilities?

Effective pricing management includes such tasks 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. As discussed earlier in the chapter, pricing is inherently dominated by human interactions as it forms the basis for the buyer-seller relationship. Within a company, poor communication, an ill-conceived organizational structure, and inadequate skills or tools will undermine the value of improved price setting. Getting the people side right will help ensure effective execution.

5. Pricing Technology and Data Management

Pricing Technology and Data Management covers applications that can reveal customer, channel, and product profitability patterns across millions of transaction records as well as provide the technical environment required for advanced price setting and optimization capabilities. This technology can help analysts to monitor and report on pricing performance continuously. It also provides salespeople with access to real-time customer and profitability information during negotiations, which enables them to calculate a deal's profitability using a variety of price and product combinations before closing a sale. To determine whether an organization needs advanced pricing technology, managers should ask (1) What software functionality will be important with respect to the organization's customers, products, and particular competitive landscape? and (2) How is technology used to improve price execution?

As with any emerging software, pricing technology is now being portrayed as the silver bullet that will slay a firm's pricing challenges. It is not. However, it can be an invaluable tool to help a company maintain its strategy over the long term.

* * *

The Pricing Technology and Data Management and Organizational Alignment and Governance competencies appear on the sustainability axis of our model because they address incorporation of effective pricing management as a permanent improvement to an organization.

6. Tax and Regulatory Effectiveness

Tax and Regulatory Effectiveness enables a company to plan and execute more profitable pricing and, ultimately, to apply the benefits from these improvements to the bottom line. For example, profits can be directed to the most tax-friendly jurisdiction, thereby ensuring that they remain intact as they are converted from pre-tax to after-tax income. This is not solely a transfer pricing issue. Where, when, how, and through whom a company makes pricing decisions can all impact tax calculations. Proactive planning should include analysis of income taxes that affect cash flow and, for multinational companies, their effective tax rate (ETR), a measurement often used by specialists to benchmark whether companies are best in class. Assessments should also be evaluated, such as value-added taxes that can quietly drain both cash flow and profits if not properly managed. In addition, pricing data should be studied to identify benefits in the form of tax incentives, credits, and deductions.

Regulatory mandates affecting pricing include antitrust legislation such as the Sherman Act of 1890, the Clayton Antitrust Act of 1914, and the Robinson-Patman Act of 1936 (which prohibits companies from selling the same product to competing customers at different prices). In addition, the Sarbanes-Oxley Act of 2002 requires companies to assess the adequacy of internal controls over financial reporting. This requirement can have significant implications for a company's pricing-related controls and documentation.

The Tax and Regulatory Effectiveness competency is on the profit retention axis of the model because proper planning can help companies keep a greater portion of the profit they generate.

Gestalt Pricing: The Value of an Integrated Approach

Each of the six pricing competencies (presented in Fig. 1.4) delivers value in its own right. Unfortunately, there is a tendency to focus overly on one and to pay little or no attention to other competencies that can add significant value. This tendency is often driven by the culture of the corporation.

Figure 1.4 The Integrated Relationship of the Six Core Competencies of Effective Pricing and Profitability Management

In retail, for example, price setting and price optimization are widely recognized as the real drivers of value. Though they are critical, focusing on them, without a corresponding investment in other capabilities, can actually minimize their value.

One retailer learned this lesson as it attempted to master price optimization internally. Despite that added capability, margin performance actually declined. Why? A store-level analysis found that less than 50 percent of the items in stock had the right price labels attached to them. The tags often failed to arrive on time, and the stores did not have the staff in place to apply them to sales items efficiently. A constant stream of price promotions further confused staff. Clearly, the ability to execute was far below the company's ability to set an optimal price. The result? Unhappy customers who faced delays at the checkout as confused staff tried to confirm prices. Even worse, the customers, who suffered from the inconvenience

(*continued*)

anderrors, began to doubt the value of their purchases when faced with shifting prices. The sales force was eventually given the latitude to set prices whenever confusion arose over what they should be. The negative impact on profitability was as predictable as it was profound.

Ironically, the retailer's price setting should have given it a competitive advantage, but poor execution negated that advantage and caused further price erosion and unnecessary added costs. Worse, the differences between advertised prices and the store tags led to charges being made against the retailer that it had engaged in misrepresentation and ``bait and switch'' tactics. It may have been unintentional, but the bad publicity was deadly to the company's reputation and brand.

Pricing can inspire a string of decisions leading to unintended consequences. Unless an integrated approach is taken, unilateral actions in one competency can lead to inadvertent problems in another. As a result, overall performance will suffer. One need not invest equally, however, in all pricing capabilities. The key is to understand the relative value of each pricing competency in terms of the target industry, customer, and product and then to invest accordingly. Firms should not pay for capabilities that do not add margin to the bottom line; obviously, over-investing in unneeded capabilities will simply drive down profitability.

Beginning the Journey: Key Questions to Ask

Given that pricing improvement initiatives can be so complex, emotional, interdependent, and impactful, organizations must prepare for an intense and a sometimes lengthy (often multiple year) effort. Here are some key questions management must ask itself:

- Where do we begin?
- How do we build our capabilities; understand our products, markets, and buyers; create effective value propositions; develop and maintain effective segmentation models; and determine the right prices?
- How do we get the sales force (or whoever has the fundamental buyer-seller interaction) to manage its relationships so that it can execute prices in a way that meets or exceeds the required margin performance while at the same time satisfying the client?
- Just as important, how do we obtain and retain the attention of the organization? How do we quickly drive tangible value at a level that will demand continued executive attention and support?

There is no ideal time to address pricing improvement. The additional margin it can secure and the minimal time it can take to achieve it means pricing improvement initiatives should be launched regardless of most external conditions. In a chaotic or recessionary economic environment, many companies mistakenly feel they cannot work on price performance. Money is tight, customers are extremely price sensitive, and the company may seem too stressed to take on a major cross-functional initiative. In reality, a market upheaval presents precisely the right circumstances to address pricing as a discipline. The turmoil helps set expectations among customers, competitors, and employees that change will happen, and is, in fact, essential to weather the storm. While difficult times do increase the stress level and drive resource challenges, they also open the door for change that would likely not be accepted, or be extremely difficult to implement, in less tumultuous conditions. Conversely, in times of economic growth, even greater opportunities can be found because companies tend to be more relaxed about policy enforcement or they prioritize capturing market share over quality of revenue.

Even small improvements in pricing capabilities will yield immediate results. In addition, initiatives can often be self-funding; programs can be started on a modest budget, and the almost immediate returns make the ''there is no money'' argument a non-issue. Many of the software firms and consultancies in the pricing space today are also willing to work on a contingency-fee basis. They get paid when a company makes money on its investment in pricing. The results are that tangible and predictable.

Conventional wisdom encourages companies to start with strategy and then work their way down through to execution. In an existing company, that is a flawed approach. Instead, a company should begin its efforts by developing a detailed understanding of the current pricing behavior existing internally (Fig. 1.5). Management should ask itself basic questions such as: What promotions, terms, discounts, rebates, samples, and incentives are currently being offered? How do payment terms impact transaction-level profitability?

A pricing strategy that is based in fact and on a rigorous analysis of the data is not only more likely to be successful, but also will be more widely embraced in the organization. A common excuse for not starting at this point is poor quality or inaccessible data. Many organizations invest heavily in ERP systems that capture tremendous volumes of information. The bottom line is that the necessary data exist, but generally not in the right form to be used immediately for transaction-level analysis. Accounting data have to be decomposed, verified, and rebuilt around specific transactions. In pricing, data aggregation is the enemy. Knowing exactly what drives or robs a firm of profitability at the transaction level is the antithesis of most accounting-driven reporting. Even activity-based costing (ABC) is suspicious. It is better to avoid allocations and allowances and to deal, instead, with the items in a transaction that can be influenced directly (Fig. 1.6).

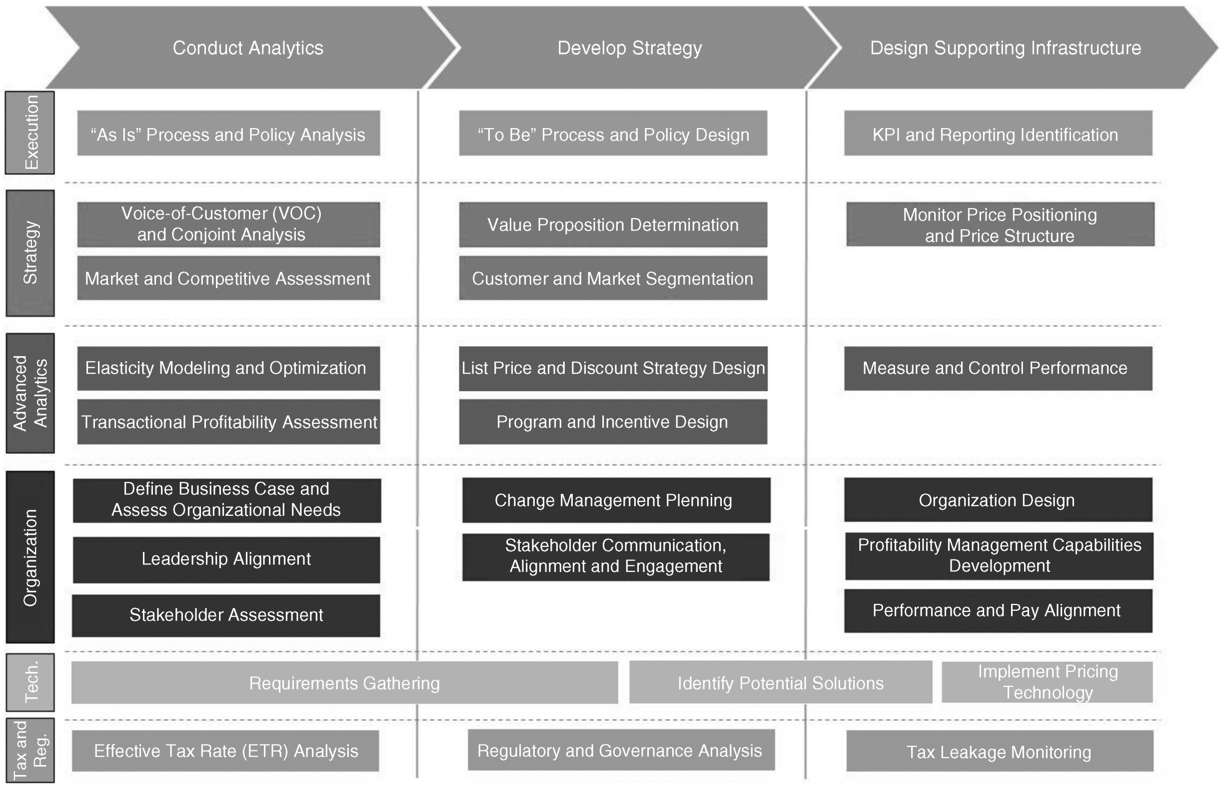

Figure 1.5 The Profitability Management Journey

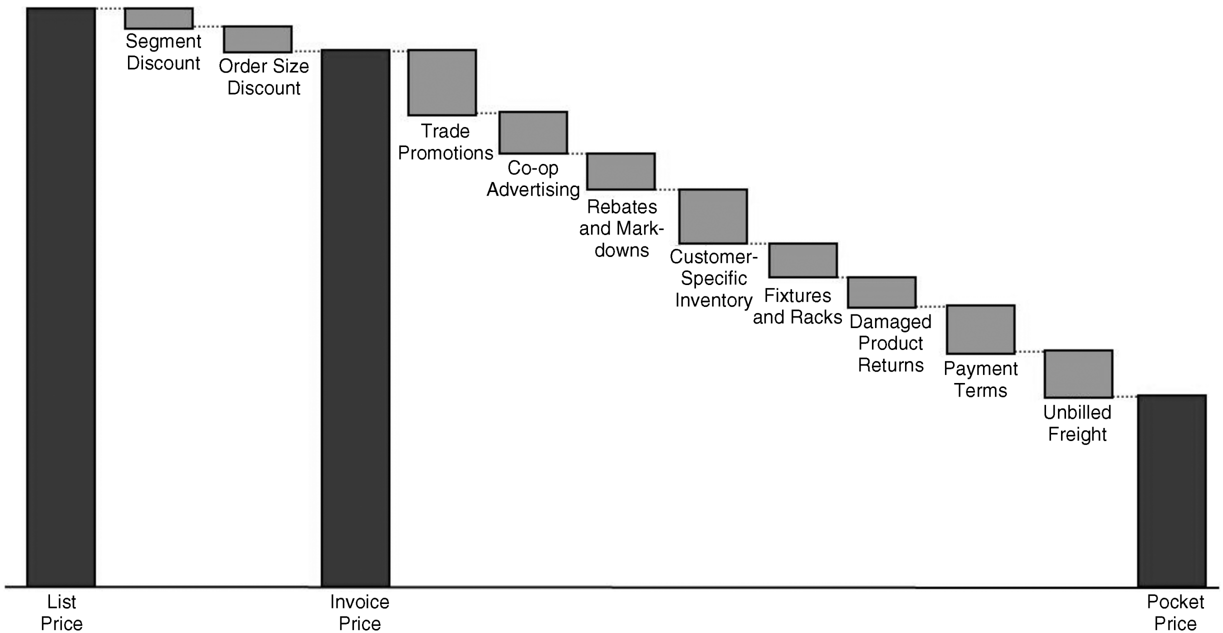

Figure 1.6 The Pricing Waterfall Provides Transaction-Level Insight Into True Profitability

Once a working model of transaction profitability has been built, it suddenly becomes easy to understand it by product, customer, geographic region, channel, and salesperson. Firms can build their revenue streams and operating margins one transaction at a time. Only by understanding what drives profitability at this level can it truly be managed. But once this granular insight has been developed, a firm can take the necessary actions by purchaser, offering, market, channel, or the specific competitive situation to improve profitability. Critical questions should be asked: What are the real implications of channel discounts? Should we even be in that market? What holes do we have in our portfolio? Are new product introductions driving new business or are we cannibalizing high-margin sales, replacing them with low-margin contracts? The insights that can be made are literally endless. And rather than simply developing strategies based on theory and high-level industry analysis, a firm can now develop *and* test strategies with real information on how its prices, products, customers, and competitors actually behave. In addition, the firm will know *why* they behave this way, and those reasons will make the insights actionable.

Consider the Midwestern lawn care products manufacturer that launched an aggressive growth campaign on the West Coast. By the firm's accounting calculations, business in the target market was running at a 26 percent gross margin, below what the firm wanted, but acceptable when it considered the need to achieve penetration in a high-growth geographic segment. After completing a transaction-level analysis, however, the company realized it was not making 26 percent on average, but was actually losing an average of 6 percent gross margin on every transaction. It had set a strategy to target the West Coast, promised performance to its lenders and the capital markets, and made a significant public display of its intention to compete aggressively in the region. The firm had doubled its sales force over the past six months and was building a regional manufacturing and distribution structure to support the expected growth. By failing to understand its true margins, the firm literally risked growing itself into bankruptcy. Unfortunately, this manufacturer had made the cardinal error of developing and executing an expansion strategy that was based on faulty assumptions about its own business fundamentals.

The understanding of transaction-level margin, while powerful, is only the beginning of pricing improvement. Each of the six core competencies must be evaluated. Efforts should be made to strengthen capabilities that are underdeveloped and are of the greatest value to the company considering its particular situation. As the examples in this chapter have shown, only a truly integrated perspective will achieve the desired results and sustain them.

Effective price setting and execution will enable a firm to tailor its offerings to its most valuable customers and to stop margin leakage driven by over-serving (or providing excessive discounts to) its most marginal buyers. If price setting and execution are used correctly, a firm may actually be able to improve margin *while* lowering price. The following chapters offer an in-depth look at the six competencies every company needs to use when embarking on the path to sustainable pricing and profitability management.

Endnotes

1. Yankee Group, ''U.S. Price Management and Profit Optimization Survey'' (Boston: Yankee Group, 2005).
2. Compustat, a Deloitte analytic tool. Note that the impact estimate is based on the average *Fortune* 1000 company.
3. Laura Preslan, ''Price Management: Conventional Wisdom is Wrong,'' AMR Research Outlook, February 2, 2004, 1.