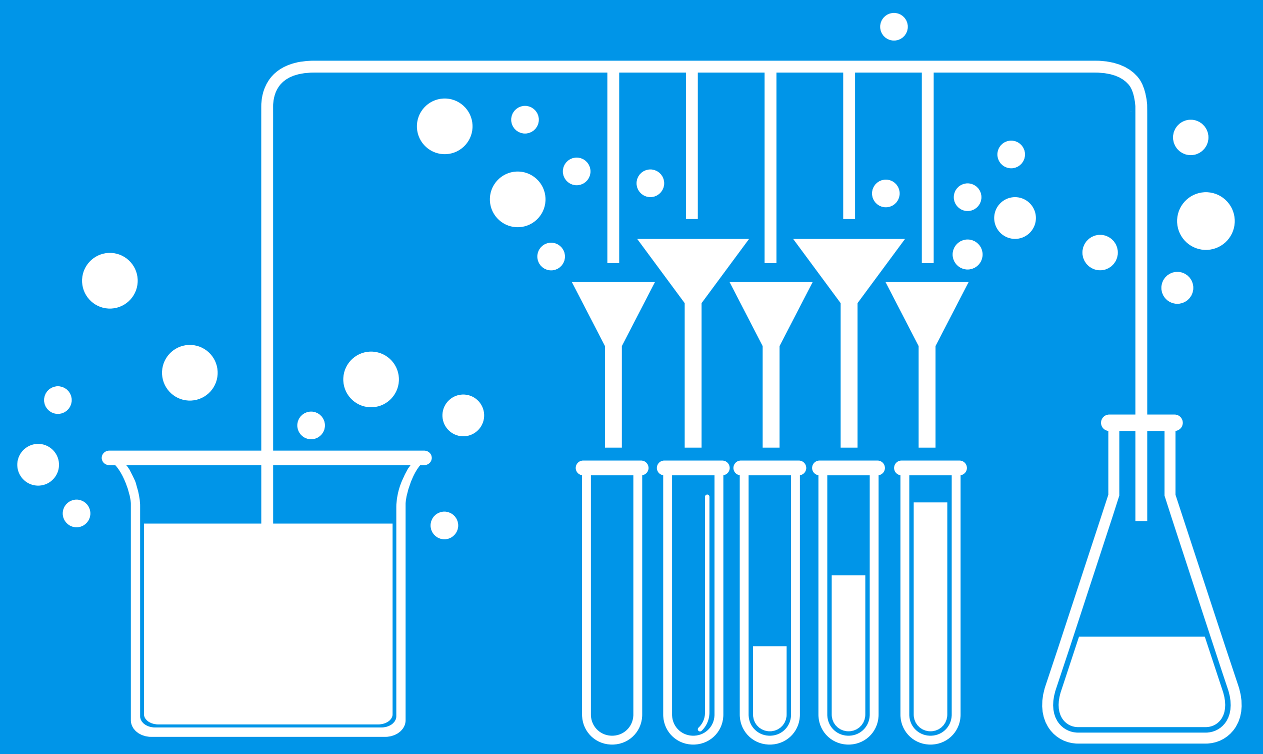

THE ART AND SCIENCE OF PRICING

Practical, structured ways to increase profitability by pressing the right pricing levers

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Pricing is often overlooked as a strategic lever for essential revenue and profits. The global economic slowdown has heightened consumer sensitivities to pricing and value, however, prompting a resurgence of interest in integrated pricing policies and strategies.

Managers often neglect the pricing lever because of the unrelenting demands of running their businesses. When pricing policies do come under review, managers may encounter difficulty in mastering the complex interplay among key variables such as customers' perception of value and their differentiated needs across core segments. Resulting pricing policies may become too rudimentary, and lead to revenue leakage, eroded margins, and lost market share.

In the place of cursory or uninformed pricing moves, there are practical, structured ways companies can exercise the pricing lever to rapidly enhance profits.

PRICING IS MUCH MORE THAN PRICE

Pricing involves much more than just raising or lowering the price. It requires a strategic context in which pricing choices are structured within a system of policies, processes, communications, and incentives. Paramount is having clear pricing decision rights within the organization.

One illustrative example is one client's experience with uncoordinated discounting. When a firm embarks on a discounting strategy, policies and processes are needed to prevent price erosion – loss of revenue through unnecessary discounting - and to avoid unanticipated costs such as personnel overtime and premium freight.

> "WHEN A FIRM EMBARKS ON A DISCOUNTING STRATEGY, POLICIES AND PROCESSES ARE NEEDED TO PREVENT PRICE EROSION"

> "ANALYSES REVEALED THAT, THE COMPANY WAS COMMITTING FREQUENT OVERLAPPING, AND HIGHLY VARIABLE, DISCOUNTING"

This company had a discounting structure with four types of discounts: 1) specific customer discounts (that only certain large key customers were entitled to), 2) volume discounts (based on order value), 3) promotional discounts, and 4) field sales discounts (that sales representatives could negotiate on an order-by-order basis).

At the project start, the client's top management claimed that their discounting was already coordinated in such a way that excessive discounting was not occurring. However, price leakage analysis (also called net sales waterfall analysis) combined with different types of discount variability analyses revealed that, in fact, the company was committing frequently overlapping, and even highly variable, discounting. Customers sometimes received more price reductions than the client intended. As a result, the company was losing money on many of its largest customers and on many of its largest product lines. With data, it was shown that uncoordinated discounting explained more than half the profitability problems the company was facing. In this case, the company needed to reform pricing policies and establish clear discounting processes and decision rights to avoid price erosion. This compellingly shows that pricing is not only about setting the right

> **"PRICING IS NOT ONLY ABOUT SETTING THE RIGHT PRICE LEVEL, BUT CREATING A WELL UNDERSTOOD PRICING ARCHITECTURE THAT MANAGERS CAN IMPLEMENT WITH CLARITY"**

price level, but creating a well understood pricing architecture that managers can implement with clarity.

WHAT IS VALUE-BASED PRICING?

A foundation to an effective pricing architecture, and understanding what price customers are willing to pay, is knowing your customers' perception of value towards your firm's products and/or services and towards the offerings of your competitors. The perception of value may include product attributes such as functionality, longevity, and even social status from owning the product. The car industry is a classical example in which makers intensively set prices to meet and shape their target customers' value perceptions and expectations.

The essence of value-based pricing is to identify the right prices of the product lines or service lines for different tiers and even sub-segments of customers with consistent value perceptions. While seemingly a straightforward task, understanding a product's worth to a customer is a considerable challenge in many organizations, especially given the variability of value perceptions across segments.

First, a company must find a way to segment its customers in a meaningful way. Appropriate segmentation meets a number of criteria. Each segment must represent distinctly different customer behavior or needs. Segments must be easily measurable, such as an absolute number or a percent of the market. Segments should be defined as to make a pricing action clearly actionable, e.g. it should be possible to reach each segment through different marketing and other efforts. And, segments must be substantial, i.e. each one is sufficiently large enough to provide an economic value to the company.

Effective pricing requires a thorough understanding of customers' needs and of a product's "worth factor" across the defined customer segments. A product's true worth, which is a metric contributing to a company's profit – is what the customers think the product is worth and what they are willing to pay. Product components that create worth to customers' eyes and minds can be very different across industries and customer segments but commonly include reliability, delivery speed, brand name, auxiliary services, impact on customers' productivity, energy efficiency, social status, and cost savings, among many others. For one client, a customer segment in one country placed energy efficiency, environmental friendliness and reliability at the top of their worthiness scale. Yet the same customer segment in a different country placed very small values on these factors and instead considered price to be their most important worth factor and consigned environmentally friendliness to the bottom.

Without a firm-wide approach, the notion of 'worth' often creates controversy within organizations. Sales, marketing and production frequently have very different views of what 'worth' really means. To harmonize how this worth factor is determined within a company, structured in-depth customer interviews can

help managers understand how value is established by products, how they are presented to customers, and how customers react to the value proposition offered by the firm's products and by competitors and substitutes.

PRICING DIAGNOSTIC

To establish a pricing architecture, a company can conduct a pricing diagnostic to understand how specific offerings are priced and compared to their full potential for profitability. A pricing diagnostic project entails conducting a series of standard pricing analyses based on internal data and customer interviews, then triangulating them to derive new patterns and insights. Example analyses include price sensitivities, discounting variability across customers and products, and price leakage, among many others. These diagnostic analyses along with the understanding of customers' perceived value of product offerings help to intelligently set appropriate price levels across product lines and within core customer segments. With the diagnostic fact-base, it becomes a logical and straight-forward task to adjust prices and develop an effective pricing system that addresses pricing policies, decision rights, and value communication. BE

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