



The Journal of Professional Pricing

A Professional Pricing Society Publication



Quick Pricing Solutions in the Crisis

Hermann Simon

Pricing, at your Service

Julie Meehan and Simon McLain

The Problem with Price

Nick Hague

The Journal of Professional Pricing

VOLUME 18 • NUMBER 3 • THIRD QUARTER 2009

ADVISORY BOARD

MR. ERIC MITCHELL

Founder and Chairman of the Board
The Professional Pricing Society

MR. JEROLD BERNSTEIN

President
The Price Improvement Team LLC

MS. JANELLE BRECHON

Director of Global Pricing
Eaton Corporation

MR. XAN CHAMBERLAIN

Global Pricing Manager
Hitachi Data Systems

MR. MARTIN COALSON

Asst. VP, Product Development
& Yield Management
Union Pacific Railroad

MR. JIM GEISMAN

President
Market Share, Inc.

DR. SCOT HORNICK

Vice President
Oliver Wyman

DR. RICHARD LANCONI

Professor of Marketing
Temple University

MS. LAURA PRESLAN

Industry Director
Microsoft Corporation

MR. GARY RITZERT

VP, Retail Consulting
AC Nielsen

MS. STACEY SCHAEFFER

Director, Price and Offering Management
SAS Institute, Inc.

PUBLISHER & PRESIDENT

KEVIN MITCHELL

PROFESSIONAL PRICING SOCIETY
MARIETTA, GA

ADMINISTRATIVE STAFF

CHRIS BUCKINGHAM, Director of Sponsor
Relations

HELEN CAUTHEN MITCHELL, CMP, Meeting
Director

LATONIA DUGGER, Membership Associate

STEPHANIE HUDSON, Meeting Planner

WYNETTA JONES, Membership Associate

FABRICIO LOPEZ, Vice President of Marketing

JULIE R. MARTIN, Certification Program Director

KATRESE PHELPS, Director of Membership

DARNELL SHEPHERD, Project Coordinator

JOAN TERRY, Meeting Planner

REBEKAH WORTMAN, Marketing Publications
Editor

PROFESSIONAL PRICING SOCIETY

3535 ROSWELL RD., SUITE 59
MARIETTA, GA 30062
PHONE: 770.509.9933, FAX: 770.509.1963
E-MAIL: info@pricingsociety.com
URL: www.pricingsociety.com

The Journal of Professional Pricing™ is published quarterly by Professional Pricing Society; Publisher Kevin Mitchell. All Rights Reserved © 2009. Professional Pricing Society accepts no responsibility in connection with any liability that might develop as a result of material published; opinions expressed are those of the authors and do not necessarily represent the publisher. No part of this publication may be reproduced in any form by microfilm, xerography, or otherwise, or incorporated into any information retrieval system, with-out the written permission of the copyright owner.

Profit.



Zilliant customers are some of the most profitable companies in their industries. Our proven price optimization and price management applications help them use data to make more informed pricing decisions and achieve the best pricing possible on every deal. Contact us today to learn how we can help you price to improve financial performance.



Price Optimization | Analysis | Execution
www.zilliant.com 877.893.1085

© 2009 Zilliant, Inc. All rights reserved. Zilliant is a trademark of Zilliant, Inc.

DRIVING PROFITABLE GROWTH

Insights

Collaboration

Action

Results



Monitor is dedicated to helping organizations grow in ways that are most important to them. Through advisory, education and diagnostic services, and capabilities building, our expertise has led to game changing strategies and more profitable growth for more than 500 companies.

MONITOR/**Strategic Pricing Group**

www.monitor.com



From the Publisher

by Kevin M. Mitchell

The Professional Pricing Society (PPS) was founded 25 years ago to connect you with the leading pricing experts and pricing practitioners in the field. Since we were established in 1984, PPS has grown to serve thousands of members, representing all leading industries in more than 50 countries.

Our mission is to nurture a growing community of professionals committed to researching, analyzing and disseminating pricing expertise throughout the business world. We do this by providing a multi-platform forum through which exceptionally talented pricers can exchange cutting edge strategies, tactics and technologies with both their peers and pricing thought leaders. If your firm is just beginning to focus on the pricing arena, PPS can help you determine how, where and with whom to start. For those who want to build your internal pricing function or are looking for ways to benchmark more effectively, we can help with next steps.

In addition to our monthly newsletters and quarterly journals, PPS produces three major annual conferences in North America and Europe. Each conference houses a technology hall where our sponsors display the latest in pricing solutions software. Because connecting pricers is central to PPS, our conferences are designed with enhanced networking capabilities, and we use the latest social networking forums to connect with peers, old friends, speakers and sponsors.

PPS also offers more than two dozen, full-day training workshops every year, taught by thought leaders and respected academics in the pricing community. These workshops serve as the foundation for PPS's Certified Pricing Professional (CPP) designation, our state of the art certification program. More than 1,500 pricers and corporate executives have earned credits toward their CPP.

Mark your calendars to join us at the 20th Annual Fall Conference, which will take place in Orlando, Florida on October 21-23, 2009. In addition to the three CPP Certified one-day workshops offered, we are proud to announce two very special events occurring on October 21, 2009:

- The Inaugural Pricing for Executives Summit will feature a full day of pricing sessions geared for those who focus on top strategic issues for their businesses. Executives from Siemens, Wharton, Marriott, Pepsico, and Seagate will offer tactics and insights that will help your company.
- The 2nd Annual Latin American Symposium will feature the latest trends, real case studies and pricing examples, and best practices from experts from Brazil, Mexico, Argentina and elsewhere in this important region.

CPP Workshops on October 21 include:

- "Price Certainty in Uncertain Times: 10 Ways to Stop Leaving Money on the Table," led by Reed Holden
- "The Pricing Organization Transformation Workshop," with Larry Montan and Parvathy Hariharan
- "Recession-Proof Price Negotiations," presented by David Palmer

The Fall Conference continues on October 22-23, 2009, with keynote addresses and breakout sessions from leaders in the pricing community and peer practitioners discussing dozens of topics within pricing.

PPS returns to Europe with programs specifically designed for the unique challenges of European and Global pricers. Please join us in Brussels, Belgium on November 25-26, 2009, for our 5th Annual European Conference where the following workshops will be offered:

- "Core Pricing Skills," with Mark Billige
- "Measuring & Managing Pricing Effectiveness," presented by Loic Le Corre and Tony Hodgson
- "Channel Pricing – The How and Why of Pricing to and through Indirect Channels," led by Stephen J. Martin
- "How to Organise and Successfully Transform the Pricing Function Inside your Company," presented by Marc Abels and Geert Vercaeren

The PPS website (www.pricingsociety.com) is the central comprehensive database for our discipline and the largest repository of pricing knowledge in the world today. Our website also hosts a job site where professionals can post or review new opportunities in the industry.

I hope that you enjoy the material contained in this issue of *The Journal of Professional Pricing*.

Warm regards,

Kevin Mitchell
President
Professional Pricing Society

10 Quick Pricing Solutions in the Crisis

Hermann Simon

The current crisis, in which supply outpaces demand, leads to unfavorable pricing and competitive outcomes. While it is hardly possible to overcome these negative effects altogether, it is crucial to mitigate their impact. In this article, the author highlights what measures are effective against these threatening developments. Author Hermann Simon is chairman emeritus of Simon-Kucher & Partners. An expert in strategy, marketing and pricing, he has published more than 30 books in 22 languages.

20 Pricing, at your Service


Julie Meehan and Simon McLain

Traditional product manufacturers, who are accustomed to viewing their services organizations as cost centers, are struggling with how to apply pricing improvements to their service offerings and are sacrificing growth and profit in the process. In this article, the authors explore how traditional product manufacturers can unleash the power of pricing on their service offerings.

28 The Problem with Price

Nick Hague

Pricing a product is one of the most challenging decisions marketers have to make. The problem is even larger when a price is needed for a product that is conceptually new. In this article, the author highlights the importance of well constructed pricing research in the increasingly competitive global marketplace, as well as specific applications for research results in pricing new products or modifying existing price structures.



Get the big picture
view on pricing

Go beyond historical pricing analysis. Explore future scenarios, work in concert with other functional groups, and choose the best course of action with confidence.

The Vistaar Price Management Solution delivers measurable and sustainable results in the following areas:

- Price Strategy
- Segmentation
- Price Setting and Optimization
- Deal Pipeline Management
- Price Execution

We do this by providing:

- Best-in-class analytics to discover price opportunities
- Advanced pricing science to establish optimized prices
- Operational decision support to make fast, informed decisions about customer negotiations
- Best-in-class scenario planning to determine the impact of any price action

Some of the biggest names in business are using Vistaar Pricing Technology to improve their pricing decisions and increase margins. Stop by our booth at the conference or give us a call. We'd love to show you how we can deliver similar results for you.



Pricing solutions for sales, marketing and product management

“To be a truly global company, you have to act like one.”

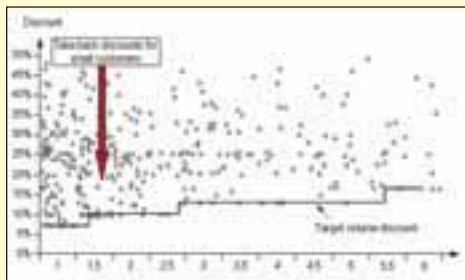
With increasing globalization and competition, your ability as a global company to quickly adjust prices is crucial to stay competitive. However, the right price on the right product and market at the right time still represents a major challenge for many large corporations. The price data is often managed and controlled in many different organizational units and systems. In such a fragmented environment, it is inevitable that delays and errors occur when relying on outdated or manual processes. This results in an

incomplete and inaccurate pricing structure with few possibilities to optimize price margins. As the product range grows, the challenge will turn into a real problem. With Synchron's Global Price Management solution you will be able to capture untapped profit potential by reacting quickly on incorrect pricing and turns in the market. It will also help you to cut costs through a significant reduction of the efforts required to maintain prices. Therefore, it is likely to generate an impressive return on investment.

For more information, please visit www.synchron.com

synchron
MANAGE YOUR GLOBAL SUPPLY CHAIN - EASILY

Quick Pricing Solutions in the Crisis



The current crisis, in which supply outpaces demand, leads to unfavorable pricing and competitive outcomes. While it is hardly possible to overcome these negative effects altogether, it is crucial to mitigate their impact. In this article, the author highlights what measures are effective against these threatening developments. Author Hermann Simon is chairman emeritus of Simon-Kucher & Partners. An expert in strategy, marketing and pricing, he has published more than 30 books in 22 languages. Learn more at www.hermannsimon.com.

A Sales Crisis, Not a Cost Crisis

Today we are facing a sales and revenue crisis, not a cost crisis. Sales volumes and revenues have dropped to a shocking extent. In many markets customers are simply refusing to buy. The reason is not that their purchasing power has suddenly evaporated or that prices and costs are too high. Nor are the competition from low-wage countries or an unfavorable dollar exchange rate the main problems, as has been the case in former crises. Indeed, many factors such as dropping prices for oil and raw materials have actually induced some relief on the cost and price front. The reason why both private and business customers are refusing to buy is that the fear of the future has them hoarding their money. “Cash is king” is true for companies and consumers alike.

How should companies respond to a crisis of this kind? One thing is clear in any kind of recession: Everything needs to be done to reduce costs. But if revenues drop by 20, 30, or 40 percent, companies face the challenge of survival itself. In such an extreme situation cost reductions alone will not suffice. If the current recession is a sales and revenue crisis, it has to be fought on the sales and revenue front with all means available to a company. Many companies have realized this. In a recent study among 2,600 industrial companies, 72 percent of the respondents said that they were going to combat the crisis not only on the cost side but also on the market front.

Price Is the Most Important Profit Driver

Each of the three profit drivers—price, sales volume and cost—has a significant effect on profit. Therefore, managers should focus on all three in a crisis. For a product with a typical relation of fixed and variable costs, price is the strongest profit lever, followed by variable costs. Sales volume is a considerably weaker profit lever. Ultimately, revenue growth generated by price increases yields higher profits than growth generated by volume increases. The opposite applies in a crisis: A decline in sales volume is less harmful to profit than a decline in price.

At the same time consumers’ price elasticity changes. One might expect that it increases in a time of crisis. However, this applies

only to price increases, not to price cuts. **Price elasticity generally develops unfavorably during a crisis.** Compared to more stable times, sales respond less positively to price cuts and more negatively to price increases. What’s more, thresholds in the price demand curve are certain to shift. Prices have to be lowered by a considerably larger amount in order to enter the price-elastic part of the curve.

Cut Your Volume!

As price is the biggest profit driver, a volume reduction usually harms profit less than a price reduction. From a market perspective, the primary goals of volume reductions are price stabilization and the reduction of competitive pressures. However, both goals of volume restriction—cost reduction and price stabilization—have welcome effects on profit and cash flow.

The disastrous results of oversupply are illustrated by the automotive industry. Per 2009 the worldwide annual automotive manufacturing capacity is 77 million units. However, in 2008 only 55 million cars were sold, and for 2009 only 50 million units or less are expected to be sold.¹ This results in a global overcapacity of at least 50 percent. In the US, total industrial production capacity in use was less than 70 percent, resulting in close to 50 percent overcapacity.² As long as such imbalances exist, pricing will remain volatile. Continued overcapacities and the physical presence of an overwhelming number of unsold cars will generate ever more radical price cuts in the attempt to find buyers. Burkhard Weller, CEO of car dealership Autoweller, corroborates this view: “The automotive crisis has nothing to do with the financial crisis. Quite simply, too many cars have been produced for years. Production must be reduced to give prices a chance to recover.”³ Similar developments can be observed for consumer electronics, hotel rooms, airlines, machinery and many another products with excess supply.

The necessity of volume reduction among individual companies is evident. But what should a company do if competitors refuse to join them and instead try to use the emerging demand/supply gaps to increase their market shares? This is a perfect analogy to pricing in an oligopoly. In an oligopoly, a price increase can be the optimal solution for a company. However, if a company’s

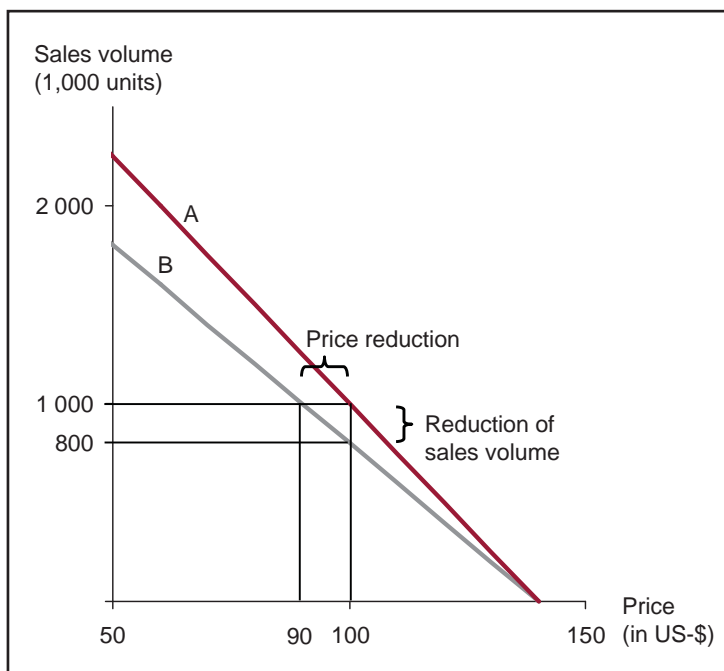
competitors sustain current prices or even lower prices, a price increase by that company is a very risky move. The same is true for volume reductions. If the competitors don't play along or even push more volume into the market the plan can easily backfire. A company would lose market share and even endanger its long-term market position.

It is therefore essential to keep a close eye on the competition and to exert all legally allowed influence to get the industry as a whole to reduce volume. Direct agreements with competitors regarding volume and price are prohibited by anti-trust laws. But it is not illegal to signal one's own intentions with regard to volume reductions. In a crisis, chances are good that the competitors will understand the overall picture and behave in a sensible manner. In many sectors, industry-wide reductions of capacities can indeed be observed. In addition to the capacity restrictions in industrial sectors such as automotive, steel or chemistry, there is similar action in tourism, airlines and other service fields.⁴

Cut Prices Intelligently!

In a crisis, price management moves to the forefront. "One of the most important decisions in this recession is what to do about prices. In booms you don't have to get pricing exactly right. Now you do," says Fortune columnist Geoff Colvin.⁵ **An indispensable requirement for intelligent pricing is a precise understanding of the relationship between price and sales. This understanding is essential in a crisis because the price-sales curve and price thresholds are shifting.**

Figure 1: Sales reduction or price cuts as a reaction to the crisis

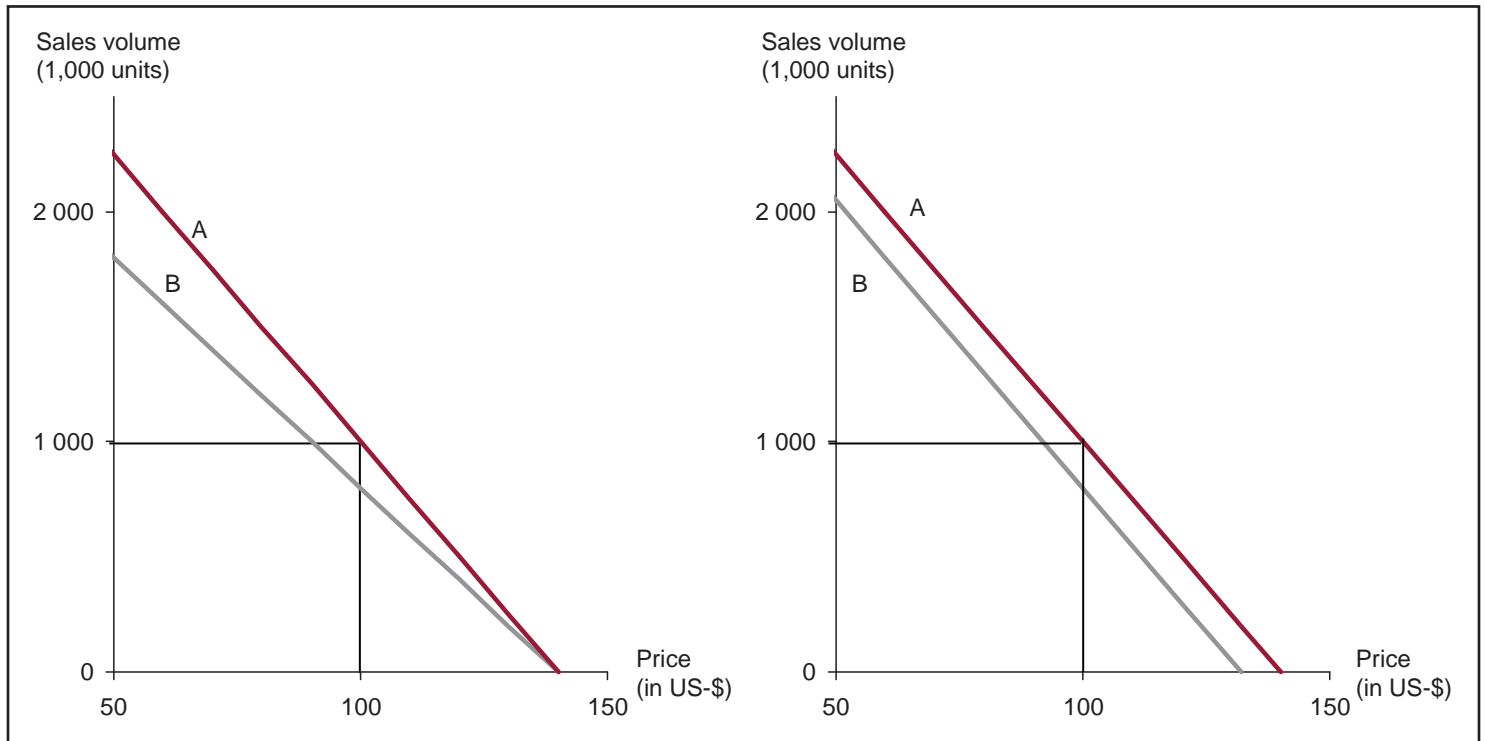


The most frequent and counterproductive reactions to the crisis have been large and premature price cuts, often implemented in the form of high discounts. How can this counterproductive behavior be explained? In most cases it is an attempt to maintain the current level of sales and employment. To discuss this we look at Figure 1. Before the crisis the price-sales curve A was valid. One million units were sold at the price of \$100 dollars. The resulting revenue is \$100 million. With variable unit costs of \$60 dollars and fixed costs of \$30 million dollars, we get a profit of \$10 million. How does the crisis affect the price-sales curve? We assume that curve B in Figure 1 applies in the crisis. For any price the sales volume is 20 percent lower. If we leave the price at \$100 sales fall to 800,000 units. The massive volume reduction induces a strong temptation to lower the price to \$90 in order to maintain the sales volume at one million units. Employment would be guaranteed and layoffs avoided. In terms of profit, however, the two alternatives of keeping the price at \$100 or cutting it to \$90 are very different. If we keep the price at \$100 and accept the 20 percent drop in volume we still get a profit of \$2 million. With a reduced price of 90 dollars and an unchanged sales volume of 1 million units, however, the profit falls to zero.

The insight that a volume reduction is preferable to a price reduction is necessary but not sufficient to make a decision. The next question asks by how much the volume and/or the price should be lowered in order to get the highest achievable profit under the new circumstances. This question can be answered precisely and reliably only with the help of the price-sales curve. Several modern methods are available and applicable even under the time pressure induced by the crisis. For instance, systematic expert judgment can be collected within a company in just a few days. The relevance of knowing the exact curve is illustrated by the two seemingly similar curves in Figure 2. The left curve shows the case from Figure 1. For any price the sales volume is 20 percent lower. On the right side the pre-crisis-curve A is identical, but the crisis causes sales to go down by 200,000 units for any price, which means that curve B is a parallel to curve A.

For a price of \$100 we get the same sales results in both cases. To defend the former sales volume of one million units the price would have to be lowered to \$90 dollars in the left Figure, but only to 92 dollars in the right Figure. The differences between the two cases seem minimal. However, in the left case, one gets the maximum profit by leaving the price on the old level of \$100 dollars and accepting a decline in profit from \$10 million to \$2 million. In the right case the maximum profit is achieved when the price is lowered to \$96 and the company accepts a decline in sales volume of 10 percent to 900,000 units.⁶ The profit falls to \$2.4 million. Although both curves look very similar at first sight there are massive differences in the optimal reactions to each, especially with regard to the sales volume.

Figure 2: Different implications despite similar price-sales curves



The following statements from two top managers in the automotive industry show how strongly views regarding price and volume in a downturn can diverge. In 2003 Richard Wagoner, CEO of General Motors from June 2000 to April 2009, said: “Fixed costs are extremely high in our industry. We realized that in a crisis we fare better with low prices than by reducing volume. After all, in contrast to some competitors, we still make money with this strategy.”⁷ Wendelin Wiedeking, CEO of Porsche until July 2009, has a very different opinion: “We have a policy of keeping prices stable to protect our brand and to prevent a drop in prices for used cars. When demand goes down we reduce production but don’t lower our prices.”⁸ Wiedeking made this statement several years ago and confirmed it again in the crisis of 2009: “One thing is clear to us: We will not flood the markets with cars for which there is no demand. We always produce one car less than the market demands.”⁹ The polar positions of Wagoner and Wiedeking point to the core of the problem. **A crisis inevitably means that sales volume drops if the price is kept at the current level. It does not mean, however, that sales remain at the current level if the price is cut.**

If price reductions are unavoidable they should be made in a way that minimizes negative effects and maximizes the positive impact on sales and profit. It must be understood that the interest of the seller is fundamentally different for price cuts and for price increases. With a price increase, the seller prefers that the customer does not notice the increase, thereby preventing sales volume from decreasing. With a price cut, the seller prefers that the customer notices the decline in price so that sales volume increases. Thus, in the case of a price cut the supplier should strive to increase price elasticity by clearly communicating the lower price to customers.

Empirical studies show that the positive effects on sales of a price reduction are considerably higher when the price cut is commu-

nicated through advertising, double placements in stores, special displays, etc. While the positive effects on sales are highly welcome in the crisis, communication budgets have typically been cut. This presents a dilemma: on the one hand, price reductions have increased; on the other hand, there is less money to communicate these reductions.¹⁰

Apart from the general question concerning whether prices should be lowered at all, special attention must be paid to the extent of price cuts in the crisis. The shape of the price-sales curve determines the optimal extent of a price reduction. The linear price-sales curves shown in Figure 2 are good approximations for price changes that stay close to the original price. For more drastic price cuts or price increases, however, we have to assume the existence of price thresholds.¹¹ How does the crisis affect these thresholds? We already know that the price-sales curve shifts downward, i.e. for any price sales are lower. In addition, we have to assume that the price thresholds go down. This new situation has drastic consequences for pricing in the crisis. The new optimal price can only be determined if the price-sales curves, and especially the price thresholds, are precisely known. If we reduce the price within the flat part of the curve the sales volume increases only slightly and profit drops sharply. Sales volume increases noticeably only when the price drops below the lower price threshold. It is only then that the increased sales volume can overcompensate for the loss in unit margin. However, this only happens if the left branch of the curve is very steep. Before implementing radical price cuts, a company must therefore be certain of its products’ price elasticity. Reactions of competitors need to be taken into account as well. Otherwise the entire maneuver might end in the unwarranted combination of prices which are far lower and sales volumes which have not increased.

The “scrapping bonus” for cars in Germany of \$3,250¹² is a case in which the prices moved into the steep lower branch of the price-

sales curve. The program is geared to subsidize the purchase of two million new cars in the course of 2009. Additional direct discounts from car manufacturers resulted in price cuts of up to 40 percent. Most consumers that qualified for the bonus belonged to lower income brackets so that these massive price reductions broke their resistance to buy a new car. Sales skyrocketed. However, the extreme price reductions in this case relied on massive public subsidies and thus cannot be transferred to other sectors which have to operate under normal business conditions. In a crisis, we recommend great caution before implementing large price cuts.

Give out Discounts in Kind, Not Price Discounts!

Price concessions can be granted as reductions of the nominal price or as discounts in kind. In a crisis, discounts in kind have several advantages:

- The nominal price level remains unchanged.
- They are generally more advantageous with regard to profit than price discounts.
- They generate more volume and therefore protect jobs.

The case of an all-terrain leisure vehicle with a list price of about \$10,000 serves as an excellent illustration of these advantages. As a reaction to the crisis, the manufacturer offered all dealers who ordered five vehicles a sixth unit for free. Since the dealers received six vehicles but had to pay only for five the actual price discount was 16.7 percent. At a price of \$10,000 the results are as follows: Revenue \$50,000, units sold 6, profit \$14,000. If the manufacturer had given a direct price discount of 16.7 percent the results would have been: Revenue \$41,650, units sold 5, profit \$11,650. Because of the discount in kind both the volume (and thus employment) and the profit are higher. Since the discount initiative is explicitly defined as a measure confined to the crisis, it should be easier to phase out after the crisis than a direct price discount, which inevitably weakens the list price.

Deploy Non-Linear Pricing and Price Bundling!

Sophisticated forms of intelligent price reductions well suited for a crisis are non-linear pricing and price bundling. A further variant is multi-person pricing. With non-linear pricing, the price per unit is not constant but decreases with the number of units bought.

In the crisis, simple non-linear price offers have become very popular. Widely used forms are: “buy one, get one free”, “two for one”, “pay for two, get three”, “50 percent off the price for a second book” etc. Such schemes help increase volume. However, the seller should exercise caution with regard to the profit impact. Such discounts are often extremely high. While they may move volume they can ruin margins.

One example of a two-dimensional, non-linear price system is the BahnCard (BC) of the German Railway Corporation. A second-class BC costs \$300 and a first-class card costs \$600.¹³ With the card the customer receives a 50 percent discount on all tickets for one year. Thus the average price per mile or kilometer goes

down as the usage increases. The price is non-linear. Passengers who travel a lot (or, more precisely, who travel more than the break-even volume) pay a lower total price than he or she would pay without the BC. For intensive railway users the BC therefore means a price reduction and an incentive to use trains even more often. Notice that the incentive structure is very different from a frequent flyer plan or similar bonus systems. With the BC the customer has to spend money upfront and strives to earn this money back through frequent usage. It is a very intelligent system of cutting prices and encouraging customers to buy more.

Multi-dimensional price systems have become very popular in sectors such as telecommunications, utilities, internet and services. They are also used in the industrial goods sector. One example is industrial gases where the total price consists of the lease for the container and the gas price. Depending on the duration of their consumption, customers pay a completely different price per gallon or liter of gas. Flat rates are an extreme variant of non-linear pricing that have become highly popular in the last few years, especially in internet and telecommunications services. Non-linear pricing schemes are best suited for services. These schemes can be implemented quickly and usually impact sales volume without

Multi-dimensional price systems have become very popular in sectors such as telecommunications, utilities, internet and services. They are also used in the industrial goods sector.

much delay. They are particularly effective during a crisis.

While non-linear pricing is restricted to one product, price bundling includes several products. A customer who buys a predefined bundle or package pays a bundle price that is noticeably lower than the sum of the individual product prices. Bundling allows the seller to make price concessions that would be disadvantageous for individual products.

The rationale for bundling is to transfer the non-exploited willingness-to-pay for a product to the bundle. The willingness-to-pay for the bundle is less heterogeneous than for the single products, and thus can be better exploited than if the products were sold separately.¹⁴ Well-known cases of price bundling are Microsoft's office suite or McDonald's menus. Norton, a supplier of anti-virus software, uses bundling heavily for all products. If you buy three licenses, you will get a license for another product (Norton Ghost) for free.

A variation of bundling is multi-person pricing, which means selling to several people at a lower price than the sum of the prices individuals would have to pay.¹⁵ This scheme is common with tour operators (a second person or the children travel at a lower price or for free), airlines (a second person pays half price) or in the catering industry (the meal for the second person is free or costs only half price).

Defend Your Prices with Tooth and Nail!

When the pressure on prices mounts, one option is to give in, the other is to defend prices. There are numerous ways and means to fight against price erosion:

- Better preparation for price negotiations
- Deeper knowledge of the customer's value chain and business processes
- Quantification of customer benefits
- Clear targets and incentives
- Appointment of competent price negotiators
- Intensified monitoring of realized prices

It has been demonstrated again and again that a more professional handling of these aspects leads to improved price performance. **In a recession, the ability to defend prices becomes the decisive factor, especially if the competitors defend their own sales volumes by massively lowering their prices.**

A recent study of 56 industrial suppliers confirms that fighting against price pressure can be effective. All suppliers in the survey were facing demands from their customers in the automotive and the engineering industries to cut their prices by an average of about 5 percent. Figure 3 shows that the price cut demands of the manufacturers were more or less uniform. The outcomes, however, differed markedly. The successful suppliers had to accept price reductions of only 1.4 percent, whereas the less successful ones had to swallow an average price erosion of 3.8 percent.

Increase Prices Under the Customers' Radar!

Despite the prevailing price pressures, selective price increases can be achieved even during a crisis. There are several reasons for this. Many price systems are so complex that customers don't have price transparency. This can be due to a large product range, numerous price parameters, or complex terms and conditions. The price list of a bank, for instance, comprises several hundred positions, many of which the customer is not aware exist. Typi-

cally, customers focus on—and remember—only a few prices. Private banking customers tend to look at the monthly rates for an account, fees for their investment funds, or money market interest rates. Business customers generally know the current interest rates or the prices for transferrals. Other price parameters, such as the management fee for funds and or the debit rates for checking accounts or credit cards, are largely unknown to customers. These intransparencies open opportunities for selective price increases.

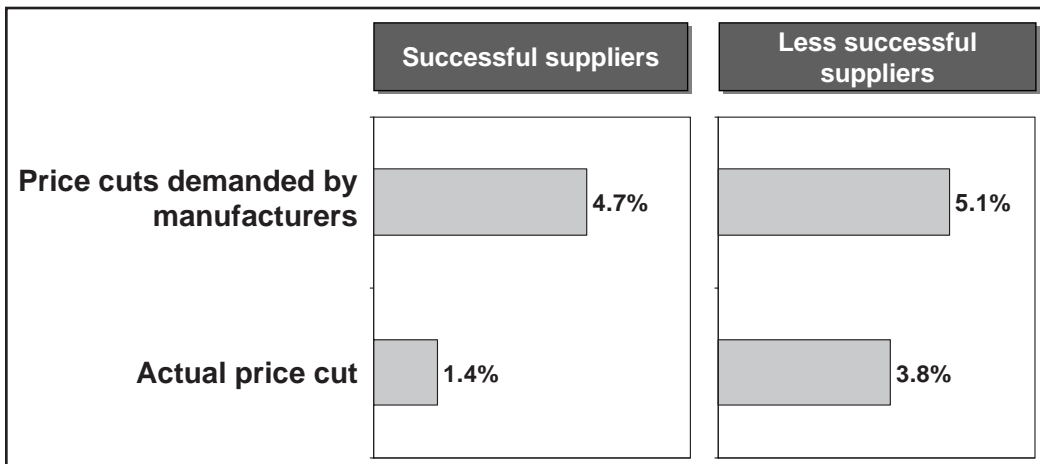
Recently a regional bank achieved immediate additional earnings of several hundred thousand dollars by selectively adjusting price components below the customers' radar. The bank received no complaints concerning the price changes. The adjustments required a careful analysis of all price and product components regarding volume (e.g. number of transactions, assets etc.), contribution to earnings, and customer sensitivity to price increases. These aspects were analyzed quickly and cost-efficiently by means of an internal survey among the sales staff.

Potential for selective price increases often exists when assortments are large. Wholesale and retail trade, spare parts, tourism, and airline travel are sectors where this condition prevails. Customers often focus on a few key items but have no idea of the prices for the rest of the assortment. This is especially true for products that are bought infrequently.

Spare parts offer numerous opportunities for price increases without volume reduction. This requires that spare parts are allotted separately into categories with varying willingness-to-pay and price elasticity. Two categories are exclusive parts, which can only be bought from the original manufacturer, and commodity parts, which can be bought from other manufacturers or from dealers. In a recent case, a vehicle manufacturer successfully increased the prices for spare parts by 12 percent and achieved a profit improvement of 20 percent – in spite of the crisis.

A very effective approach is increased price differentiation across customers. Through a detailed analysis, past transactions, prices and margins can be made transparent and the main price drivers can be identified. With the help of intelligent models, the prices can be adjusted more precisely to individual customers and the full potential of the willingness-to-pay can be tapped.

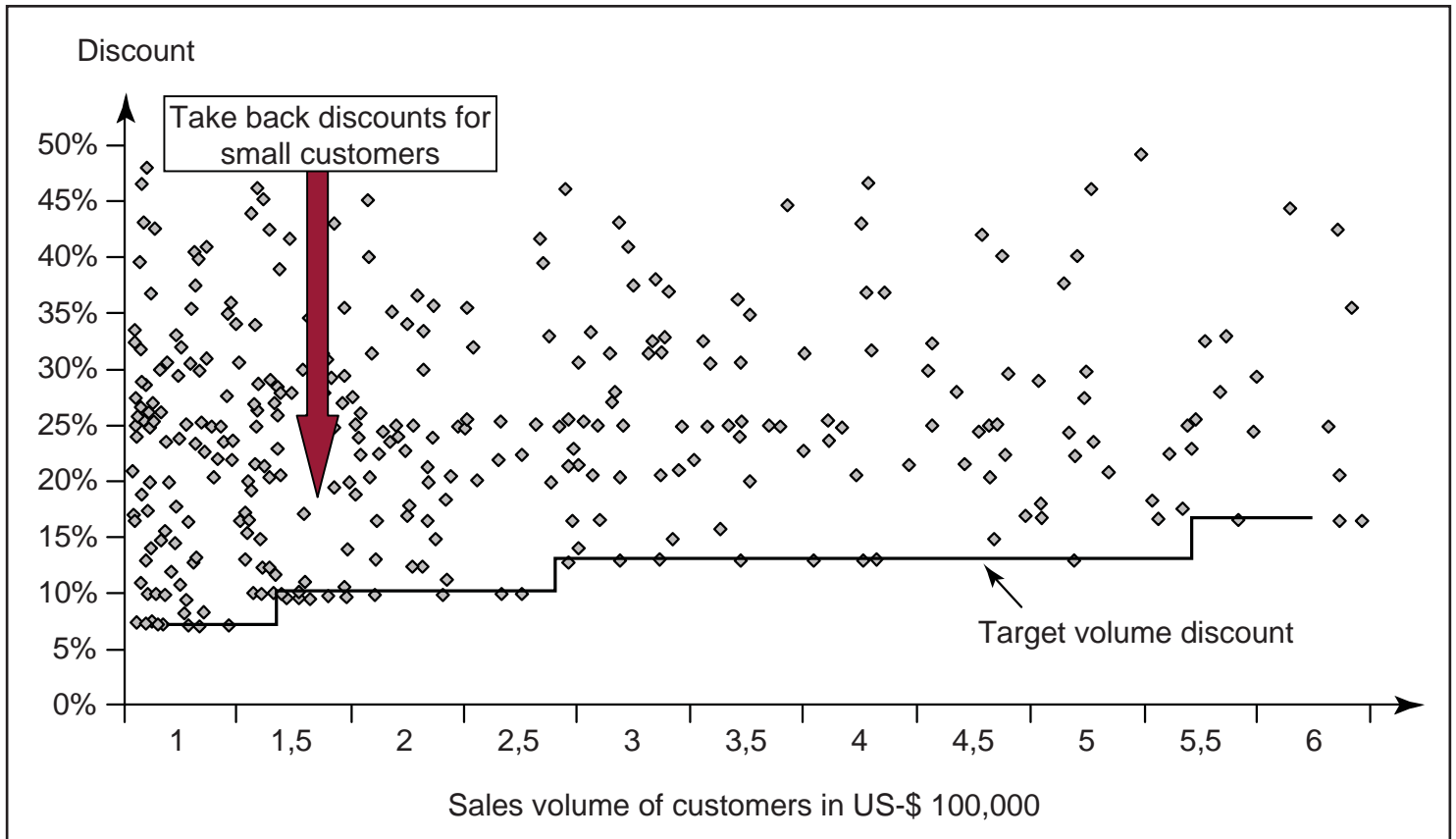
Figure 3: Demanded and actual price cuts¹⁶



Clean Out Your Discount Jungle!

Selective price increases and margin improvements can be achieved by weeding out unnecessary or inconsistent discounts and by a general clearing up of “discount jungles”. In many companies, discounts have spread wildly, are inconsistent, and are often too high. Many discounts are granted without a quid pro quo from the customer and tend to accumulate over time. Often nobody can remember why and when a certain discount was accepted. Cleaning out the discount jungle can

Figure 4: Discounts given by a software vendor



quickly and significantly improve margins.

Figure 4 shows discounts given by a software vendor. In spite of the clearly defined guidelines for volume discounts indicated by the scaled line, no correlation could be detected between customers' sales volumes and the discounts they received. It is no exaggeration to call this a "discount jungle". It is unlikely that such a jungle is justified, let alone optimal. Detection of discount jungles opens up a variety of ways to establish quick solutions for the realization of higher margins.

Figure 5 reveals a typical pattern for discount negotiations, namely the tendency to round up percentages. The case shown here is of an industrial service provider. Almost all discount percentages are round numbers, such as 10, 15 or 25 percent. Also, the discounts granted are very widely dispersed. If one goes to discount levels that are a few percentage points below the round figures the effects on the margin will be dramatic. The same applies to the steps between discount levels during the negotiations. Discounts are typically increased by steps of 5 or 10 percent. If smaller steps are applied the overall discount tends to be smaller as well.

Charge Separately for Hitherto Inclusive Services!

A further quickly implementable method of selective price increases is charging separately for services or components that were hitherto included in a package with a single price, often called unbundling.¹⁷ A well-known case is the low budget airline Ryanair which introduced a separate luggage charge of \$4.50 in 2006. The profit increase of 30 percent reported in the following quarter was largely attributed mainly to this instance of unbundling. Once a service is charged separately the price can be

repeatedly increased. Checking-in an item of luggage costs \$13 with Ryanair today.¹⁸ Additionally, low budget airlines such as Ryanair and Easyjet charge a fee for speedy boarding.

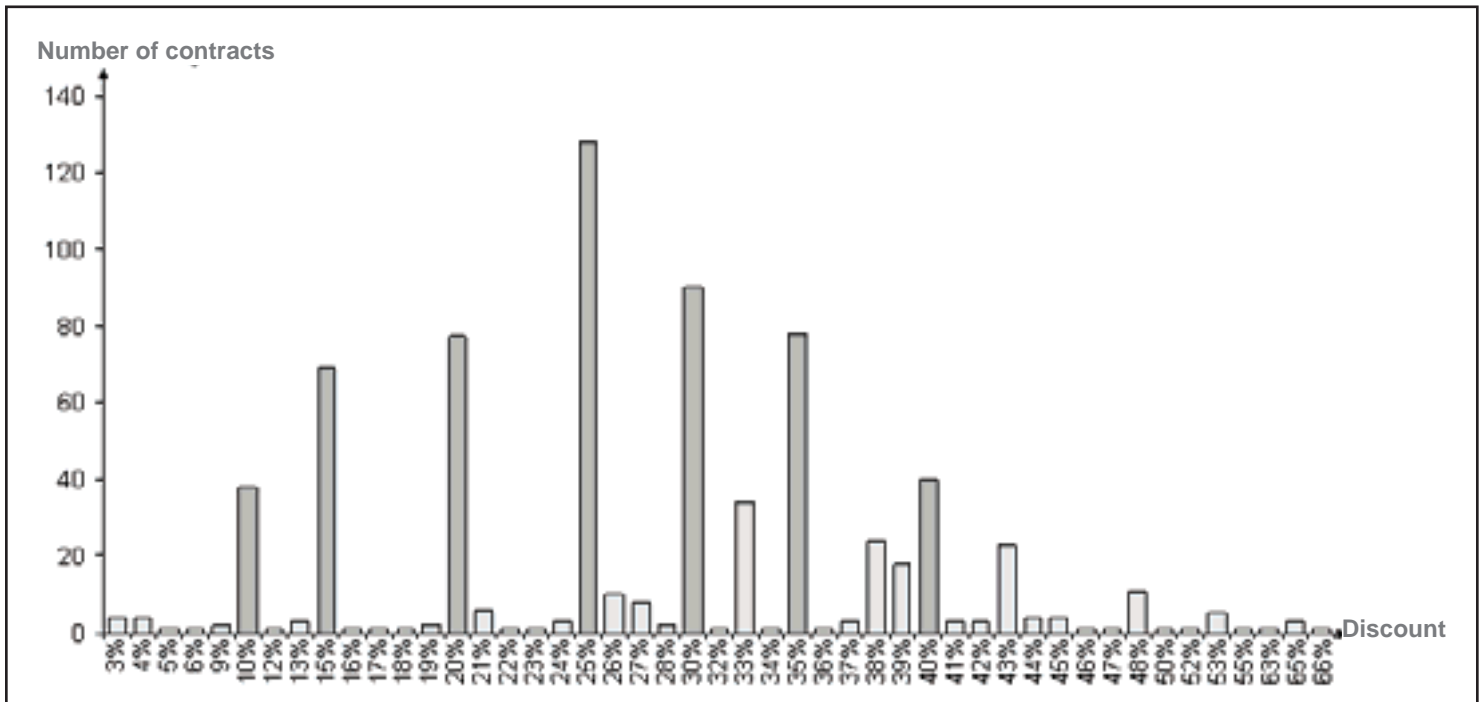
Another case is the introduction of a 50 cent fee for toilet use in motorway service areas.¹⁹ Customers now have to pay now for a hitherto free service. If they only use the toilet they contribute to the maintenance costs. Customers who make purchases in the shop or restaurant can cash in the 50 cent token. The majority of customers make use of this possibility which strongly increased cross-selling.

The crisis may not be the ideal time to start charging separately for services and products. Everything depends on the customer's reaction. It is necessary to consider and test these reactions beforehand. Ryanair, for example, reasoned that the luggage charge actually amounted to a price advantage for passengers who don't check in any luggage. If the services can be clearly separated and possibly even improved, customer acceptance can be achieved even during a crisis.

However, pricing mistakes can lead to drastic customer reactions. To achieve the delicate balance, profound knowledge of price elasticities is required. This kind of information can be obtained through systematic studies, in management workshops, or through careful experimentation in the market.

Even in good times, there is widespread fear of price increases and the ensuing volume losses among managers. During a crisis such fears multiply. When business is bad, the prospect of further revenue declines can cause panicked reactions. These are not the ideal conditions to achieve optimal results, to implement price

Figure 5: Rounded discount levels that damage margins



increases, or to fight against price pressure. In a crisis, top management must back up the sales team and alleviate their fear of price negotiations.

Not a Quick Solution: Price Wars!

Avoiding price wars is not a quick solution, since it's not about doing something but rather about not doing something. However, refraining from starting price wars can make the difference between survival and demise. **Everything should be done to avoid price wars during a crisis unless a company has the financial strength to eliminate a weakened opponent in a short period of time.** The most important guidelines in this regard are:

- In a crisis, an orientation towards market share and volume should be replaced by a rigorous profit and cash flow orientation.
- Companies should aim at peaceful competition that gives all competitors the ability to guard their margins.
- Aggressive price actions should be avoided. Signaling and communication should be targeted towards this goal.
- Submarkets which are unattractive and where a company is weak should be conceded to competitors. Areas of conflict should be avoided.
- It is important to bring the whole organization behind the rigorous profit orientation. One way of doing this is to set profit-oriented targets and incentives for the management and the sales force.

Summary

Since the current crisis is characterized by an imbalance between supply and demand, managing offers and prices plays a central role in successfully coping with the economic environment. The following points should be noted:

- Volume and capacity should be limited to take the pressure off the market and stabilize prices.
- Efforts should be made to achieve an industry-wide volume reduction. The rules of conduct for oligopolistic markets should be observed.
- Supply should be reduced in connection with the price decision and taken into account with regard to the price-sales curve.
- It is important to quantify these interrelations as precisely as possible. Even small changes in the price-sales curve can lead to large differences in the optimal price-volume combination.
- Price reductions are often unavoidable in a crisis. It is important to achieve the highest possible positive effect on sales when prices are cut. This may require going below price thresholds and enhancing price communication.
- Discounts in kind tend to be superior to direct price discounts.
- More professional preparation, negotiation and monitoring can help to stabilize prices.
- Despite the crisis, selective price increases should be considered and realized. Chances are best with price components which remain below the customers' radar and with increased price differentiation between customers.
- Separately charging for formerly inclusive services can be a way to achieve higher profits despite the crisis.
- Price wars should be avoided in a crisis, unless a company has the financial strength to eliminate an opponent in a short period of time.

The numerous approaches and cases in this article show that, despite the crisis, all is not lost. Effective management of offers and prices present many opportunities to beat the crisis and to save revenue and profit. Solid information and the will to act are all it takes.

Endnotes

¹ Cf. "Freude am Sparen." *Focus Money*, February 4, 2009, p. 76.

² "U.S. Industrial Production Drops More Than Forecast." Bloomberg.com, April 15, 2009.

³ "Nach Ostern beginnt wieder das normale Leben." Interview with Burkhard Weller, founder of car dealer Autoweller, *Frankfurter Allgemeine Zeitung*, March 9, 2009, p. 15.

⁴ Cf. Klaus Meitinger, "Wege aus der Krise." *Private Wealth*, March 2009, pp. 26–31.

⁵ Geoff Colvin, "Yes You Can Raise Prices." *Fortune*, March 2, 2009, p. 19.

⁶ In linear price-sales curves the optimal price is in the middle between variable unit costs (here \$60) and the maximum or reservation price, i.e. the point of intersection of the price-sales curve and the price axis. In the left case the maximum price is \$140, in the right case \$132 dollars (cf. Hermann Simon and Martin Fassnacht, *Preismanagement*, third edition, Wiesbaden: Gabler 2009).

⁷ Statement made in September 2003 during the International Automotive Fair in Frankfurt.

⁸ In a personal conversation with the author, Georg Tacke, CEO of Simon-Kucher & Partners, reported this statement of Wendelin Wiedeking.

⁹ "Sportwagenhersteller Porsche muss sparen." *Frankfurter Allge-*

meine Zeitung, January 31, 2009, p. 14.

¹⁰ Cf. Robert J. Dolan and Hermann Simon, *Power Pricing*, New York: Free Press 1996; Hermann Simon and Martin Fassnacht, *Preismanagement*, third edition, Wiesbaden: Gabler 2009.

¹¹ Cf. Robert J. Dolan and Hermann Simon, *Power Pricing*, New York: Free Press 1996.

¹² The scrapping bonus was 2,500 Euros which at an exchange rate of \$1.30 per Euro corresponds to \$3,250.

¹³ Prices in \$ are rounded. Actual prices in Euros are 225 for the second class and 450 for the first class BahnCard. At an exchange rate of \$1.30 per Euro, this results in the approximate \$-prices.

¹⁴ For a more detailed description of price bundling cf. Georg Wübker, *Preisbündelung: Formen, Theorien, Messung und Umsetzung*, Wiesbaden: Gabler 1998, and Georg Wübker, *Power Pricing für Banken*, second edition, Frankfurt: Campus 2008.

¹⁵ Cf. Hermann Simon and Georg Wübker, "Mehr-Personen-Preisbildung: Eine neue Form der Preisdifferenzierung mit beachtlichem Gewinnsteigerungspotenzial." *Zeitschrift für Betriebswirtschaft*, 2000, pp 729–746.

¹⁶ Study by Simon-Kucher & Partners.

¹⁷ For a more profound description cf. Frank Bilstein and Sebastian Voigt, "Früher war das doch umsonst?," *Absatzwirtschaft*, March 2009, pp. 40–42.

¹⁸ \$-prices rounded, exchange rate \$1.30 per Euro. Ryanair's actual luggage charges in Euro were 3.50 Euros in 2006 and 10 Euros in 2009.

¹⁹ This fee was introduced in 2008 by Tank & Rast, the company operates motorway service areas in Germany.

(Insight + Creativity) x Confidence = Results Profit



Wiglaf Pricing

Price Levels

- New Product Pricing
- Exchange Value Models
- Economic Price Optimization
- Elasticity of Demand

Price Structures

- Two-Part Tariffs
- Add-on Pricing
- Version Pricing
- Bundle Pricing
- Yield Pricing
- Subscription Pricing
/ Customer Lifetime Value
- Two-sided Markets

Price Discounts

- Price Sensitivity Analysis
- Price Variance Management
- Price Promotion Management
- Discount Management

Strategic Price Management

- Pricing Organizations
- Competitive Price Reaction
- International Pricing

Executives seek Wiglaf Pricing to set price levels, manage price discounts, and identify price structures that improve profits. Wiglaf Pricing serves globally leading firms and entrepreneurial endeavors through strategic pricing consulting, executive pricing policy summits, corporate training, and as a keynote speaker at management conferences.

“We know exactly what goes into the cost of each of our goods and services.”

“Our sales force is focused on deal profitability.”

“A 10% increase in the price of our premier product would lead to a 3% increase in revenue...with no net effect on market share.”

We can help you develop the support for such statements – and help you organize the data to back them up, too.

Contact us to learn how.

usdeloittepricing@deloitte.com

www.deloitte.com/us/pricing



Deloitte.

Audit. Tax. Consulting. Financial Advisory.

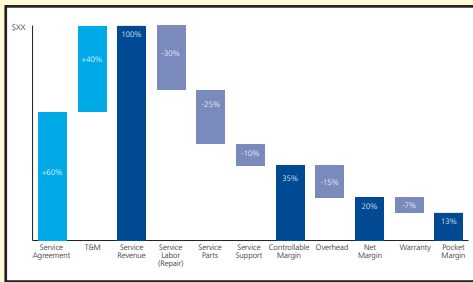
www.deloitte.com

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright © 2008 Deloitte Development LLC. All rights reserved.

Pricing, at your Service



Traditional product manufacturers, who are accustomed to viewing their services organizations as cost centers, are struggling with how to apply pricing improvements to their service offerings and are sacrificing growth and profit in the process. In this article, the authors explore how traditional product manufacturers can unleash the power of pricing on their service offerings. Julie Meehan and Simon McLain are both senior managers with Deloitte Consulting LLP. Meehan can be reached at jmeehan@deloitte.com and McLain at smclain@deloitte.com.

Pricing continues to be one of the most powerful levers available to increase top and the bottom line, and companies continue to leverage sophisticated pricing techniques to improve the profitability of their products. But what about services? **For traditional product-based manufacturers, pricing improvement initiatives are typically focused on the product portfolio, and services are often overlooked or ignored.**

Yet services are becoming increasingly important for both top and bottom line performance across companies and industries. Customers often consider the longer term service component in the total cost of ownership more than the product manufacturers might think. The quality and types of services offered sometimes play a bigger role in the initial purchase decision than the characteristics of the products themselves.

Still, manufacturers have been slow to respond to these customer-driven preferences and are missing very real opportunities to improve their pricing performance. Traditional product manufacturers, who are accustomed to viewing their services organizations as cost centers, are struggling with how to apply pricing improvements to their service offerings, and are sacrificing growth and profit in the process.

The Importance of Services: How should product companies view service?

Given the proliferation of low cost competitors, the increasing demands from customers, the complexity of global supply chains, and the commoditization of products in several markets, product manufacturers are starting to rethink their overall strategy and the impact of service on their business. For many manufacturers, the basis of competition is shifting towards service, as it becomes increasingly difficult to produce a differentiated product and extract the true value of that product from the market.

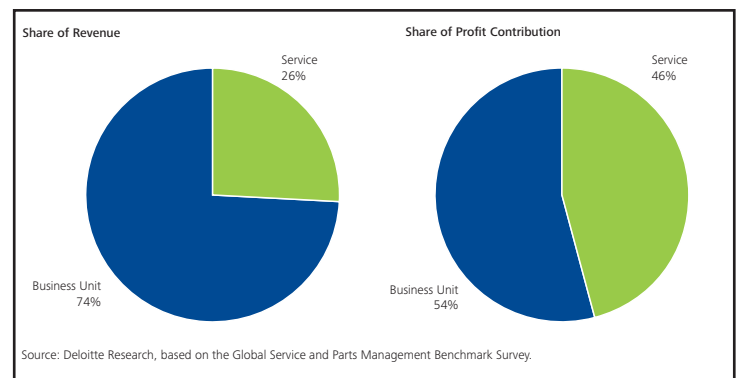
Service businesses that evolved under a product umbrella are frequently viewed as a less valuable “bolt on” to the product business. Sales goals are stated in terms of product revenue only, and services are an afterthought or just a line item under SGA. Often

the sales force is only trained to sell product features, and will use service hours as a leverage point in the negotiation. This attitude can result in millions of dollars of lost profitability.

Regardless of the industry, service is an integral part of the product’s value proposition from a customer’s perspective.

Whether the price of the service is bundled with the product price or not, most customers are savvy enough to consider the Total Cost of Ownership (TCO) when making purchasing decisions. And in many industries, service revenue can be several times the price of the product over the product’s lifetime.

Figure 1: Services Provide Higher Quality Revenues



For an increasing number of companies, services are driving disproportionately more value (i.e., higher margins) than products (see Figure 1). According to one study, the average profitability of service operations is more than 75 percent higher than overall business unit profitability. In fact, the study reported that the most profitable service businesses are more than three times as profitable as the average business unit.¹ And there are many manufacturers who would not be profitable at all without their service businesses (see Figure 2).

Product-based companies that do not recognize the value of their service offerings and their service organizations incur a huge opportunity cost. Service organizations are often the “face of the company” – while a product salesman may interact with the

customer to make the initial sale, the service organization usually has regular and repeated interaction with the customer over time, which could be several decades, depending on the product. This means there could be recurring opportunities to create a positive customer experience and increase customer loyalty by developing long-term relationship, not to mention repeated opportunities to gather market intelligence on behalf of the company.

In addition, service is an essential component of brand identity, and can often become the brand itself. Service is often the differentiator, particularly in increasingly commoditized markets or segments. It is often easier to train service personnel to deliver exceptional service than it is to design a better (or differentiated) product. Organizations can exploit the natural adaptability of a service offering to deliver a truly customized offering to their customer, which can provide much more value than an inflexible, mass-produced product.

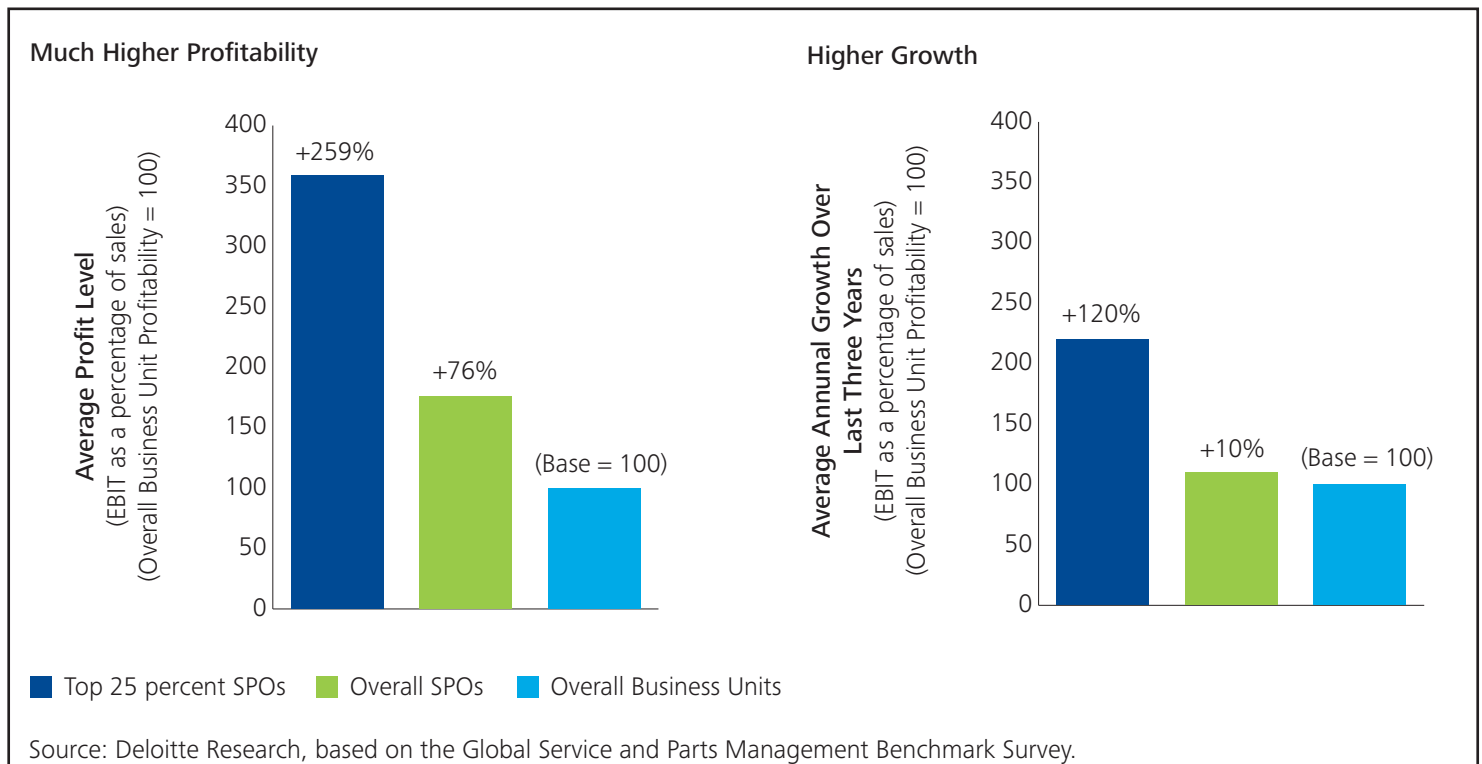
Service revenue can also act as a complement to product revenue, and therefore help in managing a company's overall profitability. Revenue from services can offset product revenue during a trough (if cyclical), or if the product is too expensive to replace. The bottom line is that product manufacturers should recognize the value that their services offerings bring to their bottom line, and then capture that value in the market.

Finding the Value: In what ways can you define the value of services in the context of a product offering?

Quantifying the value of a service offering is, of course, challenging, particularly when the offering is entwined with a product portfolio. A manufacturer is accustomed to defining the value of features that are inherent to the product itself; specific, static qualities that differentiate one product from another, such as size, color, or functionality. With services, on the other hand, customers often value just the opposite: the variability and flexibility of the offering to tailor to their specific needs. For example, they pay for intangible qualities such as responsiveness, uptime, and time to resolution related to aftermarket support. So, are there ways for a manufacturer who offers both products and services to determine where the true value of services lies?

Clearly some straightforward market research will help. Voice About the Customer (VAC) is a good place to start because a lot of the work to prepare for subsequent analysis can be completed without even touching the customer. By conducting internal interviews and surveys, hypotheses about value drivers can be formed and used to define the preliminary structure and parameters of the remaining surveys. Furthermore, perhaps the more valuable result of a VAC analysis is the identification of misconceptions and misunderstandings that may currently be causing the erosion in the market. Sales Reps may think they know what

Figure 2: Profits and Growth: The impact of the service and parts operation (SPO) on business performance



a customer values, but could very well be proved wrong when the customer has the chance to voice their preferences directly. It is important that the survey be multi-dimensional: it should include several functions (such as Sales, Marketing, Services, and Sales Operations) as well as several levels within each function (VPs, Directors, Regional Managers, Sales Reps, etc.). The comparison of the responses should provide valuable insight into behavior that may be affecting the value of the service offering in the marketplace.

Voice Of the Customer (VOC) is an effective way to gather qualitative information that begins to prove and disprove hypotheses about a service offering's value proposition. A VOC survey can not only help a company determine the perceived importance of service offering elements, but can also provide insight into a company's performance relative to competitors and demographic and other information to help identify potential segmentation schemes. And again, the results of the VOC analysis can be compared with the responses from the internal surveys to identify any misalignment between the sales and service organizations' perceptions and the customers' true needs. The areas where there is a large gap in perception are the areas that will require the greatest change management and training efforts upon implementation (see Figure 3).

However, a product manufacturer will still require a tool that isolates elements of the service offering and quantifies the value of each element to the customer. Conjoint [CONsidered JOINTly] analysis is a marketing research technique that forces customers to make tradeoffs in choosing between hypothetical offerings typically in a marketing survey. The key concept is that it is easier for customers to consider attributes jointly as part of a product or service profile rather than evaluat-

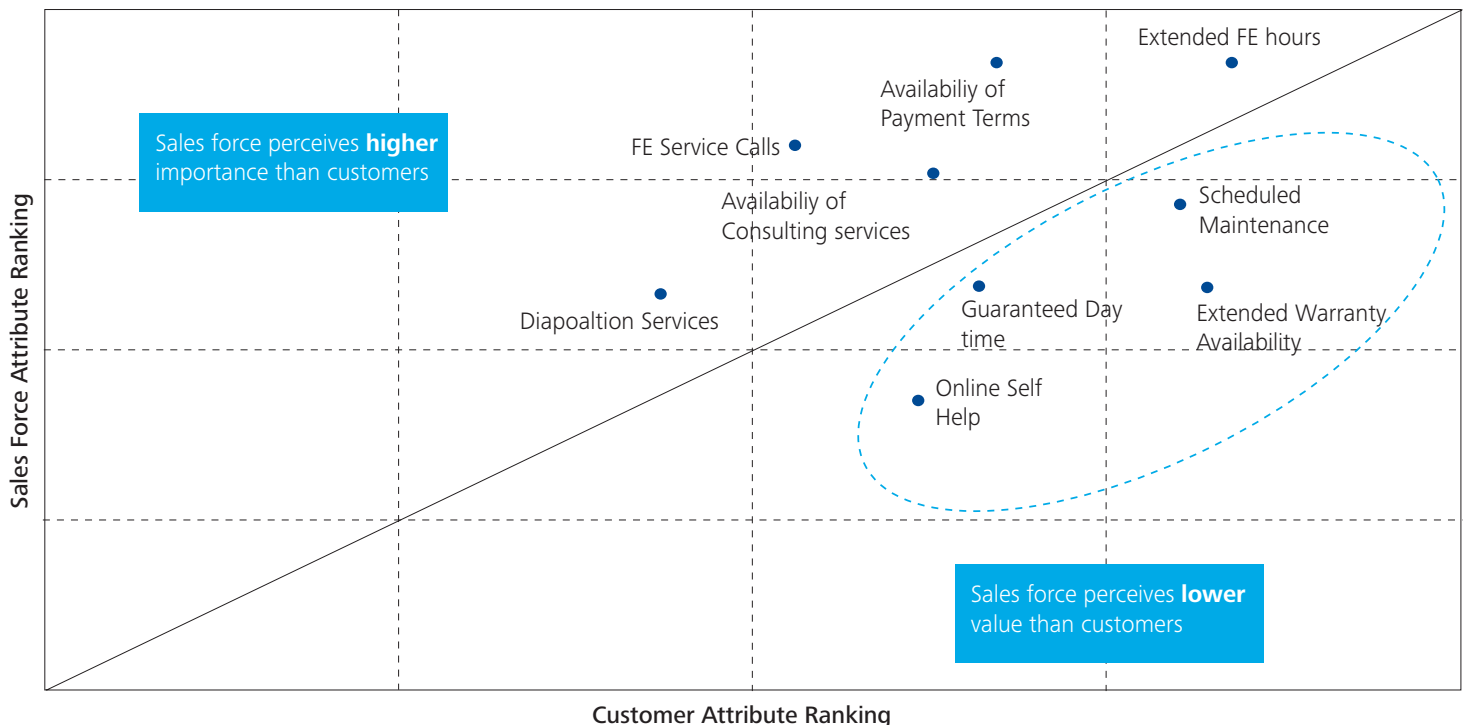
ing the attributes in isolation. In a conjoint study, a survey will present profiles to respondents and ask them to either choose a profile among a list of 2-3 alternatives or to state the likelihood to purchase a given profile. Conjoint Analysis involves questions that are more tangible for customers because it simulates decisions that customers confront in the real world.

Conjoint Analysis is a good tool for product manufacturers attempting to understand the value of their service offering because of the forced trade-offs. If the product and service are integrated, it can be difficult to discern the exact feature that the customer values – and whether it's the product or the service, or the convenience of a supplier that offers both. By forcing the customer to make a tradeoff between scenarios that involve features of both, the value drivers can be more easily identified. The results of a Conjoint survey can help quantify the relative importance that each customer attaches to an attribute of a service offering (see Figure 4).

The combination of the qualitative nature of the VAC and VOC analysis and the quantitative foundation of Conjoint Analysis helps provide a holistic view of the value of a service offering in the market. The data and calculations should be supplemented with anecdotes and customer quotes that complete the picture. This panoramic view will help provide the information necessary for the appropriate and strategic decisions involved in setting a profit-maximizing price without negatively impacting customer satisfaction or loyalty.

Once the service value is identified and captured in the market, the next challenge for a product manufacturer is managing the profitability of their combined product/service offering over time.

Figure 3: The gaps between VAC and VOC can reveal differences in perceptions



Note : All data points are hypthetical

Figure 4: The results of Conjoint Analysis can help quantify the value of each service attribute

Attribute*	Average—30.0%										Importance Level
	10%	15%	20%	25%	30%	35%	40%	45%	50%		
1. Response Time											15%
2. Uptime Guarantee											11.3%
3. Parts Cost Coverage				7.1%							
4. Price			10%								
5. Labor Cost Coverage	17.5%										

*Note:- All data points are hypothetical

Once the value of the service is quantified, pricing the service requires consideration of other factors such as customer segments, competition, and firm strategy. Needless to say, competitive pressures often define a band of price that would be viable in the given market setting, and companies have to be careful that they don't set a price that gets the service and associated products out of the consideration set of its customers. The company should also be wary of the negative brand connotations that accompany setting a price far below a reference price set in the minds of the customer. Above all, every analysis should be checked for validation and compliance with company strategy. Companies with a market penetration strategy often set prices aggressively low to capture market share and drive out competition from the business. On the contrary, a skimming strategy would entail setting a premium price and enjoying the high margin from a select few customers who can justify the premium price for the value provided by the service.

Providing Service at a Profit: How is pricing for services different from pricing for products?

Armed with a better understanding of what customers value across a company's product and service offerings, are there ways an organization can more effectively turn this value into profit? It starts with understanding profitability.

Understanding the profitability of services differs considerably from understanding product profitability. To start, the "price waterfall" construct is increasingly being used to understand profitability for an organization or business unit (Figure 5). If developed appropriately, this construct allows an organization to "cut" the underlying data in different ways to reveal the variations in profitability across markets, segments, customers, product offerings, etc. and therefore understand the major drivers of margin leakage. Although the specific components of a waterfall will differ across organizations, typical elements include initial discounts off of list price (special pricing, volume discounts), off-invoice discounts (rebates, commissions), various costs-to-serve (freight, free goods) and the costs of the product itself (cost of goods sold).

In order to understand the profitability of services, it is helpful to develop a "Service Price Waterfall" to more accurately define the various service-related elements that impact profitability. For example, whereas the cost of goods sold is often a

major driver of product profitability, service costs are primarily related to labor (including associated costs such as travel) and other support costs (warranties, call centers operations, etc). Additionally, whereas product revenue can often be related back to an individual transaction, service revenue (and costs) is often spread out over months or years depending on the service arrangement.

Depending on the structure and maturity of a service organization, developing a Service Price Waterfall can, at first, be challenging. For example, many organizations embed services into product-based business units and bundle service revenue into product pricing. On the other hand, some service organizations operate as a profit center and therefore have consolidated service-based revenue and costs into a P&L, which may make the initial waterfall definition somewhat easier. In either case, however, there are significant differences that must be considered in constructing a service price waterfall (see Figure 6).

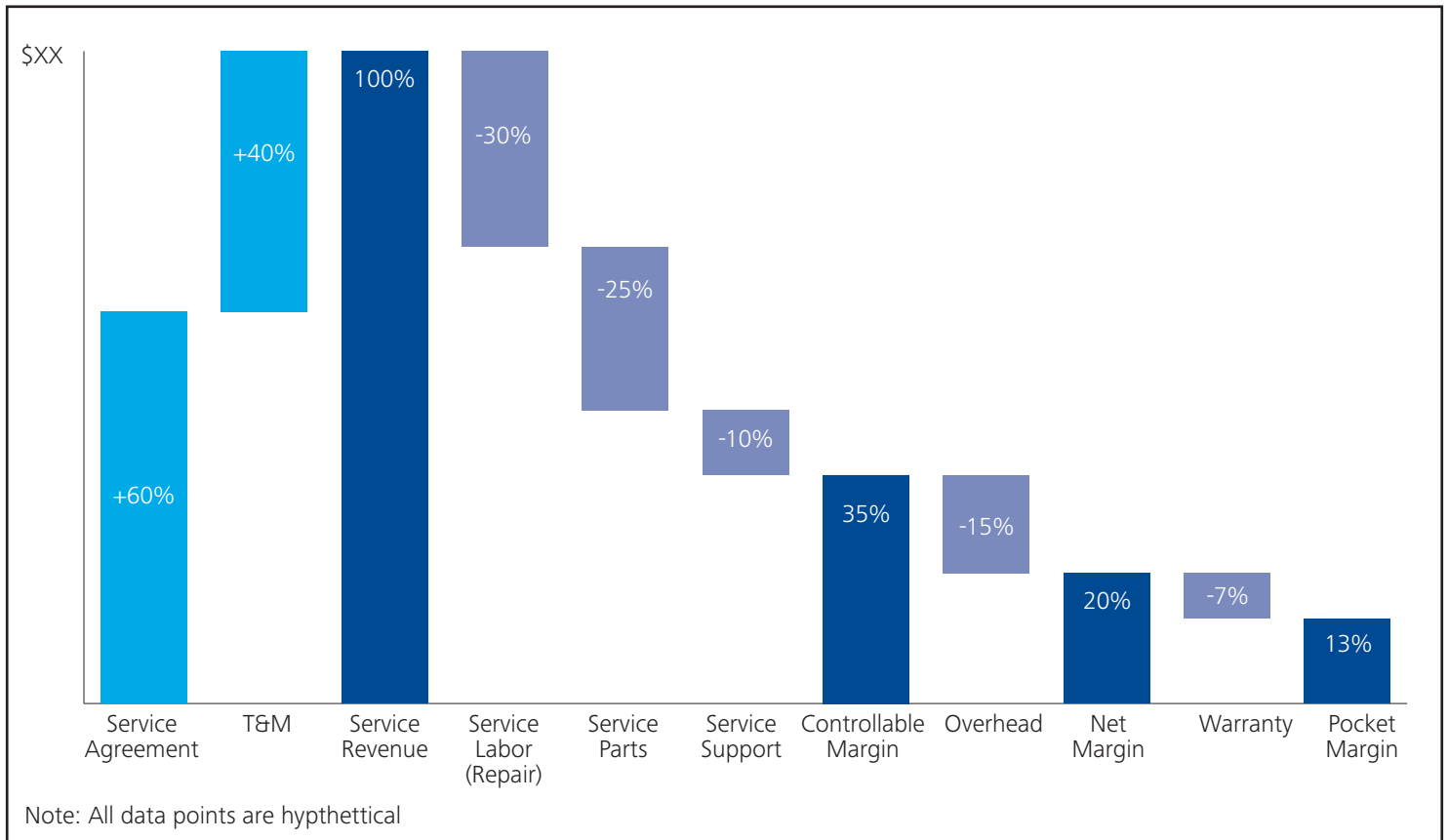
Once a service waterfall has been developed and an understanding of the revenue and profitability drivers across the product/service spectrum has been identified and quantified, an organization can more effectively manage the short and long-term tradeoffs between product and service revenue/profit.

Making it Stick: In what ways can an organization look holistically across the product/service offering to maximize profits?

Some manufacturers have recognized the changing landscape and have initiated pricing improvement projects. However, even for these companies, the challenge will lie in making short-term and/or narrowly-focused improvement efforts sustainable for the entire organization. **Like all successful transformations, sustainable and profitable growth of the service business requires a significant investment in talent and resource development.**

For many manufacturers, this represents a fundamental change in how they view their business. These companies produce a product, a tangible good, and their entire infrastructure exists so that the product can be designed, produced, and delivered while maintaining a profit. However, a holistic view of a combined product and service offering requires the business to focus on customer requirements, not what a company has to offer. It requires customer-centric planning and analysis, not product-centered data and reports. Repositioning an entire organization to

Figure 5: Illustrative example of a Services Price Waterfall



focus on customer needs is a significant undertaking, and requires changes to compensation plans, training programs, and even supporting technology.

For most manufacturers, the service organization grew up in the shadow of the product portfolio since the founding of the company. This means there is often an innate organizational attitude that products are the main driver of profitability and that product sales must be achieved at all costs. Overcoming this prevailing mindset can be extremely challenging, and the group facing the biggest change in this situation is the Sales organization.

An effective and immediate tactic for changing the behavior of any employee is to change the rewards and recognition system. This is especially true of the Sales organization, which often has a variable component to their financial compensation. It is therefore imperative that metrics and compensation plans are aligned with the holistic view of the business and the enterprise-wide goals for profitability. A straightforward yet effective way to implement an appropriate incentive scheme is to base the metric on profit margin, and not revenue or volume.

Under this approach, Sales Reps no longer re-

Figure 6: Significant differences between product and services Price Waterfalls

	Product Waterfall	Service Waterfall
Revenue	Associated with an individual transaction; identifiable to a specific product sale	Often associated with a service contract; may cut across product offerings (e.g., service contract that covers a range of product offerings)
Timing	Transaction-based (point in time)	Contract-based (viewed over months and years)
Discounts	Based on volume, product mix, etc.	Often based on service levels, with additional discounts applied
Major Profitability Drivers	Discounts off list price, rebates, commissions, costs of goods sold, freight etc.	Labor, travel, support operations, parts (for service parts businesses), etc.
Cost Allocations	Often based on product volume/sales	Often based on labor
Base level of Profitability	Developed at a transaction level	Typically not transaction based; viewed over a period of time
Data	Typically housed in various parts of the organization; need to consolidate and associate with individual transactions	Often embedded in product organizations "cost to serve"; need to break out service related revenues and costs

ceive a bonus for landing a big deal in which a large volume of products are sold but the service component is practically given away to close the deal. Inappropriately discounting services to drive product sales is a behavior that must be corrected instead of rewarded. Instead, Sales Reps must be motivated to craft a deal with the right balance of product and service volume and discounting so that overall profitability is maximized. In some cases, this may mean significantly more services revenue than product revenue will be logged on individual deals. If the incentive structures are aligned correctly, both the Sales Rep and the company will benefit from these deals.

This scenario assumes that the Sales Force is trained appropriately to price holistically across the integrated product and service portfolio. The effort and timing for adequate training should not be underestimated; it requires training on sophisticated profitability analysis as well as on selling service features that may be unfamiliar to the Sales Reps. The Sales Force must not only become well-versed in the company's service offerings, but must also learn how to be effective in selling service and its components. Given the infinitely customizable nature of a service offering and the complexity of product-service interplay, this skill requires time and practice to master, even for the most experienced product Sales Rep.

The Sales and supporting organizations must be trained to understand the true profitability of each deal, which includes analyses such as Price Waterfalls, Customer Profitability, and Price Bands. If these concepts are new to the organization in general, there will be a significant learning curve. Even if these concepts are familiar, a thorough profitability analysis that integrates products and services will take effort to design

and understand to a degree that it can be used to create profitable deals.

Any improvement in services profitability, whether great or small, short- or long-term, can be beneficial to a manufacturer in several ways. But ultimately the goal should be to avoid deploying a one-time, short-term project and to create an organization that is focused on pricing excellence and designed to maximize profitability on an ongoing basis across the entire product and service portfolio. An effective way to expand and sustain the improvement is by implementing changes to compensation plans in the Sales organization, designing comprehensive training programs, and making use of appropriate supporting technology.

An effective and immediate tactic for changing the behavior of any employee is to change the rewards and recognition system. This is especially true of the Sales organization, which often has a variable component to their financial compensation.

Conclusion

A company's service offering can significantly impact customer buying decisions, as well as drive improvements in top and bottom line performance. However, many traditional product-based companies overlook services due to their historic focus on products and product development, which limits their ability to leverage the service

elements that are often integral to their value proposition. By understanding the value of services to different customer segments, determining the profitability of service offerings, and addressing the organizational constraints that often pit products groups against service functions, companies can finally unleash the true profit potential of Services.

Endnotes

¹ Jeffrey J. Glueck, Peter Koudal, and Wim Vaessen, "Putting a Premium on Service." *Supply Chain Management Review*, April 2006

UP AND TO THE RIGHT GET BACK ON TRACK WITH VENDAVO



IMPROVING PROFITS ACROSS INDUSTRIES

HIGH TECH

MANUFACTURING

CONSUMER GOODS

MILL PRODUCTS

PROCESS

SERVICES

DISTRIBUTION

Leading Provider of Price Management and
Optimization Solutions for B2B Companies



Vendavo Headquarters 1029 Corporation Way, Palo Alto, CA 94303 | **Phone** 877.836.3286 | **Fax** 650.962.0645

European Headquarters 3rd Floor 24 Chiswell Street, London EC1Y 4YX, United Kingdom | **Phone** +44 (0) 208 133 0744

Email info@vendavo.com | **Web** www.vendavo.com

Recognize this company?

There is a good chance that insights and solutions from Simon-Kucher helped create the pricing strategy for the:

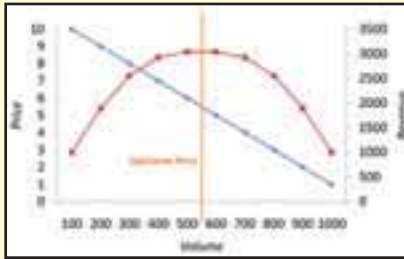
- ▶ raw materials to build its factory
- ▶ machines running in that factory
- ▶ raw materials that go into those machines
- ▶ ERP software
- ▶ chips that enable that software
- ▶ labels on the products
- ▶ ink on those labels
- ▶ courier that ships the products
- ▶ trucks that the courier uses
- ▶ fork lifts in the warehouse
- ▶ tires on those fork lifts

Are you sure that you have the right prices for your products and services?

SIMON • KUCHER & PARTNERS
Strategy & Marketing Consultants

www.simon-kucher.com

The Problem with Price



Pricing a product is one of the most challenging decisions marketers have to make. The problem is even larger when a price is needed for a product that is conceptually new. In this article, the author highlights the importance of well constructed pricing research in the increasingly competitive global marketplace, as well as specific applications for research results in pricing new products or modifying existing price structures. Nick Hague is a founding member and director of B2B International (www.b2binternational.com). He has extensive experience in the design and execution of market research projects across a wide variety of industries, and can be reached at info@b2binternational.com.

In the ever-changing business world of today, with increased globalization and low-cost manufacturing from Asia, competitive advantage is key. Competitive jostling is a never ending battle as continuous product innovations result in shifts in competitive advantage. Consequently the question most companies ask themselves is ‘How do we get more?’ This is one of the hardest questions to answer.

The strategy of cost cutting, whilst intuitively making sense, is usually a road to ruin as some smarter competitor, often working from a new geography with a lower cost base, undercuts you. Very few companies can sustain the cost advantage for long. Equally, attempts to increase sales by any means such as ramping up the promotions (or cutting costs) or increasing the value added, takes considerable time. In fact, raising prices has to be seen as the easiest option to give more profit.

Therefore the big question that needs answering is this: “If the price is increased, will sales volume decline and if it does, will it be more or less proportionately to the rise in price?” No company wants to leave money on the table and so obtaining the optimum price has always been a key issue to marketers. However, asking customers to quantify the price they would be willing to pay for a product or service is one of the hardest questions for any researcher as the customer may not feel that they can answer such a question or, if they can, it may not represent their true actions if such a price was introduced to the market.

This paper explores these quandaries and lays out some principles of pricing research.

The Basics Of Pricing

Testing the price acceptability of a product or service in comparison to the competition is the main principle of any pricing research. The basic law of demand is the relationship between the price people or companies want to pay and the amount they want to buy. However, the relationship needs to be carefully considered in business to business markets because the rules differ considerably according to whether the product is a commodity (grains, minerals, metals, etc.) or manufactured. We can recog-

nize a simple supply and demand curve that illustrates output will settle at an optimum price.

Pricing In Industrial Markets

Commodities within any one group are totally undifferentiated; they are classified according to a standard such that their price depends upon supply and demand. Speculation about a shortage of the commodity or the belief that it is an investment hedge will have short term and maybe dramatic effects on the price. As the commodity becomes processed into cement or steel, it gains value, and the sophistication of the processing method enables a premium price to be charged. As the design element of a product increases and the value of the raw material becomes less important, so pricing becomes more complex. The price for design skills is more difficult to pitch.

No company wants to leave money on the table and so obtaining the optimum price has always been a key issue to marketers.

A product with a considerable element of design becomes “differentiated” from those with which it competes, and buyers are faced with the problems of placing a value on the various benefits on offer. Normally a differentiated product allows the seller to take advantage of the multiplicity of features and charge a higher price. This is not to say that the customer is insensitive to price - rather that he perceives differences in the choice of products available and selects one which best meets his needs. However, the price elasticity, or the level to which demand changes with a price change, may be quite low with differentiated products. This may be because of the uniqueness of the offering but it could also be because of difficulties of switching industrial products. Getting a new product specified, changing

the inventory and persuading the users in the company that the new product is just as good may introduce a serious level of inelasticity.

Of course, design is only one factor which buyers evaluate when considering the price of a product. They will also attribute a value to after sales service, reliable delivery, speedy delivery, quality, longevity as well as the brand. A strong brand gives the buyer confidence and enables companies to command a premium price even if the products are similar to the competition. Any pricing research needs to take these factors into consideration.

How Can Research Help?

The link between prices charged and volumes sold is not a hard one to grasp; the difficulty arises when the question is asked – With an X% price increase, how much will it affect our sales? A price increase may result in a customer's reduced consumption, switching to a substitute product or ceasing to purchase your product altogether. On the other side of the coin, your company may be missing the chance to gain additional profit through charging more – it is all down to customers' value perceptions and what they will pay.

When looking at pricing strategies, information on customer value, the market competition and costs are all paramount to the customer value created and whether the given price can be sustained. However, taking all this into consideration still doesn't help us place a value on customer inertia and product or company brand. Therefore, pricing research should be seen more as a tool to confirm assumptions rather than to scientifically pinpoint exact market dynamics.

First Steps In Pricing Research – Desk Research

The first question that needs to be asked before commissioning any piece of pricing research is “Are there any previous indicators of what has happened to sales figures when prices have changed in the past?” Historical data can give useful clues

Figure 1: Simple Supply & Demand Equilibrium

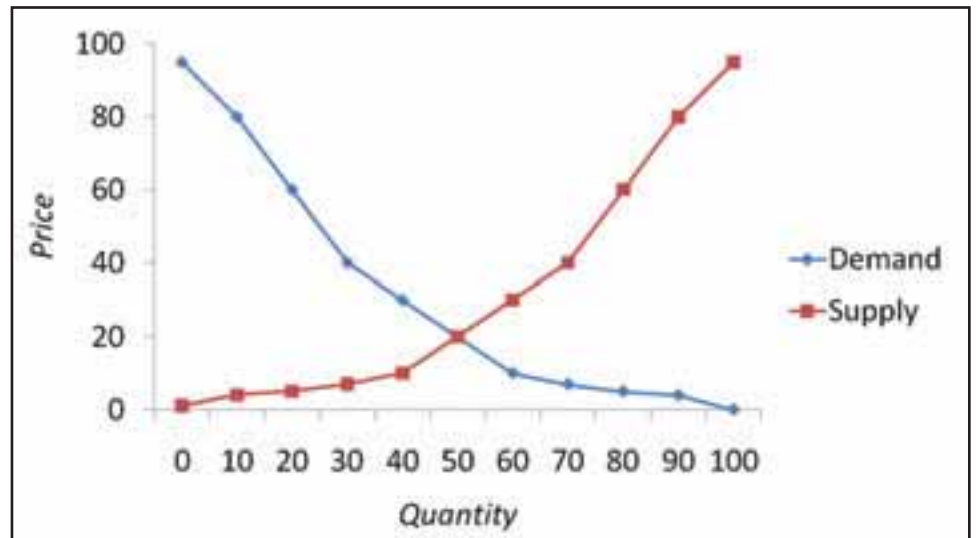


Figure 2: A Product With An Inelastic Demand

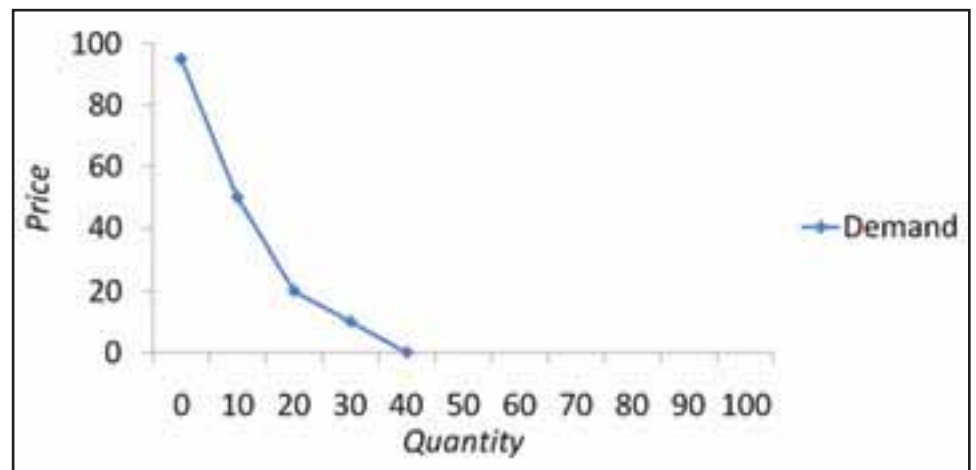
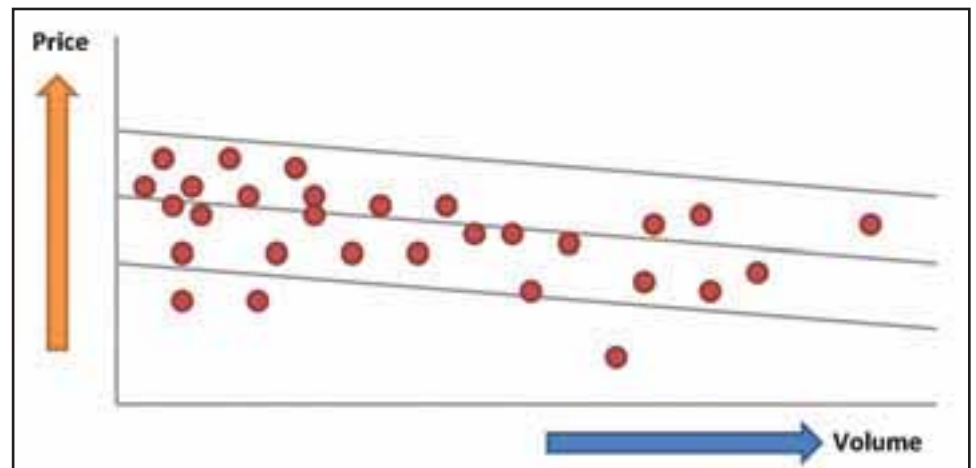


Figure 3: Dispersion Graph Of Customers



but needs to be handled carefully, especially if a price change resulted in negligible volume effect because competitors' prices may have moved in line at the same time. It is therefore vital when looking at past price data that awareness and knowledge of the competition's past pricing strategies is available. Another problem with historical data is that it is just that: past data. We are interested in predicting future trends and changes and the relationship between price and volume established in the past may not hold true with different market forces. However, a scatter graph of prices paid for customers buying different volumes has to be a starting point in gauging the slope of the demand curve.

Primary Research – Different Pricing Techniques Used

Primary research is based on customers' predictions of what their possible actions would be if a price increase/decrease was to take place. It is one thing asking the customer how much extra he or she will pay for a new and improved product/service but in the cold light of day, will that person put their money where their mouth is?

Due to the hypothetical nature of such questioning caution needs to be taken with any research conclusions.

Figure 4: Gabor-Granger Price Volume Curve From Market Research

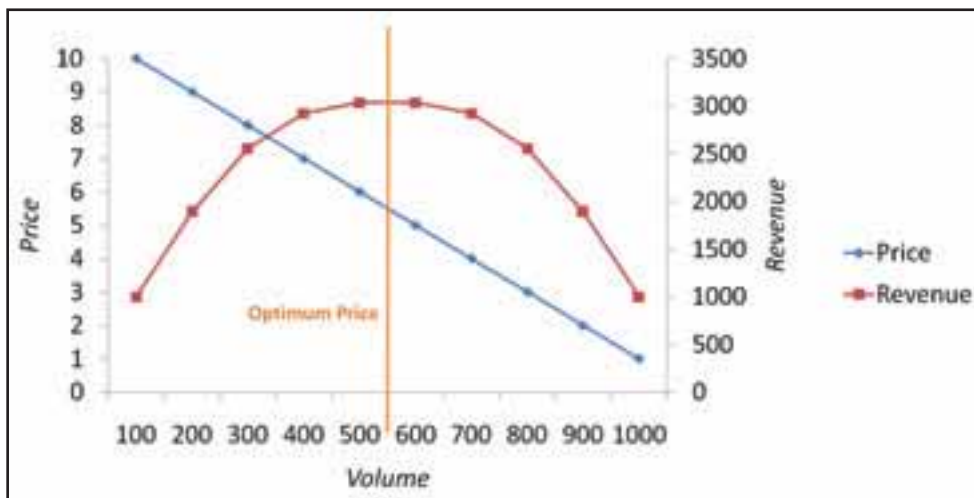
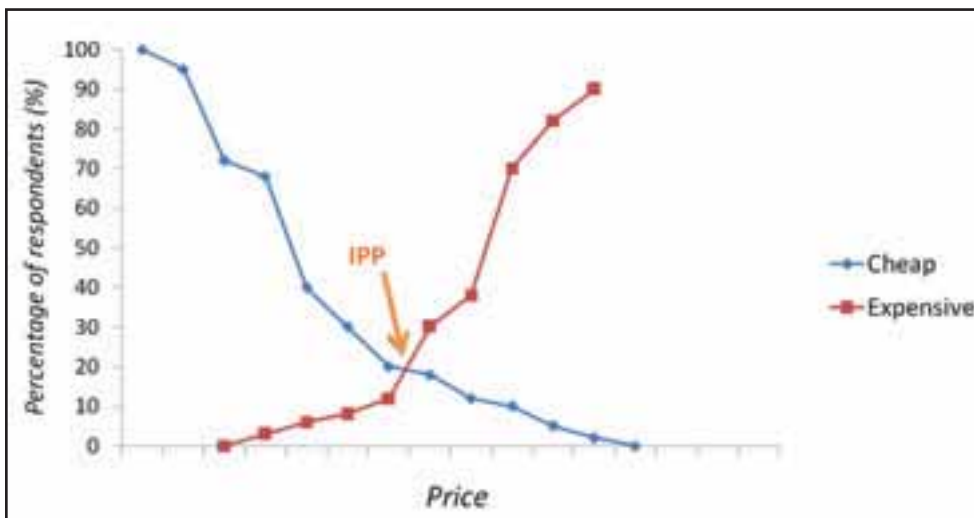


Figure 5: Indifference Price Point



Various research techniques have been developed to overcome nuances in the data collected, giving more robustness to research recommendations.

The only sure way of obtaining accurate price elasticity information is to carry out a test market – in other words to create a situation where customers are exposed to real price changes with real demand pressures. This is almost impossible to engineer and so we use the best alternative that was developed by two economists (Gabor Granger) in the 1960s. Customers are asked to say if they would buy a product at a particular price. The price is changed and respondents again say if they would buy or not. From the results we can work out what the optimum price is for each individual and by taking a sample of customers we can work out what levels of demand would be expected at each price point across the market as a whole (the demand curve in the following diagram). Using this estimate of demand, the price elasticity (or expected revenue) can be calculated and so the optimum price-point in the market established.

A more sophisticated variation of the Gabor Granger technique is called **Van Westendorp** pricing. Price Sensitivity Measurement (PSM) was devised, in the 1970's, by a Dutch psychologist, Peter van Westendorp. This technique uses four questions about a product or service and requires the respondent to rate each price on a scale from too cheap to too expensive.

The respondent is asked the following four questions concerning a product or service they could receive at various different price rotations:

1. At what price would you consider this product/service to be cheap?
2. At what price would you consider this product/service to be too expensive?
3. At what price on the scale would you consider this product/service to be priced so cheaply that you would worry about its quality?
4. At what price would you consider this product/service to be too expensive to consider buying it?

Analysis of the data yields several distributions shown in the following diagrams. Various intersections on the curves yield inputs for pricing decisions and the resultant price difference helps to determine the pricing options that can be used.

The Indifference Price Point (IPP) is where the number of respondents who regard the price as cheap is equal to the number of respondents who regard the price as too expensive (see Figure 5). According to Van Westendorp, this gener-

ally represents either the median price actually paid by consumers or the price of the product of an important market leader. IPP is based on customers' experiences with price levels in the market and will change with market conditions.

The Optimum Pricing Point (OPP) is the price at which the number of customers who see the product as too cheap is equal to the number who see the product as too expensive. This is typically the recommended price.

The range of prices between the Point of Marginal Cheapness (PMC) and the Point of Marginal Expensiveness (PME) is the Range of Acceptable Prices for a product. According to Van Westendorp, in established markets, few competitive products are priced outside this range – see Figure 7.

Pricing a product is one of the most challenging decisions marketers have to make. The problem is even larger when a price is needed for a product that is conceptually new. Because customers are not familiar with it, benchmarks for price are not available and the purchasing decision is an unknown quantity. A price too high would scare would be customers off while underestimating a product's value can be a costly mistake since the introductory price often fixes its worth in the buyer's mind. It is therefore crucial that a larger than normal sample size is used so that all findings are statistically robust. For many companies, this can make pricing research expensive, unless combined with a range of other measurements that can establish where customers would welcome an improvement in either products or services and what premium they would pay for those improvements. This type of research looks at what the opportunities are for up-selling (obtaining more value for the products and services) and where there are unmet needs that a company could exploit by making a more attractive offer.

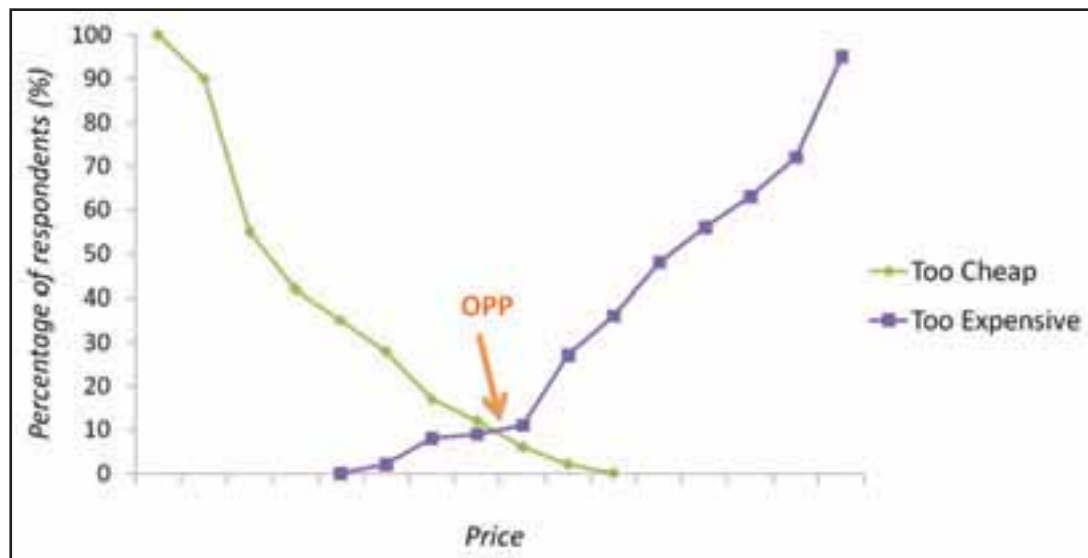
Conjoint Analysis – Trade-Off Research

In the 1960s and 70s, academics were looking to understand how people made decisions. If you just asked people, they tended to say what was top-of-mind, or what they thought the interviewers wanted to hear (so that people said didn't necessarily reflect what they actually did).

However, the academics noticed that almost all choices involve compromises and trade-offs, as the ideal is rarely attainable (we might want a Rolex watch, but we typically have to compromise to something a little less expensive for example).

In their studies, the academics found that by looking at how people made selections between a limited number of products involving different trade-offs, they were able to accurately predict which choices would be made between previously untested products. Conjoint Analysis was born and is based on the un-

Figure 6: Optimum Pricing Point



derstanding of how people make choices between products or services, so that businesses can design new products or services that better meet customers' underlying needs.

To understand how conjoint analysis works, we need to be able to describe the products or services consistently in terms of attributes and levels in order to see what is being traded off.

An attribute is a general feature of a product or service – say size, color, speed, delivery time. Each attribute is then made up of specific levels. So for the attribute color, levels might be red, green, blue and so on.

For example, we might describe a mobile telephone in general terms using the attributes, weight, battery life and price. A specific mobile phone would be described just by levels say as 80 grams, 8 hour battery costing £150.

Conjoint analysis takes these attribute and level descriptions of product/services and uses them in interviews by asking people to make a number of choices between different products.

For instance would you choose phone A or phone B?

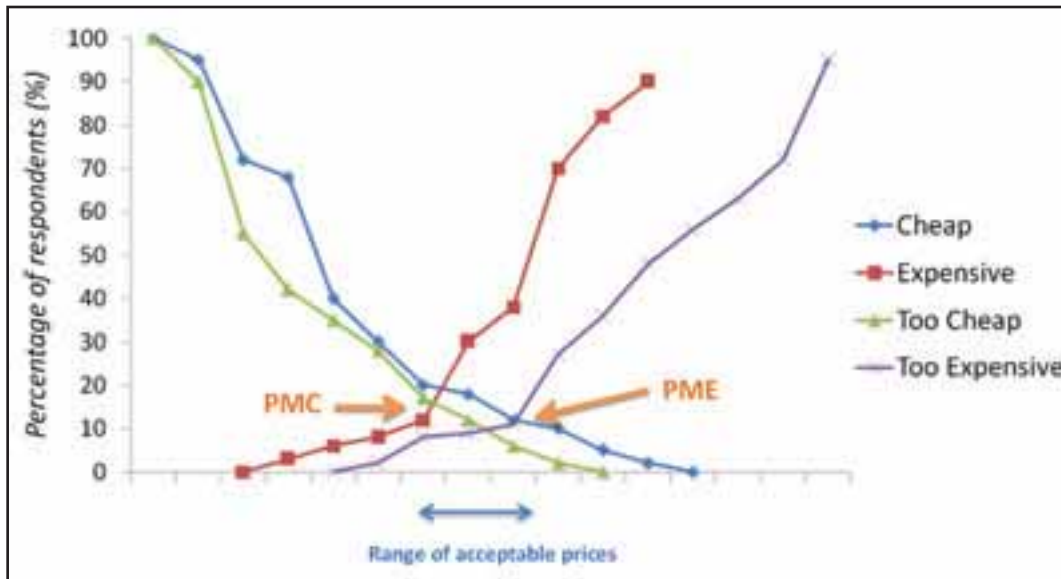
	Phone A	Phone B
Weight	200g	120g
Battery life	21 hours	10 hours
Price	£70	£90

In practice you can see how difficult some of the choices can be. The thought process might be:

“Phone A is bulkier, but has the battery life and lower cost, but Phone B is smaller and neater yet more expensive and with lower battery life. Lighter weight is worth more than the loss of battery life, and it's probably worth the extra £20, so I'd choose B in this instance.”

By asking for enough choices (and with good design to mini-

Figure 7: Range Of Acceptable Pricing



mize the number of choices you need to ask), the researcher can work out numerically how valuable each of the levels is relative to the others around it – this value is known as the utility of the level.

The problem for business researchers until now has been the cost of carrying out conjoint analysis. In order to arrive at reliable results it is necessary to carry out at least 100 interviews and we feel more comfortable with 200 or more. These interviews have to be face to face so that respondents can view the concept cards and make their choices (in practice the choices are usually presented on a laptop computer screen). Think 200 face to face interviews scattered across Europe and you are thinking €300,000+ survey cost. For many companies this will break the market research budget. However, the same project carried out on line could be carried out for a fifth of the price. The conjoint on-line interview would use the telephone to recruit and qualify the respondent and collect base data while the conjoint choices are made by the respondent in a self-completion interview that is e-mailed back to the research company.

SIMALTO - Simulated Multi-Attribute Level Trade Off

Trade-off grids are an approach to collecting information from respondents that recognizes that an individual customer cannot have everything. He or she has to make trade-offs to get the best product they can buy. The classic trade-off is between price and quality, but in practice when considering most purchases we make trade-offs between different features and service levels and even emotional risk.

A trade-off grid is a method of getting underneath a customer's general wish list to really understand what they must have and what are "the nice-to-haves." This means we can see what is really valuable to a customer and with a few further questions. We can also understand what their priorities would be for trading up or improving the current system.

The factors that a customer may be interested in (also called attributes) are laid out on a grid showing different levels (see figure

8) - low levels of the attribute at the left rising to higher levels towards the right hand side of the grid. With the grid, we can then ask the respondent to complete a number of tasks. Typically the first task is to find out where he or she would want a "first class supplier" to perform – this sets the ideal standard. Next we can ask where your company is currently performing. We can then ask them to do a number of different things – for instance to prioritize improvements in your company's performance one square at a time, or to ask questions such as if you had more of x, what would you be prepared to sacrifice from y.

Each level of attribute has a number which is used by the respondent in a "points spend" question where they are asked to show how they would spend 30 points (by way of example) to improve the offer they receive at present. The way that the points are spent indicates the trade-off that each respondent is prepared to make to move from one level of delivery that they receive at the present to one that could be offered (but at a higher price). This trade-off enables us to see specifically what a supplier could do to win more business and at what price. The outcome is thus a detailed understanding of where the customer would like improvements and what those improvements should be.

SIMALTO grids have the advantage over conjoint in being easier to apply in business to business situations. For example, we often have to test many attributes in business to business customer value propositions and this creates a complex task for the development of the conjoint choices. Respondents get tired in conjoint interviews which require them to make dozens and dozens of choices between attributes or to consider concepts, which, after the 30th one has been shown, begin to look the same. Also, the output from a SIMALTO survey makes complete sense to a manager in business who wants to know "what proposition should I go for" and "how much should I charge." They are saved from the black box mystery of the conjoint utility values.

The Guiding Hand Of The Agency

With product life cycles shrinking, customers becoming more sophisticated and demanding, and tougher local and even global competitors emerging in most markets, markets are shifting at faster rates than ever. The payoff for getting your company's pricing strategy right has never been more important.

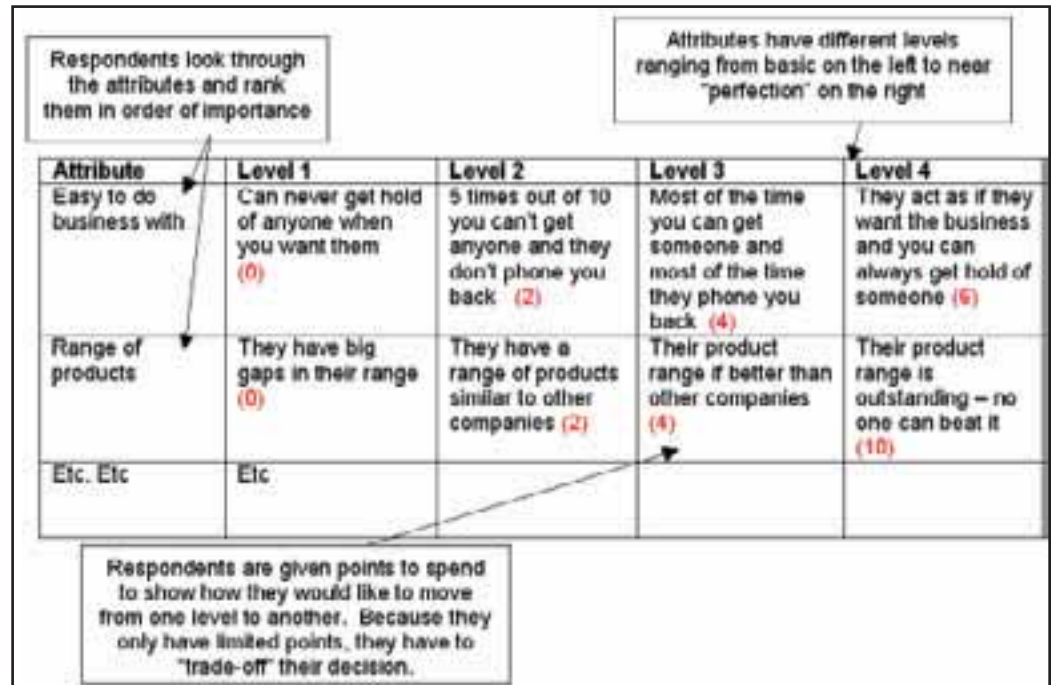
Pricing research usually concentrates on customers' sensitivity to pricing. This price sensitivity is driven by the nature of the market, the competitive environment, the target within that market, the differentiation level of the product or service, and the value of the brand.

The responsibility of any research agency is that of the being

a realist. The subject of pricing research is an emotionally charged area and who can really say what a customer will do until it comes to them actually putting their hand in their pocket. We need therefore to have the confidence to say that a specific price is the one that respondents have stated they would buy at – but we know that it is all hypothetical and that sometimes a ballpark is needed to enable a test market experience so to gather buying patterns on how buyers/users will react.

Pricing research can be used to obtain an understanding of the pricing levels for specific product service offerings. It can also be used to attain an understanding of the additional services customers subscribe to and what additional price they would pay, to identify the elasticity of demand for a product or service, and to establish where customers would welcome an improvement in either products or services

Figure 8: SIMALTO Grid



offered and what premium they would pay for those improvements.



FASTER RESULTS. HIGHER PERFORMANCE.

**PROS PRICING SOFTWARE DRIVES PROFITABILITY AND
KEEPS YOU AHEAD OF THE CURVES.**

Business moves fast. You have to move faster. That's why PROS, the leading provider of business-to-business price and margin optimization software, gives you the only enterprise-class system that upgrades in hours. It's no wonder all of our manufacturing and distribution customers upgraded their PROS software this year.

PROS gives you an additional edge with access to the latest in pricing science and technology thought leadership that helps you understand your pricing challenges and make smarter decisions. In fact, one company using PROS improved its annual revenue by \$200 million.

Get more performance from your pricing. Visit PROS online for more information.

THE WORLD LEADER IN
ENTERPRISE PRICING SOFTWARE.

PROSTM
www.prospricing.com

NYSE: PRO

