PROFESSIONAL PPS PRICING SOCIETY™

NOVEMBER 2018

PRICING ADVISOR™

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80/20 Companies Are Missing a Big Opportunity in Pricing

The 80/20 business model is not just about squeezing out the complex customers/product lines that only makeup 20% of your revenue. It is also about extracting more value out of those who make up the critical 80% with value-based pricing strategies, as the author explains. Author Paul Hunt is the president of Pricing Solutions and a frequent PPS presenter, instructor, and contributor. He can be reached at phunt@pricingsolutions.com.

by Paul Hunt

Is there such a thing as selling too many products or having too many customers? The resounding answer is 'yes'! Many successful industrial manufacturing companies have proven it by using the 80/20 process developed and refined at Illinois Tool Works.

80/20 is a proven methodology for reducing complexity, which decreases costs and dramatically improves profits, but there is one area that 80/20 does not do a great job of addressing and that is **pricing.** For this reason, pricing is a major opportunity for companies using the 80/20 process to increase revenue and price effectiveness.

First, let's briefly review what the 80/20 process is and how it works.

80/20 is a process of sorting products and customers into two categories: those in the "80" category comprise 80 percent of the company's revenue. Those in the "20" category include the remaining 20 percent of the company's revenue.

Companies use transaction data to segment customers and products into two groups based on their revenue contribution.

The chart in Figure 1 is a nice way to organize customers and products for the 80/20 model. "A" Customers/SKUs are those that account for 80 percent of the revenue. "B" Customers/SKUs account for 20 percent of the revenue (hence the name 80/20).

Companies can place their individual customers, SKUs, and services on this chart or use hierarchies and families as an alternative.

Basic Pricing Principles of 80/20

There are a few simple pricing moves prescribed by 80/20. The most basic of them is to dramatically increase the price in quadrants three and four, which results in significant price increases for 20's customers.

Many businesses that are using the 80/20 model are deathly afraid of raising prices for their 80's customers. In fact, **the focus is on overserving 80's**

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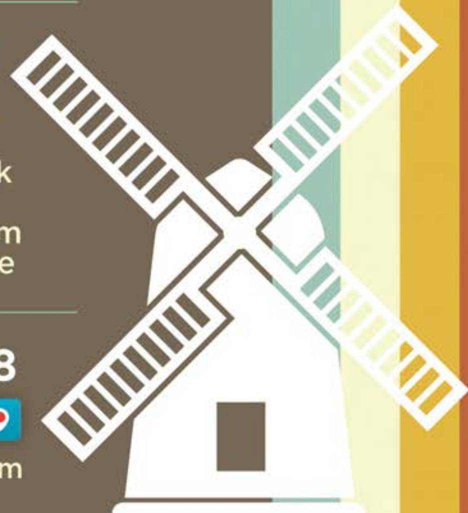

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customers because that is where the least complexity and biggest growth opportunities are.

However, price increases aren't the only pricing strategy for companies using the 80/20 process. You can use a layered approach to the 80/20 model that drives significant profit improvement in addition to the more traditional cost savings that come from the 80/20 process.

The Layering Process and Segmentation for 80/20 Pricing

Businesses using the 80/20 model have already organized clients into an 80 or 20 category based on internal data and analyses. However, further refinement by layering pricing segmentation overtop of the 80/20 model is critical to optimize outcomes and reduce pricing leaks.

By having a margin driven cross-section of customers and products, a clearer picture forms of which products or customers need specific pricing actions.

From a cost and complexity perspective, the four-quadrant chart in Figure 2 is still an effective way to organize customers for the 80/20 model. To create a different view for pricing, we use margin and discount data, placing customers, SKUs, and services into the quads to create a new layer or view of the four-quadrant chart.

After organizing customers and products into each of the four quadrants, the next step is to focus on the first quadrant and further segment to make better, more targeted pricing strategies. To do this, a company can apply a scoring system to reveal how the current customer base or product portfolio scores within each quadrant.

Scoring refers to the product's pricing power. Not every 80's product in a company's portfolio will have the same pricing power, but when you segment the products by pricing power within a quadrant you can uncover increased margin opportunities.

A useful tactic to consider at this stage is to run the 80/20 pricing analysis separating those products sold directly to customers or to OEMs from those sold through distributors. Often it also helps to separate parts from original equipment.

When a company has thousands of products and customers the potential to save money in terms of cost, and explore untapped opportunities to make more money by pricing for value is very powerful.

To identify pricing inconsistencies within each quadrant, a business must:

- Interview customers and internal stakeholders
- Conduct an analysis of pricing data
- Work with the company's 80/20 stakeholders

To better understand pricing opportunities, ask these questions:

1. What prices are quoted to customers for these products?
2. Are these customers offered an incentive program?
3. What is the value and pricing power by product and customer?
4. What is the net margin or discount alignment?

Note: Criteria that you use for scoring should ideally be in your data. For example, some of the criteria we have used for Products include revenue, growth and total price. But there can be several more depending upon your data.

Once a layered and segmented pricing approach has been successfully implemented in the first quadrant, the business can then move onto the second quadrant and refine strategies through segmentation. Then to the third and fourth quadrants.

Identify and Correct Inconsistencies

Many customers in quadrant one often receive essentially the same discount as those in quadrant three. In one example, the difference between customers in the

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Figure 1: The Quad Chart is created by using revenue data: "A" Customers/SKU's account for 80% of the total revenues, "B" Customers/SKU's account for 20% of total revenues

PRODUCTS

CUSTOMER	A SKU's	B SKU's
A Customers	Quad 1 64% of revenue The Fort	Quad 2 16% of revenue Necessary Evil
B Customers	Quad 3 16% of revenue Transactional	Quad 4 4% of revenue Eliminate / Isolate

Figure 2: Pricing Power – Misaligned

80 and 20 categories was one percent. We would expect the difference to be more like 30 to 40 percent. This inconsistency meant that the company was leaving 29 to 39 percent margin on the table across all four quadrants.

Other common inconsistencies are often found around net margins and list price. A layered approach to pricing in the 80/20 model also helps businesses identify areas where their current pricing practices are faulty.

When it comes to shifting a company's core pricing strategies, our **four most common suggestions include**:

1. Stop applying discounts or price increases across the board. Instead, focus on the margin each quadrant can generate. This strategy will yield the best margin on each individual product.
2. Let go of past decisions. Offering legacy products, or discounts based on volume or relationship will not increase margins. Only offer discounts where it makes sense to, based on the quadrant analysis.
3. Examine freight, shipping and distribution practices for leakages and reconsider taking pricing actions around these services.
4. Reconsider the pricing of innovative products. If you price the new product based on legacy pricing, then the new product will often fail to yield a significantly better return on sales (ROS). Instead, use the 80/20 score and segmentation analysis to set pricing and capture target margins.

Correcting these pricing inconsistencies will increase margins significantly. Overall, companies find an average of two to four percent increased profitability by overlaying a segmented pricing strategy to their traditional 80/20 strategy. An annual review of the 80/20 strategy and continuous refinement further reduces internal costs and supports strategic price increases. Importantly, investors see these price actions as sustainable and equal to creating long-term value through price effectiveness.

Refining the 80/20 pricing model year after year with a layered approach provides a better return on investment and moves a firm away from legacy pricing practices or basic cost reductions to improve performance. ❖

The Pricing Advisor™ is the monthly member newsletter of the Professional Pricing Society. If you have feedback regarding this newsletter or want to contribute an article, please email: editor@pricingsociety.com.

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A Segment of One: Fixed vs. Variable Pricing

In this article, the author explores various methods of price segmentation, and the pros and cons of each. As he explains, tailoring price according to willingness to pay is theoretically sound but culturally still questionable. Segmentation according to value and cost-to-serve is more likely to be seen as fair and acceptable, but there is no hard and fast rule. The promise of better earnings and more customers is high, but so is the peril of customer alienation and backlash. Kyle Thompson-Westra is a Consultant at Wiglaf Pricing. He can be reached at kthompsonwestra@wiglafpricing.com.

Kyle Thompson-Westra

One of the first decisions that a company must make in its pricing strategy is whether to offer different prices to different customers. Doing so is called variable pricing.

The alternative is fixed pricing. Fixed pricing entails every customer in every situation receiving the same price for the same product or service. One price.

Fixed pricing is simple, but economically inefficient. Potential customers have a wide range of willingness to pay, and so long as that willingness is higher than the marginal cost of providing the good, accepting the deal will leave your company better off, i.e., with more revenue and higher profitability. Grouping and charging customers by willingness to pay is called price segmentation.

Price Segmentation

If such segmentation is defensible so that the right customers get the right price, tailoring price to customers' willingness to pay will enable your company to serve more customers and earn more money.

It is important that such segmentation be fair, however, if you want your customers to accept variable pricing. Your pricing strategy should help with your customer relationship. The last thing you want to do is alienate potential customers through unfair price discrimination.

It is fair to charge a customer a higher price if that customer is more costly to serve, or to offer a discount to a customer who is less costly to serve. It is not fair (or legal) to give a customer a favorable or less favorable price because of their race or religion.

> **Your pricing strategy should help with your customer relationship. The last thing you want to do is alienate potential customers through unfair price discrimination.**

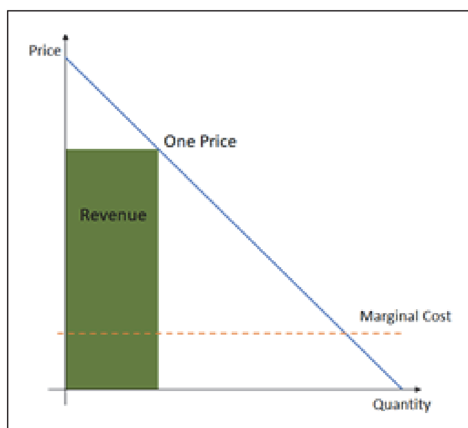
Price segmentation by willingness to pay is especially common in B2B markets. Let's say your company in the life sciences industry has developed an innovative new method of testing the medical efficacy of various compounds.

Both universities and pharmaceutical companies will be potential customers. The university will be able to conduct better research and publish more papers. The pharmaceutical company, through better research, may be able to deliver a billion-dollar product to the market faster than before.

While the university may gain prestige, the pharmaceutical company may gain enormous profits. The value to the company, expressed in dollars, is much higher than the value to the university. From a value-based perspective, it makes complete sense to segment customers according to the different value that they receive from a product or service.

Grouping customers by common characteristics is a good step in variable pricing, but inevitably ignores significant or subtle differences between customers within the same group. Wouldn't it be better to have ever smaller, more targeted segments? Even down to a segment of one?

Figure 1: Fixed Pricing



Individualized Pricing

The goal in individualized pricing is to flatten out that sawtooth edge in the graph of many prices so that every customer receives its own individual price:

At this point, theoretically the company is optimizing its revenue and profit potential by serving every customer who is willing to pay at a profitable price, at exactly their willingness to pay.

The idea that every customer may receive his or her own price is gaining in popularity as information technology makes it both easier to present any number of prices and know enough about a customer's willingness to pay to present the correct price to that customer.

Promise and Peril

This can be incredibly profitable to companies, as illustrated in the growth in size of the green area in each graph above. Studies on web companies suggest that they could see double-digit profit gains from enacting even relatively basic price segmentation, let alone individualized pricing.

So, what's the downside? Well, it turns

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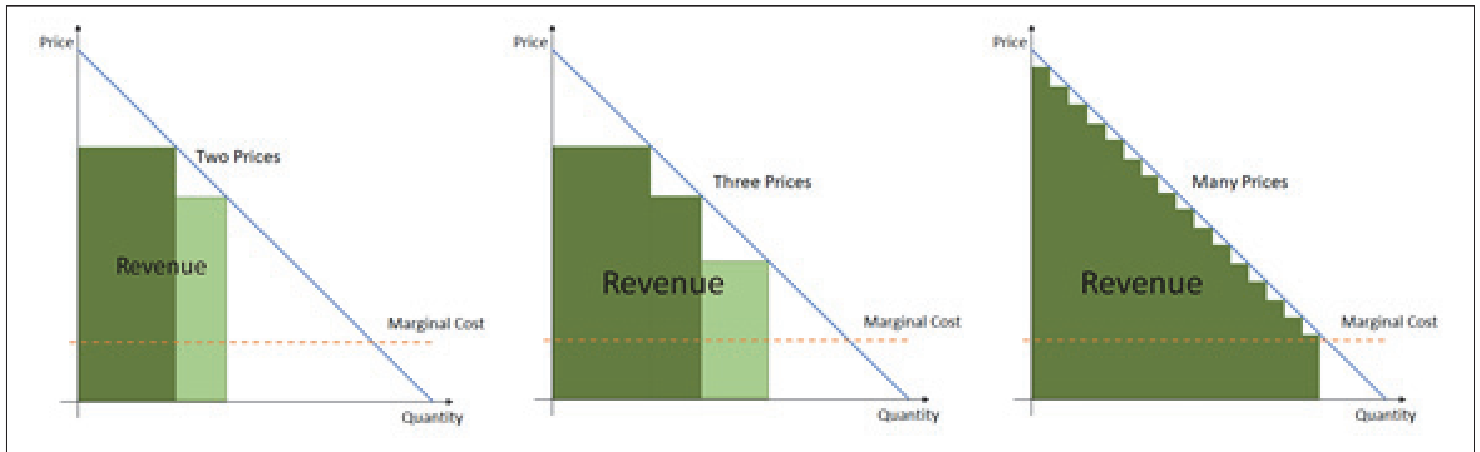
Figure 2: Variable Pricing



out customers don't particularly like feeling taken advantage of, and receiving a different price for the same product often feels that way.

You may have sat next to a friend and searched online for the exact same flight, only to discover that you don't see the same price. Whoever received the higher price probably wasn't elated to know that the other was getting a better deal.

In an infamous example from 2012, it was found that Staples and other companies varied online prices based on zip code. Customers felt tricked.

Especially if you are in a customer intimacy-heavy company, you risk alienating your customers by offering different prices in ways that feel unfair. Some companies, therefore, decide to forgo the potential increased revenue and profits from segmentation or individualization in order to have a better customer relationship.

Example: Groupon

Groupon is one company that has decided to have fixed pricing, perhaps surprisingly given its complete e-commerce focus and wealth of pricing data. It certainly has the ability to segment and individualize like Amazon, but determined that doing so was against its larger strategy and priorities.

I spoke with a leading data scientist at Groupon for my upcoming book, **The New Invisible Hand,** about just this. Here's a sneak peak of what I learned.

"You can charge different consumers different prices," he told me. "But the route we've gone is we think that results in a poor consumer experience. I don't want to charge you one price and charge someone else a random price just based on different browser histories."

For Groupon, the customer experience is critical to its strategy. It doesn't want to engender any feelings of exploitation, whether or not those feelings are justified by theory.

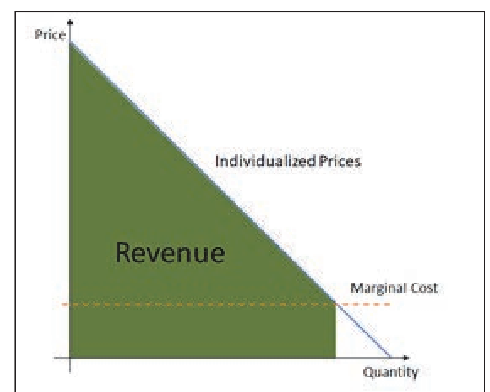
He continued: "We're going to focus on targeting what the right price is, rather than experimenting on individual users. We want to figure out which deals are overpriced and adjust them downward, and figure out which are underpriced and adjust them upward." In sum? "Taking a data-driven approach to the prices we offer every day."

Conclusion

Tailoring price according to willingness to pay is theoretically sound but culturally still questionable. It's important to determine how your customers will react to such variable pricing when deciding whether to have price variance and by what characteristics.

Segmentation according to value and cost-to-serve is more likely to be seen as fair and acceptable, but there is no hard and fast rule. More so, culture around pricing is constantly in flux. The promise of better earnings and more customers is high, but so is the peril of customer alienation and backlash. ❖

Figure 3: Individualized Pricing



Supermarkets: How to Compete Against Walmart and Amazon Using Price

by Hubert Paul, Shikha Jain and Ricardo Rubi

How can supermarkets compete against online retail giants Walmart and Amazon who are aggressively entering their markets via online grocery ordering, curbside pickup and home delivery? In this article, the authors explore how supermarkets can use pricing strategy to actively compete and improve their price image with consumers without giving away their bottom line. Hubert Paul is a Director, Shikha Jain is a Senior Director, and Ricardo Rubi is a Partner in the Simon-Kucher & Partners Consumer and Retail Practice. They can all be reached via www.simon-kucher.com.

Hubert Paul

Shikha Jain

Ricardo Rubi

While the shift to ecommerce and innovations in the digital experience will continue to dominate the press, reality shows that shopping at physical supermarkets is still a great American pastime. This doesn't diminish the fact that threats vying for the same basket continue to put pressure on brick and mortar stores.

Already the world's largest retailer, Walmart posted its best sales in more than a decade by fueling their grocery business, particularly by improving their fresh offerings at those established everyday low price points. The other elephant in the room, Amazon, has been using its Whole Foods physical presence to roll out Prime loyalty promotions and discounts in an effort to make quality food affordable. European discounters like Aldi and Lidl are learning from their early missteps to better understand how Americans shop. The threat these two discounters pose once they crack the code is so large, that even Walmart has had to slash prices for the past three years.

What's the common thread here? The current ecommerce arms race is based on the foundation that Walmart, Amazon, and European discounters are very price competitive from the viewpoint of the consumer. For example, Walmart now continues to brickwall its 25% share of an $800B addressable market by investing further in online grocery, adding curbside pickup at more than 1,800 stores and piloting same-day delivery this Fall. This will directly compete with Amazon's existing Prime Now and Amazon Fresh delivery services. Supermarkets can (and should) join in to improve their digital capabilities but if they aren't first getting the credit that Walmart and others are getting for value, the American grocery shopper will continue to shift away.

With more options than ever over the past decade, households are spending more and more on groceries every week. Food prices have stayed flat during that same time period, which means Americans are buying and consuming more. However, supermarkets aren't getting those dollars like they used to. Whereas supermarkets used to be the primary store, households are now using as many as 3-4 channels to meet their grocery needs. **With more places to buy that exact same box of cereal from, price remains king and will most likely be the tiebreaker at checkout.**

The urgency for supermarkets to best compete by first focusing on improving their price image could not be greater. However, experience has shown common pitfalls supermarkets make in an effort to take the right steps toward pricing excellence:

Building the foundation: Organize the assortment

Supermarkets cannot beat Walmart and Amazon simply by matching their prices across the board. Supermarkets first need to know what role (i.e. price image driver vs

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Figure 1

margin builder) each of their SKUs plays within the assortment from the perspective of the consumer. It's easy to fall into certain pitfalls where prices are set using only the first two out of the three crucial Cs – cost, competition and you guessed it, consumer.

Pitfall 1: Guiding pricing decisions solely based on margin targets and/or competition

Most businesses have minimum margin mandates. To that end, supermarkets typically look at cost and competitor prices to guide their pricing strategy. Both of these inputs are highly tangible and should be factored into the final decision. However, since consumer reactions and price sensitivity across categories are not as transparent and harder to quantify, supermarkets more often than not end up ignoring the consumer. In reality, consumers are the ones who establish the supermarket's price image.

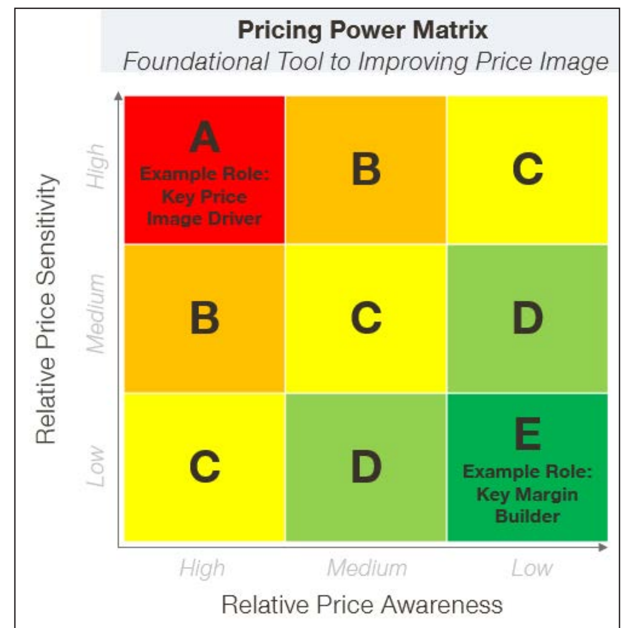
Pitfall 2: Relying on gut-feel or general shopper insights

Even when supermarkets claim that consumers have been incorporated into pricing strategy, it's usually based on gut-feel or general shopper insights. In the worst case, it's based on personal biases that put themselves in the shoes of the consumer (because let's face it, almost everyone buys groceries). As a starting point, supermarkets can use historical data to analyze consumer behavior as it relates to price, and then build on it through targeted primary pricing research.

Pitfall 3: Treating all SKUs equally

Organizing the assortment means not all categories are created equal. However, we typically see supermarkets operating at the category level either because they structure their P&Ls at this level, or because it is easier to break down the complexity of the entire assortment into manageable chunks. As a result, overall store performance is not fully optimized. Understanding the roles categories play compared to each other is crucial to shaping your overall price image objectives.

Figure 2



Where supermarkets strive to be: Competitive only where supermarkets need to be.

We recommend utilizing a pricing tool, such as the Pricing Power Matrix shown in Figure 2, as a foundation that can organize the assortment and assign roles for all SKUs. From here, supermarkets can create a differentiated and surgical pricing strategy. It is crucial to getting price image right on the 3-5% of SKUs across the assortment that are the primary price image driving, or "A" role. Not only should the pricing on these SKUs be competitive to drive overall price image, but they should also be promoted on the front page of your circular to drive traffic to the stores. Supermarkets can then use the opposite end of the spectrum, or the "E" SKUs, that can withstand higher prices with volume drop-offs to help build margin.

In conclusion, a one-size-fits-all cost-plus pricing approach to the assortment poses significant revenue (and as a result market share) risk to the business.

Be proactive especially in this challenging and evolving retail environment. ❖

3 Essential Tips to Improve Your Commercial Strategy

All companies need to utilize value when developing and executing their go-to-market pricing strategies. However, if you are an innovative company and "…live or die on your ability to get price," this process can become all the more complex. In this article, the author recommends three strategies to help innovation companies improve their commercial strategy. Author Richard Harrington is a Pricing and Value Consultant at Holden Advisors. He can be reached at rharrington@holdenadvisors.com.

by Richard Harrington

At a recent networking event, I was chatting with a pricing manager from a major company famed for their innovation. She made a comment that really struck me:

"As an innovative company, we live and die on our ability to get price."

As a professional pricer, I frequently work with companies to understand how pricing strategy can and should support the overall business strategy, but this comment reminded me of the fundamentals. Famed economist Michael Porter describes two generic sources of competitive advantage: cost leadership and differentiation.

Generally, companies will leverage one of these strategies. Cost leaders focus on delivering products of adequate quality to customers who seek the lowest prices. Differentiation leaders provide innovative new products and services to customers who seek additional value. The challenge is, differentiation leaders must not only justify a higher price, but also capture that price in the age of procurement. Here are a few tips on how to do that:

1. Offer differentiation that matters (Differential Value)

The value that customers derive from your offering is the key thread, underpinning all efforts of differentiation. It's not just about making something different; it's about delivering something to customers in a way that they would willingly pay you more than they would for a competitive offering. In fact, differential value is so important to an innovative company that it may be more accurate to call a differentiation strategy a value strategy.

Note: Senior leadership should strive to foster a value culture, in which everyone is focused on delivering benefits that customers care about and competitors can't match - and getting paid for it. Aligning internal functions around unique value created for customers is key for differentiation focused companies to thrive.

> **Cost leaders focus on delivering products of adequate quality to customers who seek the lowest prices. Differentiation leaders provide innovative new products and services to customers who seek additional value.**

2. Target customers who will benefit and are willing to pay (Customer Qualification)

Not all customers value the same things. Customers care about how you can help their business and ultimately how your solution improves their bottom line. For B2B companies, it is essential to quantify value. Your buyer may see your intrinsic value, but if he can take a dollar value to his CFO, you are much more likely to gain her support.

Note: The most successful salespeople within differentiated companies learn to identify and walk away from a price-sensitive commodity buyer when they cannot offer the low-cost solution.

3. Continue to act earlier in the sales cycle (Value Selling)

In the B2B world, sales is where the rubber hits the road; this is where price setting meets price getting. You need to arm your sales force with value messages tuned to each member of the customer buying center to educate and explain how your solution uniquely helps each stakeholder achieve their goals. Building internal support within your customer buying center is crucial to holding price in the final negotiations.

Note: If procurement pushes for commoditization, the sales force needs the confidence to hold their ground. Arm the sales team with Give-Gets to pull out valuable features or services and call procurement's bluff.

All companies need to utilize value when developing and executing their go-to-market strategies, however, if you are an Innovative company and "…live or die on your ability to get price," I recommend implementing these three strategies across your organization. ❖