PRICING POWER: USING PRICE STRATEGY ROADMAPS AND TOOLS TO MAXIMIZE BOTTOM-LINE RESULTS

CMAs are trained to achieve best-in-class practices that strive for continuous improvements in profitability, cost management, and efficiency. And yet, when it comes to pricing, many organizations fail to use the tools and processes that enable a best-in-class approach

By Scott Miller, CMA

More often than not, anecdotes and "gut feel" remain the key drivers for pricing decisions. Consequently, these organizations fall short of their potential for revenue and profit maximization (RPMs). In addition, lack of a pricing focus can translate into millions of dollars in hidden margin leakage, as well as an inability to support an effective growth strategy. As described in a previous article, "Is the Price Right?" (CMA Management, May 2007), neglecting pricing practices can leave an organization's RPMs stuck in first gear. But all is not lost. Pricing, too, can become an effective process when it is based on developing a pricing roadmap using sound data and pricing tools to optimize RPMs. In Sodhi and Sodhi's Harvard Business Review article "Six Sigma Pricing," they note: "Many organizations use disciplines to decrease the cost of manufacturing and service processes. They can use the same tools to increase revenues" (May 2005). CMAs, therefore, can lead the way as change agents, by leveraging the power of pricing and implementing best-in-class practices, an opportunity that translates into both short- and long-term financial gains.

Power of pricing

According to an often-referenced study by Marn and Rosiello (1992), pricing is the most effective lever for increasing profitability – more so than managing cost and volume. In fact, for the average organization, a 1 per cent increase in price can result in an 11 per cent increase in profitability. If pricing has such a major impact on net income, why do so many organizations fail to use an effective pricing strategy? "It's like throwing a dart at a dartboard," as one manager said.

"How can anyone know what price will work? Just provide a target for the sales teams and leave it to them to hit that target. That's our pricing strategy." But as time passed and margins shrank, organizations needed to dig deeper into their world of pricing. In this particular case, the management team chose to conduct a pricing diagnostic. This assessment revealed a strong need to gain control of the pricing process, to reevaluate the organization's value offering, and ultimately to strive towards optimizing profitability by focusing on pricing disciplines.

Pricing Audits

As an increasing number of boards of directors are realizing that a sound pricing process drives improved bottom-line results, there has been a corresponding increase in deployment of price audits to assess areas of improvement and opportunity. As outlined in "Is the Price Right?" an internal pricing process assessment helps determine which level within the five levels of world-class pricing (also called the world-class pricing framework) best describes an organization's current situation. This audit can help answer questions such as: how effective are the current pricing processes? and what pricing areas need improvement? The framework (Figure 1) establishes a snapshot of where an organization is today, and helps chart a vision of where it needs to navigate.

Figure 1: The Five Levels of the World-Class Pricing Framework

Each level within the Framework provides an opportunity to add new tools and processes to the CMA toolbox that sets the stage for improving an organization's bottom line. This article highlights many of these pricing tools (with a strong focus on the Level 2 toolbox) that have proven to be highly effective as organizations progress along the path to pricing improvement.

Improving pricing competency

Level 1: Baseline process is ineffective

Management meetings at Level 1 companies are usually fraught with stress and tension. One manager described this level as "table-banging arguments whenever the topic of pricing comes up." At this stage, there is no defined pricing strategy; pricing processes and reports are non-existent; high margin leakage occurs at every turn; and there is a lack of understanding about the price–value relationship. Revenue changes are often explained using anecdotes rather than sound data and analytical details. As well, pricing managers find they spend a large portion of their time extinguishing internal political fires with little or no time spent investigating margin opportunities. If an organization resides within Level 1, it is important to perform a full pricing diagnostic across all departments to identify areas of pricing weaknesses that require process and tool enhancements. It is also important to meet with different levels of employees and map all potential areas for margin leakage. Once these weaknesses have been defined, it is necessary to audit and track improvements using various pricing management tools as described in Level 2.

Note that moving towards Level 2 will require a change agent, as there are internal cultural implications with pricing policy changes, as well as a need to constantly sell the advantages of using world-class pricing management practices—a perfect leadership opportunity for a CMA.

Level 2: Internal processes in place

This level is primarily defined as the "gaining control" stage for pricing. It involves tracking key pricing pitfalls, areas of margin leakage, and poor pricing practices that the company has identified as weaknesses in Level 1. It is important throughout this stage to employ pricing tools that co ntinuously audit pricing activities, track progress, and ultimately strive for improvements. It is also necessary to train and gain buy-ins from important stakeholders to ensure they use the pricing tools. A prime reason why many organizations remain locked within Level 2 is the lack of engagement and communication with such stakeholders. A majority of the price audit tools are focused within Level 2, since their key objectives are to take a snapshot of the current state and provide a target that overcomes a pricing weakness and gains control. Gaining control of pricing practices is a critical stage within

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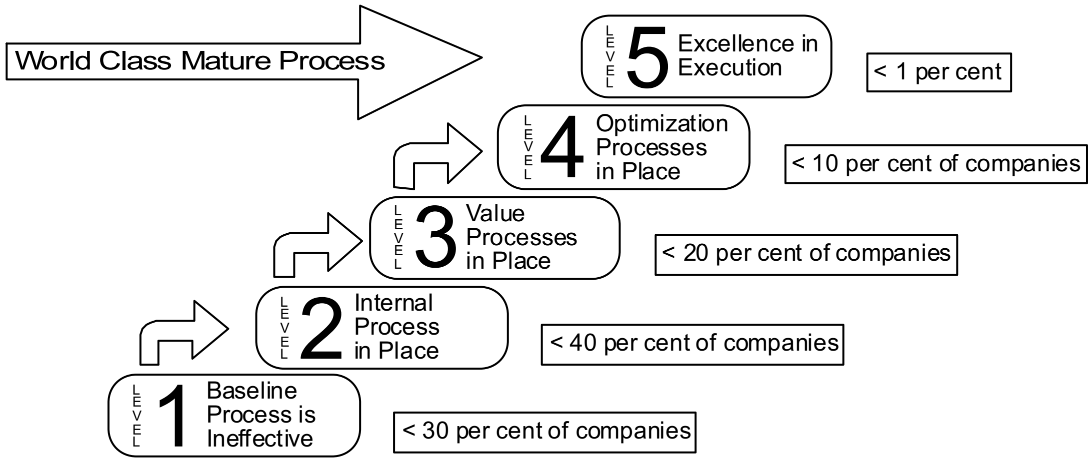


any organization, and requires the support and engagement of stakeholders in order to progress towards a higher level within the five-level framework.

Case Study: Using a competitive pricing report (Level 2) to grow margin

A large technology value-added reseller wanted to increase margins within its hardware category (e.g., printers, cables, notebooks, etc.). However, it was having trouble convincing its sales force. Negotiations were excessive, and pricing, to say the least, was out of control (Level 1). A newly formed pricing committee created a competitive price audit report (Level 2 price tool) that was routinely reviewed to assess competitors' online and print catalog pricing against the company's own. To its amazement, the company discovered it had been "giving away" seemingly irrelevant add-on accessories, items that ultimately translated into a bottom-line gain of over $1.5 million after the organization had trained sales reps to take advantage of this margin opportunity. The report ultimately helped the company gain control of pricing, and set the stage for moving to the Level 2 roadmap.

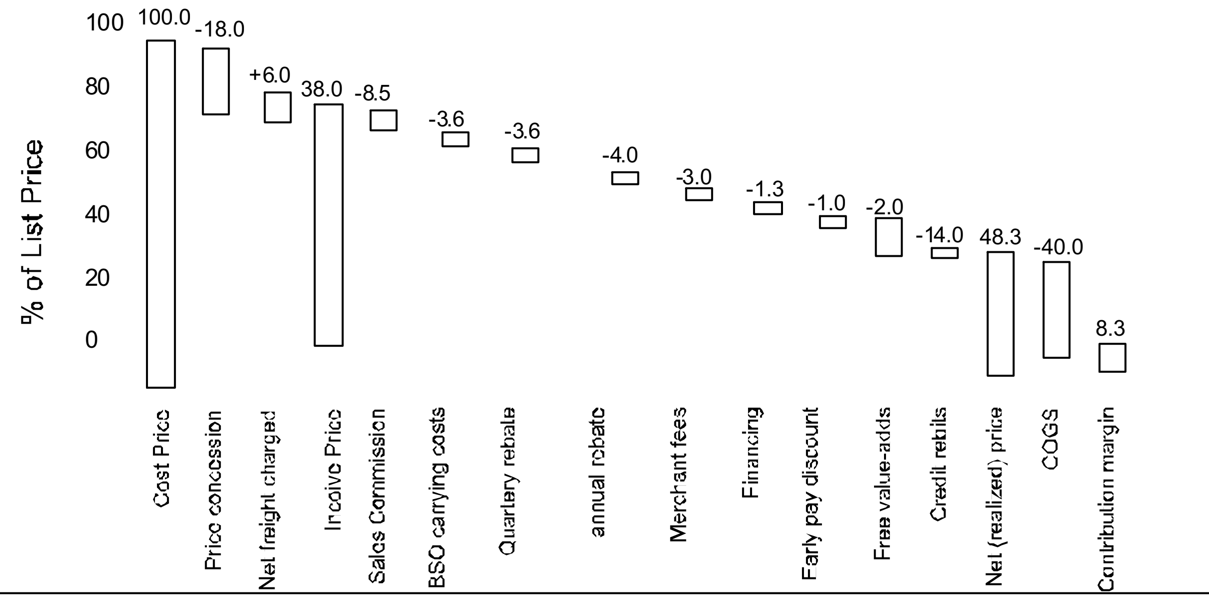
Two of the most commonly used Level 2 tools include the price waterfall and price dispersion charts. A successful Price Waterfall chart (Figure 2a) must integrate the CMA's talent for costing analysis, as well as the ability to work closely with all departments to identify areas contributing to margin leakage. Not all revenue is good revenue, and the Price Waterfall helps companies truly understand the net realized price being charged to customers after factoring in these hidden costs. A price dispersion chart is another useful pricing management tool that focuses on gaining control of pricing practices. It provides a snapshot of customer discounts based on their account size (oftenmeasured as revenue per year). One CEO experienced a highly uncomfortable situation when the company's largest multi-million-dollar account discovered that a smaller account was receiving better pricing (buyers often move around companies that are within the same industry). This created a crisis internally, but it also caused the company to try to understand the current state of discounts and use the Price Dispersion tool (Figure2b) to establish future discount boundaries. The choice of which pricing tools to use will depend on an organization's pricing-strategy roadmaps, defined within its original pricing diagnostic. Some tools will be more relevant than others, depending on your pricing needs, and it is important to use those that drive the greatest improvements in RPMs. Other Level 2 tools include: competitive analysis reports, outlier analysis/reports, deal/bid sheets, pricing process documentation – accountability & guidelines, customer profitability reports, and cost-to-serve analysis.

Level 3: Value Processes in Place

Value is a frequently used term within the B2B and B2C environments, but it's also one that is least understood. What does value have to do with price, one might ask? Everything. In fact, pricing and value go hand in hand, and drive the top-ofmind mentality at the higher levels of the world-class pricing framework. Level 3 is often considered a paradigm shift for many CMAs, especially for those who rely heavily on cost-plus pricing practices. Cost, of course, is always an important consideration for ensuring a price point drives profit. But a cost-plus pricing approach is far from an optimization practice. Value-based pricing, on the other hand, seeks to truly optimize revenue and profitability by understanding what customers are willing to pay based on the value of your offering. Historically, value has been more subjective than quantitative. But there are ways to measure how customers perceive value, their willingness to pay, and methods to relate value with pricing.

Value also plays a critical role in market segmentation and growth strategies. Many growth strategies fail, unfortunately, because they focus too much on acquiring market share with price, a tactic that often leads to lower profitability and back-and-forth market-share gains and losses. A best-practice growth strategy, by contrast, takes a more hands-on approach to help companies understand the value perceptions of different market segments. An understanding of how these market segments perceive product attributes, and their willingness to pay, is critical for value-engineering effective products and offerings. The price-value map (PVM) is an excellent Level 3 pricing tool that can help assess how customer segments perceive a company's offering and prices relative to the competition. Other Level 3 tools include: In-market research tests, pricing tests (conjoint analysis), transactional analysis, cost by SKU, cost by customer segment, and price-volumeprofit modeling.

Figure 2a: (Price Waterfall)



This price-audit tool defines direct customer costs that translate into a net realized price. The identification, tracking, and management of potential regions of margin leakage can help manage the net realized price, and is critical to improving overall profitability.

Level 4: Optimization processes in place

Level 4 is the stage in which an organization fully integrates what it has learned in Level 3 about its customer segments, as well as the purchasing behaviour driven by these segments, based on pricing and the value of an organization's offering. Level 4 pricing
experts will integrate all of this knowledge within an optimization model to drive a product offering that results in the optimal RPM. Such models estimate the impact of short-term promotional prices as well as longer-term price scenarios.

Historical transactional analysis can also play a critical role in optimization, by helping companies understand the past purchasing behaviours of their account base. This stage will require CMAs to wear their statistical and analytical hats, since they will need to build optimization and forecast models. The key to building such models is to understand the price actions and reactions as determined from both Level 3 research as well as historical transactional datasets. For a bank, this might include a model that determines which combinations of account savings rate offerings produce the most profitable outcome. Models would need to address key questions, such as how savings rates affect new-customer acquisition, as well as their impact on the current customer base. For a newspaper firm, a model could address how historical classified advertisement purchasing data can be used to determine optimal bundles that encourage these customers to upgrade to larger and more profitable classified ads.

Another key consideration for optimization modeling is the long-term optimization benefits (i.e., customer lifetime value, or CLV). In the case of a bank optimization model, a low savings rate might show a dramatic short-term increase in profitability (e.g., paying out less interest to customers). But as time passes, the bank could lose current customers and find it difficult to acquire new ones, thus lowerin optimization profitability in the long run. An optimization model would factor in a balance that strives for both short- and long-term profitability.

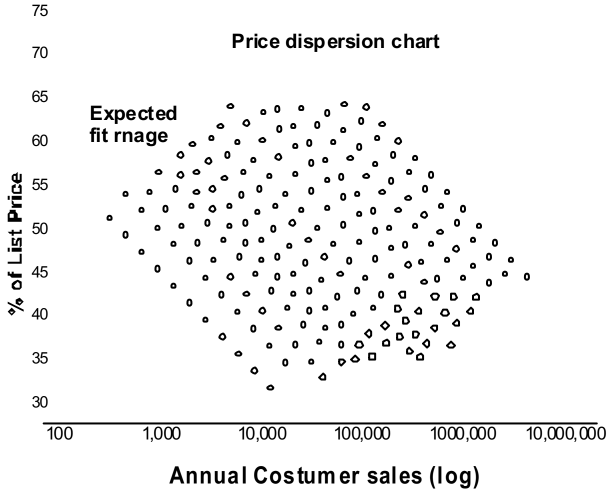
Various optimization tools available in the marketplace include the Microsoft Excel add-in Solver and SAS. It would be worthwhile as a CMA to learn Solver and begin to understand the inputs and constraints that go into optimization modeling (see Solver training link provided in the endnotes).

Level 5: Excellence in execution

As the pinnacle of the pricing framework is reached, there will be an increasingly strong sense of pricing synergy across all departments and channels. At this level, the benefits of pricing are a top-of-mind mentality for all managers and executives. Pricing is no longer considered a "battle," but rather, pricing excellence is integrated into the culture throughout the organization. marketing, sales, operations, and accounting all have a stake in the world of pricing, and regularly ensure they: (a) review and improve upon key price audit tools within Level 2; (b) continuously strive to understand customer segments and value perceptions from Level 3; and (c) optimize the organization's offerings based on understanding customer behaviour in Level 4. As well, Level 5 CEOs recognize pricing is a core capability, and ensure the pricing mindset is a priority across the entire organization.

A great example of Level 5 world-class pricing involves a well-known Fortune 100 hotel chain. This chain has over 150 revenue management analysts who are able to optimize room rates based on region, segments, room types, bookings, and forecasted vacancies. These analysts seek to optimize revenue and profitability, as well as key pricing indicators (i.e., Revenue per Available Room, or RevPAR), by measuring, analyzing, and improving both prices and the pricing process itself. In addition, the company is constantly evaluating its value offerings and making changes in product offerings that strive to fully

Figure 2b: (Price Dispersion)



This additional price-auditing tool can help determine if there is a logical relationship between price discounts and account size. Organizations that lack a pricing policy wil often see an irrational pattern, referred to as a "shotgun blast".

understand its customer segments and their purchasing behaviour. For example, various hotel regions tap into luxury segments, while others focus on conference and "guest experience" opportunities. Ultimately, the chain's pricing mindset and commitment to delivering value (price and value go hand in hand) has generated year-over-year growth in both earnings per share and return on invested capital). In its most recent financial statement, the chain said these results were "largely driven by pricing."

Building a pricing strategy roadmap, as well as expanding the CMA toolbox, is critical for pricing success and improving bottom-line results. The roadmap provides a plan of action and sets a vision for revenue and profitability improvement. However, it is important to understand that this is a step-based process that takes time. Some organizations try to rush from one level to another at the expense of not gaining internal buy-in, or not effectively integrating and implementing a new pricing process. It can take 12 to 18 months to achieve and consolidate a position at a new level before progressing to the next. Even exposure to new pricing tools requires sound training and buy-in from key stakeholders. One colleague uses what is termed "the seven times rule"– it can take seven times for stakeholders to be exposed to a new tool before they stop fighting the data and start using it to their advantage.

The benefits of using the five levels of world-class pricing are too great for any organization to ignore. Many companies are already reaping the rewards, while others remain stuck in first gear for their RPMs. CMAs have an excellent opportunity to improve their organization's pricing power and take it to the next level. As one Fortune 100 CEO mentioned: "Nothing gets me more excited than someone providing me a detailed plan to generate an extra $2 million in profitability." If an organization is stuck in first gear, now is a better time than any to rev up its RPMs by navigating the roadmap to pricing excellence.

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Unless sufficient time is allotted for accounting personnel to re-align the data capture and accounting process before the next big-change event occurs, a black hole can form.

Take for instance a distributor that acquires a manufacturing operation whose employees need to be set up on the distributor's payroll system. This requires analyzing each employee's eligibility for benefits. If the manufacturer has a union shop, accruals need to be determined and set up by the distributor for things such as supplemental employee benefits funding in accordance with the union agreement. The manufacturer's suppliers and customers need to be notified of the distributor's purchase of the manufacturing business. In addition, contact names and other information must be exchanged and ways of conducting business must be shared. If consolidation of operations takes place, then numerous other actions, activities and processes must be put in place, understood and aligned before the organization is functioning optimally again. Any combination of failures in the process can, potentially, create black holes.

Poor accounting system design

Too many or too few general ledger accounts can be black hole-creating. Numerous redundant balance sheet accounts, for example, can choke a thinly staffed accounting department. Staff will not have time to reconcile all the accounts. Underutilization of sub-ledgers cause valuable details to be lost and administrative tools to be absent — such as the aging ability of an accounts payable sub-ledger or the details associated with fixed assets. Anyone who has tried preparing a tax return without a proper fixed asset sub-ledger knows what a black hole looks like.

Areas outside accounting can affect accounting

Accounting's ability to produce an accurate set of records depends, to a degree, on other departments. Work orders and other documents not forwarded along the management information system in a timely manner distort information reported. Poor execution of data captured by personnel outside the accounting department weakens the value of the data that is reported. An executive who fails to approve a valid customer claim alters the integrity and usefulness of the financial statements. Just as accurate and reliable accounting and reporting are, to a degree, dependent on non-accounting employees, so too is the avoidance of black holes. In both cases, the assistance of nonaccounting personnel must be solicited. CMAs are heroes when they save the organization money and villains when they enforce accountability. CMAs have an opportunity to swing the pendulum toward the "hero" side by identifying and eradicating potential items that create black holes within the accounting department and elsewhere.

This heroic effort is important, even crucial, to the survival of the organization because black hole-creating items can threaten an organization's very existence.

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