PROFESSIONAL PRICING SOCIETY

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*In his consulting practice at Strategic Pricing Group (A Monitor Group Company), pricing expert George Cressman is asked frequently about managing pricing and about "commodity" offerings (those products and services where there is little differentiation, where competition is difficult and where purchase decisions are made mostly on price points). Here is George's expert guidance from his latest article submitted to The Pricing Advisor Newsletter. You may reach George at (617) 252-2865 or George_Cressman@Monitor.com.*

# Managing Commodity Offerings

Commodity offerings are most frequently found in mature markets. Mature markets are characterized by:

• Intense competition, with competitors usually at parity on offering design and cost position. Competition is especially difficult from competitors who are poorly positioned and who have little competitive advantage.

• Significant customer price sensitivity because customers have developed deeper knowledge of all offerings and supplier positions.

Consequently, many businesses selling commodity products see their price levels and profits decline.

Offerings become commodities when managers decrease investment in building differentiation. As markets mature, competition intensifies. Prices come under pressure and profitability suffers. Because of the profitability challenges, managers may seek to find markets and offerings where competition is less intense and the profit potential seems brighter. If markets with lower competitive intensity are found, managers may begin to shift resources away from more commodity-like markets.

As resources are shifted to newer markets and offerings, less investment is made in the commodity markets. Less differentiation of the commodity offerings follows, and customers are presented more and more similar offerings. This makes

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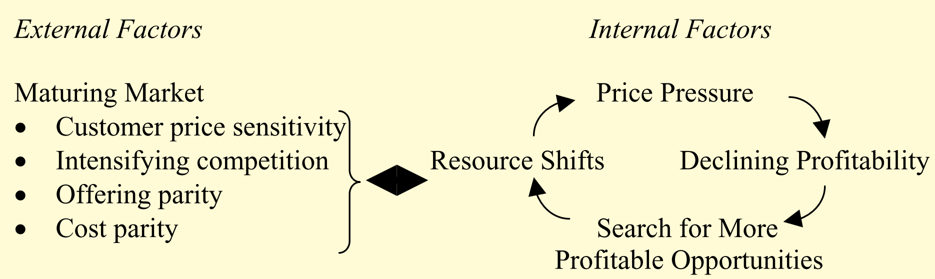
## The Commoditization Cycle




it easier for customers to select offerings on price alone. The result is often the negative cycle of commoditization, seen in the figure above.

It is important to recognize that commodity offerings are not a consequence of the "invisible" hand of the market. Instead, commodity offerings are the result of actions undertaken by managers. Because commodity offerings are the result of managerial action, the march to commodity markets is largely within the control of the management team.

The emergence of "commodity" offerings is underpinned by a deeper, strategic question the management team must address, specifically, **"Are we the supplier of an offering, or are we partners in our customers' businesses?"** The management team's answer to this question drives the business's pricing and marketing strategy. If, instead of consciously addressing this question, the management team defaults to a reallocation of resources, in effect, divesting in the "commodity" offerings, it has chosen to function as a supplier only. While this is not necessarily wrong, it may reflect an unconscious choice. Management teams that do not make a strategic choice about their business's position with their products give up the ability to set marketing and pricing strategy.

Why is the supplier-partner choice so critical? There is no inherently right answer to the supplier-partner question. The result of the choice, however, sets in motion follow-on issues for the management team. Table 1 summarizes these management issues.

## Supplier Choice

Choosing to be a supplier of products or services requires the management team to take a market focus. With this market focus, all customers in the market are potential customers. Suppliers try to spread a minimum set of offerings across the entire market. Offerings from suppliers have restricted options and supporting services to minimize costs.

Suppliers manage for a low cost position to appeal to customers. Their market communication emphasizes price over offering variety, hoping to convince customers that low price is more important than offering variety. The selling focus of suppliers is directed at customers' purchasing departments. This focus helps the supplier minimize selling expense, and the low cost message often gets a favorable hearing in purchasing offices.

From a competitive perspective, suppliers must manage to stay ahead of the capital investment cycle in their industry. Falling behind in the investment race often means the firm will lose market share, with consequential impact on driving costs down.

The implication of reducing offering variety is that differentiation declines. Competitive offerings are increasingly similar, and customer price sensitivity increases because of the low price selling appeal. This, of course, is desirable to a supplier who has managed to a favorable cost position, but is very difficult for suppliers who have not achieved the low cost position.

**Of course, there can only be one low cost firm in each industry.** Firms who have taken the supplier approach but have not achieved low cost dominance are in a dangerous place, forced to compete on price but without a low cost position. Profitability is the first casualty of this untenable position.

Price management for suppliers concentrates on earning an acceptable margin over total costs. Suppliers use price cuts as a tactical weapon to hold market share. The management team must invest to continue to hold its low cost position and ensure the market as a whole understands its low cost advantage.

## Partner Choice

Partners do not focus on all customers. Instead, partners take a segment focus approach — targeting segments of customers where they can deliver differentiated offerings. The consequence of choosing to be a partner is that the management team does not pursue all potential customers in the market, but instead focuses only on specific customer segments.

**Table 1: Characteristics of Supplier and Partner Strategies**

| Strategy Element | Supplier Strategy | Partner Strategy |
|---|---|---|
| Customer focus | Entire market | Target segments |
| Offering plan | Standardize, few options | Tailor for target segments |
| Cost management | Achieve low cost position | Add cost efficiently for tailored offerings |
| Competitive action | Use price cuts to hold share | Use offering differentiation to hold targeted share |
| Selling strategy | Drive price, focus on purchasing function | Drive value, focus on parts of customer organization where value is realized |

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In contrast to suppliers, partners tailor offerings to their specific segment targets. Partners have greater diversity of offerings and expand their offerings with additional products and services to meet customer needs.

From a competitive perspective, partners seek to protect their position by constantly renewing their offerings. As competitors match offerings, partners reinvigorate their offerings by seeking new ways to meet customer needs and finding additional customer needs to serve.

Partners also sell differently than suppliers. **Partners seek to build relationships throughout their target customers' businesses, especially in those areas where the real value of the offering is realized.** Value communication (vs. suppliers' price communication) is especially important for partners, since they seek to be rewarded for the value they create for customers.

Frequent reassessment of value delivery is essential for partners. As competitors match offerings, differentiation is lost. Partners who do not invest in renewing their differentiation will be forced to price compete and may find they do not have a cost position suitable for price competition. The implication is that a partner strategy based on differentiation requires ongoing investment to renew differentiation. Managers who decline to make this renewal investment are, in effect, choosing to send their business on to commoditization.

The difficult news about maturing markets is that customers know more about all of the firms vying for their business. In addition, mature markets are more competitively intense as poorly positioned firms struggle to find some viable operating position. That's the bad news. **But there is also some good news: mature markets are typically highly fragmented with many customer segments.** This multiplicity of customer segments offers many opportunities for unique partner strategies. So while there is only one low cost firm in a market, there are frequently many differentiation strategies possible.

The pricing process for partners is very different than that used by suppliers. **Partners price for their value delivery not for their costs.** An essential part of becoming a partner lies in understanding value delivery for the specific customer targets. Price is always positioned versus the value customers receive. Under competitive attack, partners do not respond with price cuts; instead, partners intensify their value communication stressing their differentiation from competition.

## Where Mistakes Are Made

Perhaps the biggest mistake managers make in maturing markets is failing to consciously choose between becoming a supplier and becoming a partner. While there is no formula to guide the choice, failure to choose will drive the negative cycle of commoditization. Not choosing is a choice of course, but managers may not like the profit consequences of not choosing.

But even when managers make the supplier-partner choice, there are still some pitfalls to guard against. Suppliers, in their zeal to reach a low cost position, occasionally strip the essential elements of offering functionality out of their offerings. While they may reach a low cost/low price position, their offerings may not provide even a base level of functionality.

Suppliers also run the risk of misunderstanding what a cost advantage is. For purposes of profitably implementing a low cost supplier strategy, managers must drive to achieve a low total variable cost position. Having the lowest variable cost position gives the firm using price reductions as its competitive weapon the greatest price flexibility.

Partners run the risk of confusing offering differences with offering differentiation. Differentiation results from providing an offering that delivers value that competitors cannot match. Offering differences do not always create value and thus may not be desirable to target customers. But offering differences does increase cost — cost that cannot be recovered if customers won't buy the differences.

Partners also run the risk of incurring too much cost in creating differentiation. **It's not differentiation at any cost — it is differentiation created cost efficiently.**

## Supplier-Partner Choice

The choice between a supplier or partner strategy should be based on:

- The potential for differentiation strategies. If there are customer segments that are underserved or poorly served, and the value of serving these segments is significant, pursuing a partner strategy can be justified.

- The cost of differentiation. If offerings can be cost efficiently tailored, pursuing a partner strategy is possible. If the cost of differentiation is too high, pursuing a supplier low cost strategy is more attractive.

- The resources available to invest in renewal of differentiation and the skill sets of these resources. If critical skill sets to tailor offerings are available or readily developed, a partner strategy may be the appropriate course.

- The potential to achieve a truly low variable cost advantage. If it is possible to pursue a significant variable cost advantage by standardizing offerings and reducing other costs, then a low cost strategy is favored.

- The return on resource investment utilized in either the supplier or partner strategy. If it is possible to capture a reasonable portion of the value delivered in tailored offerings and there is a reasonable margin available for the tailored offerings, then managers should pursue a partner strategy.

- The sustainability of the proposed strategy. If competitors can quickly match differentiated offerings, then a low cost supply strategy should be pursued. If, alternatively, a cost advantage is easily matched by competitors, then a differentiated partner strategy is more attractive.

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# The Price May Be Right, but the Execution May Be Wrong

*Too often, companies assume that successful pricing is only about setting the right price. Not so. In fact, there are several reasons why companies under-perform on their pricing execution. For instance, they may lack the right information. Measurement and metrics may be misaligned, or management may not be focused on pricing execution. This article by Gerry Boyle and Tim Wilson is reprinted with permission from the Deloitte Magazine UK. For further information, please contact Ranjit Singh, Strategy and Operations Pricing Center of Excellence, Deloitte Consulting LLP at ransingh@deloitte.com.*

Executives at consumer products companies are facing a tough environment with huge pressures to deliver top-line revenue and margin growth in mature and static markets. Additional requirements to manage costs but deliver innovation and brand investment highlight the urgent need to manage pricing effectively.

So why are so many consumer products companies struggling to translate this opportunity into reality?

Despite the pressure on optimizing margins, most traditional metrics used to evaluate operational performance often ignore the importance of pricing. And even more importantly, the effectiveness of managing "pricing execution" — all the activities that take an agreed net price down to the real net-net price.

## Does This Sound Familiar?

• Your sales force is not able to understand the real net effect on profitability of each transaction/deal and remains resolutely focused on selling on price or volume, despite your practical efforts to change behavior or reward structures.

• "We know who our most profitable customers are" — is this really true? What if you discovered that Tesco or Asda was actually your most profitable account?

• You can't be certain that your best customers are getting the best prices.

• You were caught off guard when Safeway and Morrison's merged, highlighting significant, perhaps indefensible, differences in pricing between the two accounts.

• Despite setting up conditional trade terms that reward certain retail behavior, you still don't really understand if you have made more money.

## What's Really Included in the Price?

Even the best pricing strategy has to be properly executed to achieve both the right market impact and the right bottom-line return. But this is not always as straightforward as it might seem.

The sheer volume of transactions, promotional overlays, complex market structures and a multitude of systems and deals can make it very hard to identify the net-net price or to understand which are really your most profitable channels, territories or brands, let alone individual accounts or SKUs.

All too often, companies assume that successful pricing is all about setting the right price. Of course, it's essential to understand the competitive landscape, develop an effective product strategy and customer segmentation and set list prices that address this mix.

But that's only part of the picture. A company can be outstanding at price setting, but still unwittingly lose money on many transactions because its execution is flawed.

Execution is the forgotten side of pricing. While so many consumer products businesses have successfully improved and streamlined the execution of their manufacturing and distribution, pricing execution has remained relatively untouched ... a ripe fruit for picking.

## How Attractive Does This Sound?

♦ Significant increases in operating income and margins, with a direct impact on the bottom line.

♦ Typical payback on investment in about nine months, with some quick wins achievable in a matter of weeks.

♦ Redesigned processes and pricing models, delivering greater profit per segment, SKU, customer, etc.

♦ Better understanding of pricing opportunities and how to manage them across all the functions that play a part in determining net-net price.

♦ Reduced exposure to market consolidation because your pricing execution is better understood, more defensible and more consistent across your business.

## Transforming the Right Price into Bottom Line Profit

Pricing is at the core of achieving commercial excellence. So what is stopping even well managed consumer products companies from managing it effectively and improving

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their profitability?

There are four main reasons why consumer product companies under-perform on their pricing execution.

■ First, **they lack the right information** to effectively manage price/profitability at the transaction level. Often the picture from their reporting systems is incomplete, and there is no real understanding of the many factors that erode the invoice price.

■ The **complex nature of pricing** means it touches almost every part of the organization and requires real cross-functional integration and information sharing to allow all the different factors to be controlled at the micro level and balanced overall to achieve the best results. And many companies quite simply have too many new SKUs coming on stream or changing too rapidly to keep effective control of pricing.

■ **Measurement and metrics** are often misaligned. So, for instance, sales force incentives can actually drive down profitability even as they encourage growth in volumes. Reporting is often at the invoice level, rather than at net-net price. Even when the sales team is rewarded on a more complex mix of factors, simply looking at gross margin in broad terms is a poor substitute for transaction-level insight — and it may even give misleading or wrong information about real profitability.

■ And finally, **management is not focused** on pricing execution, often because it doesn't realize what a major opportunity this is to build bottom-line performance. Executives may have little idea of precisely what kinds of data they need to address the problem, and indeed that data is often hard to obtain — hidden in different systems and in salespeople's heads.

## The Starting Point: Understanding

To maximize the real price you are achieving, you need to understand the complete process and life cycle of a transaction: How does a price make it from a list to actually goods or services sold to a customer?

The first step is to take apart your revenue and operating profits — by invoice line item/SKU, by customer, by salesperson, by channel, by region — to determine the real profitability of a specific transaction.

Based on this insight, you can focus on the small set of SKUs (typically the top 10-20%) that drives the majority of your business.

You can start to challenge the traditional, size-based customer segmentation model that is so often used to set prices. You can start to understand the contribution margin by transaction, so you can use this (rather than the blunt instrument of gross margin) to incentivise the sales force and inform pricing decisions. You may even be able to reduce some prices!

> The first step is to take apart your revenue and operating profits — by invoice line item/SKU, by customer, by salesperson, by channel, by region — to determine the real profitability of a specific transaction.

Most critically, you need to identify every source of margin leakage in a transaction and manage those leaks to your advantage. After all, your revenue stream is built one transaction at a time: If you can manage it at that level, you can't fail to improve your performance.

## Getting a Clearer Picture: Five Key Analyses

♦ **SKU velocity analysis:** Which SKUs generate the majority of your revenues and volume? This uses a Pareto-based technique to clearly identify the top 10-20% of SKUs offering the greatest opportunities to make a financial difference. This vital first step typically leverages the company's own understanding of which SKUs drive the business.

♦ **Product and customer contributions:** This builds a picture of the cumulative contribution (rather than revenues) and often produces surprising results. Companies typically discover that a number of products actually generate negative contribution! Used in conjunction with the SKU velocity analysis, this often identifies some significant opportunities for improvement.

♦ **Price band analysis:** Focusing in on the SKUs with the highest impact, this plots how well your actual pricing performance aligns with your expected customer segmentation model: again often highlighting some unexpected findings. Your "best" customers may well not be getting your best prices, while many of your lowest-value customers could be getting your best prices!

♦ **Customer segmentation performance:** This analysis tests the effectiveness of your current segmentation

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scheme, helping to identify the actual financial value of the sacrifices you are making to achieve volume, at a transaction level.

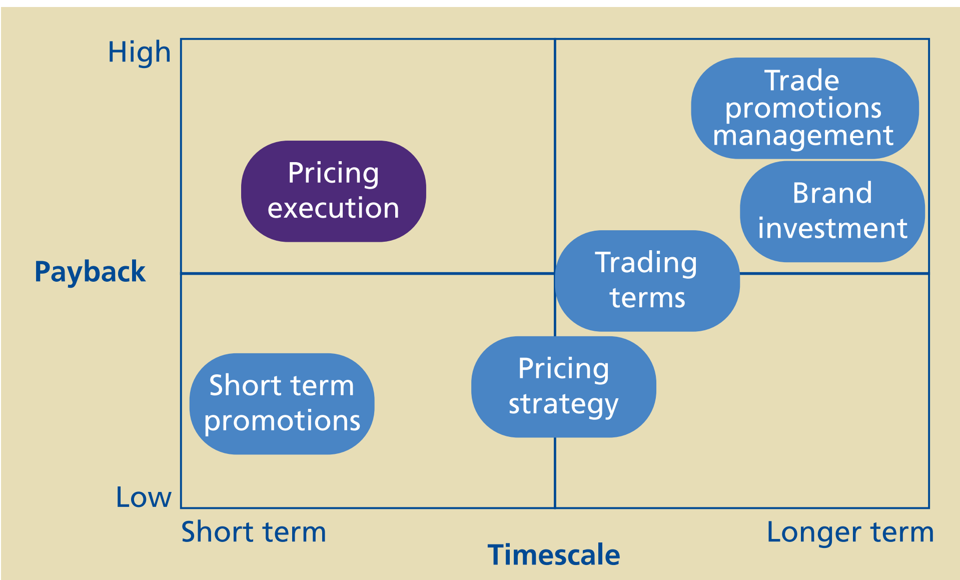
♦ **Price/profitability waterfall:** This is the most valuable of the analyses in terms of potential benefits, but it is also the most labor-intensive as it involves building a detailed understanding of the economics and leverage points of each transaction, to identify each point where margin may be leaking away. Unfortunately, the data needed to carry out this analysis usually cannot be found in common systems and often doesn't exist at all.

and encouraging your whole business to start evaluating its activities in terms of how they affect profitability.

## Improvement Opportunities: Major Return on Investment

An initial analysis of the factors affecting pricing execution will typically identify three kinds of opportunities for improvement.

The **short-term, quick wins** — that can be implemented within three to six months — highlighting immediate "fix or flush" candidates: accounts or categories that don't comply with trade terms or promotional frameworks or SKUs where the pricing is unfavorably positioned.




In the short term, some data requirements can be put together manually, or modeled. In the longer term, a sustainable and repeatable process needs to be put in place for collecting and analyzing the "waterfall" data. However, it's an investment worth making.

Many companies discover that they have misjudged who their most profitable customers are because they have such an incomplete picture.

Once in place, this on-going analysis becomes a powerful tool for managing the sales process, enabling your sales people to manage the profitability of their transactions using facts rather than intuition,

Equally important, even at this early stage, your sales team can start to use the data to counter price pressures from customers and focus their efforts on the most profitable customers, SKUs and channels.

You might also identify actions or projects to take advantage of specific opportunities highlighted by the pricing execution analysis; e.g., reviewing your whole approach to managing trade promotions, given the scale of investment that most consumer products companies now invest in the trade.

**Medium-term improvements**, taking up to a year to implement, can include more effective customer segmentation, the development of targeted action plans for specific accounts and categories, and the revision of some of your promotional guidelines or policies.

It is usually feasible to introduce some simple pricing analysis reporting and to refine and clarify trade terms agreements to close any loopholes and ensure customers meet their volume commitments before being given agreed discounts.

**Longer-term improvements** could take between one and three years to put in place, and involve more deep-seated changes, such as the development of new business strategies to address any fundamentally non-compliant or difficult accounts, SKUs or categories.

The result could lead to delisting, reviews of list prices, changes to packaging, new product development. Over this longer time frame, you should also be able to implement more detailed reporting and analysis and establish a framework for continually reviewing your pricing policies, trade terms and promotional programs.

To achieve sustainable long-term pricing improvements, the greatest challenge is to deploy workable measurement and control frameworks within your organization. And of course, this has to be supported by fundamental behavioral change among the account teams and other groups within the business who have a direct or indirect impact on the achievable net-net price: from finance to supply chain and marketing.

An important by-product of this work may be to highlight hidden opportunities to improve your pricing strategy, perhaps through using your consumer insight to drive increased value in the category.

Work may also be needed to address the "cost to serve" for your key customers, with many elements of this having a profound effect on your net-net prices.

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# Making Good Decisions With Bad Data

*This is another fine article on how to handle the Quantitative aspects of pricing by Reuben Swartz of Mimiran. It is from his latest newsletter and reprinted with permission © 2006 Mimiran, LLC. You can reach Reuben Swartz at reuben@mimiran.com.*

At end of the football game, we see the 40-yard touchdown pass in the highlight reel, the spectacular play that broke the game open.

Likewise, in pricing projects, we try to point out the key decisions and policies that made the project successful. Like the football game, pricing is about the endless blocking and tackling assignments, the simple, unsung actions that lay the groundwork for the attention-grabbing plays.

In pricing, a lot of the blocking and tackling involves collecting relevant data and distilling them into a usable form. This process can be painstaking, but it is essential.

In this article, we look at why gathering and interpreting pricing data is harder than getting financial or sales data, and how to "tackle" the challenge.

By now, most people in the pricing world are familiar with the substantial profit gains from the proverbial "1% improvement" in pricing. With the appropriate pricing dashboards, we can pinpoint opportunities, create a plan, execute it and measure the results. However, getting the appropriate dashboards implies a level of data quality and usability that we typically do not enjoy.

This problem is especially acute at companies that have not undertaken pricing projects and, therefore, have never scrutinized their data as only a pricing project can. These companies are also least likely to have business analysts or IT staff who can handle these issues.

How should your company handle messy information, so you can make good pricing decisions with bad data?

## Business and Technical Considerations

Many people with a technical or business intelligence environment may say, "This is an ETL [extract, transform and load] issue." And they would be at least partly right. A rigorous ETL process ensures that data flows appropriately from one system, such as an ERP application, to another, such as a pricing analytics application.

ETL is primarily a technical process, however. As such, it implements business requirements. The really important activities surround the ETL process — defining what the business cares about, why, and then going on a detective hunt for the information.

## Gathering and Interpreting Data (Extract)

Gathering pricing information can indeed be a detective hunt. Financial systems may only contain the most basic revenue information and often lack a mechanism for interpreting how a sale resulted in a particular price.

Sales systems may record the sales rep and the quote, but the quote identifier may not make it to the ERP system to match against orders and invoices.

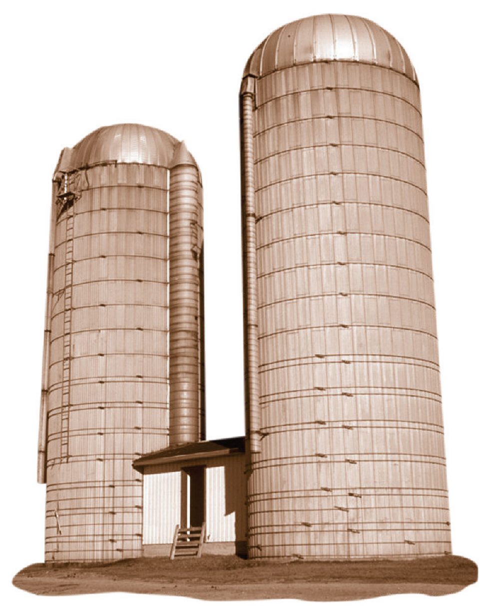
Companies that have grown by acquisition or that have implemented multiple systems, face even greater hurdles. Finding pricing data is difficult because the pricing process takes place across the organization.

The systems and data that support the pricing process typically lie scattered (and siloed) across the organization, as well. The data silos support a particular piece of the overall pricing process, often without any type of integration to other parts of the process.

We must extract the relevant data from these systems and stage them in a database that allows us to manipulate and transform them into useful information.

## Transform

An extract of pricing information often resembles ancient hieroglyphics more than a clear view of pricing with obvious low-hanging fruit. This problem is particularly acute when information comes from multiple systems. The transformation process attempts to unify customer, product and pricing information.



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We must consolidate duplicate customer information, convert to a common currency if necessary (while preserving the ability to analyze in local currencies), match dates and build hierarchies.

### Scrub, Load and Scrub Some More

With data gathered, interpreted and transformed into a useful format, all we have to do is analyze, right?

Unfortunately, we are rarely so lucky. There is usually a post-transformation scrub phase that identifies erroneous, missing, suspicious and valid data records.

A set of heuristics is helpful to automatically classify data. Simple heuristics may include that an invoice price is greater than $0.00 for an order and less than $0.00 for a return or credit.

Other rules may be more complex, such as "The inferred promotional discount is the difference between the list price and the invoice price if the order type is OT1.

"Otherwise, the promotional discount is $0.00 and the difference between the list price and the invoice price is the contract price if there is a contract number associated with the order.

"Otherwise, the difference between the list price and the invoice price is the sales discount if the order type is manual, and the Web discount if the order type is Web.

"Otherwise, flag the transaction as a potential error."

As you can see, the data validation rules can become quite complex, since we often have to infer and interpolate pricing results that do not reside permanently in any systems.

Also, these rules may vary from customer to customer and even from region to region. For example, imagine the preceding rules apply to North American orders, while Europe may have slightly different rules.

**The critical aspect to this scrubbing and validation phase is the ability to flexibly define these rules** and run them on a repetitive basis for ongoing data extracts.

### Segment

Segmentation is a critical pricing activity, and it's also a critical part of pricing analysis. By tagging information with meta-data about source systems and using inherent regional, customer, sales and product hierarchy information, we can segment the data to understand what parts of the business have incomplete, missing, suspicious or incorrect data.

### Analysis and Making Good Decisions

Analysis turns data into useful information. Pricing analysis is a big subject, and other materials cover it well. Here, we focus on making good decisions with bad data.

First, the previous steps in the process allow us to measure how good data are in a particular area. Reports on data quality may be as important as pricing reports to make the organization comfortable with making pricing changes.

In addition, these reports highlight areas that require attention at the data level, such as inconsistent names or transactions whose figures do not appear to add up correctly.

> Making decisions as best as we can with bad data may be a necessity at the start of a project, but we should not settle for bad data over the long term.

Overall data quality may be low, but Web data may be more complete than information filtered through an ERP system and a business warehouse.

European data may be good because of a new systems implementation, but North America may still run on legacy systems filled with strange data, and Asia may have information that may as well be in kanji.

Turning from areas with limited or unreliable data, we can focus our pricing efforts on parts of the business with good data.

### Improving Data

Making decisions as best as we can with bad data may be a necessity at the start of a project, but we should not settle for bad data over the long term.

Like pricing, data often gets scattered around different systems with no single point of responsibility. **People often run from data quality projects because they fear that the task may be too difficult** or that the changes required to improve data quality and enforce data quality standards may upset other parts of the company.

While unfortunate, these fears have a rational basis, so companies must support such efforts at the highest levels.

In the age of Sarbanes-Oxley, data quality is not just a money-saving convenience, but also a legal requirement, making the CFO a natural sponsor for data clean-up efforts.

However, the CFO's focus on finance means that he or she must also include customer-facing groups like sales, marketing and pricing to make sure the business does not stifle itself in the name of data cleanliness.

While no one really enjoys "spring cleaning," the benefits are substantial, providing better financial reporting and enabling more frequent, more accurate automated data extracts to support pricing decisions and their far-reaching profit implications.