The PRICING ADVISOR

PROFESSIONAL PRICING SOCIETY

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Discounting is often used by managers as a short term solution for hitting revenue targets. However, most managers don't understand that the effects of discounting are long term, and often become so addicted to the "quick fix" that they are unable to kick the habit. This practice can have a detrimental effect on how customers value your products and services, as the author explains. Dr. Reed K. Holden is Founder & CEO of Holden Advisors, PPS CPP Faculty Member, and frequent PPS contributor and presenter. He can be reached via www.HoldenAdvisors.com. This paper published in The Journal of Business Strategy by Emerald Publishing Group. (© 2008 Journal of Business Strategy, Emerald Publishing Group)

Kick the Discounting Habit: The 1st Step to More Effective Pricing

Price discounting has become the crack cocaine of business. A brief high is followed by devastating effects on both revenue and profits.

The addiction starts when managers decide to use price discounts to hit revenue targets. They assume it is only temporary, that price discounting is a quick fix to a small problem. Soon that quick fix becomes a major element of business strategy. Eventually discounting becomes the tool of first resort to fight the effects of a market downturn, intense competition, and increased sophistication of buyers.

It's a futile strategy. Customers know that if they hold orders for the end of the quarter, even the strongest managers will panic and fall to the siren's song of the price discount. The net impact of this terrible habit is that margins and profits fall. To make matters worse, when markets begin to slow, those price discounts begin to cause revenues to drop.

The real problem is that over time, the quick fix of discounting becomes so in-

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- **Maximising Profits with Razor Sharp Pricing Research Insights** – Paul Hunt & Tony Hodgson
- **Implementing Value-Based Pricing & Value Selling in your Organisation** – Frederik Van Bever & Daniel Soto Zeevaert
- **Global Pricing for Executives Summit** – presentations by Kellie Ecker, Mark James, Frédéric Duhamelle, Jim Rich, and Raymond Almeida
- **Business to Business Pricing** – Andrea Maessen, Ph.D. and Philip Daus
- **Pricing Negotiations** – Marc Abels & Mar Areosa
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grained that managers are incapable of kicking the habit. They believe that discounting is a necessary evil–that theirs is a unique and tough business where price discounting is the real test of the abilities of seasoned managers. This is when discounting causes managers to lose sight of what's really at stake: how customers value a firm's products and services.

The White Horse Syndrome

I once attended a presentation to a high-tech firm's dealers. During the event, the CEO of the firm stood up and talked about how the firm was going to make value a key element of their strategy going forward. Sure everyone listened, but no one believed in it. Why? Because she and most of her senior managers suffered from an affliction we call "The White Horse Syndrome." This illness tends to strike senior managers in companies at the end of a fiscal quarter. A major symptom that the illness is about to strike is that the firm hasn't met its revenue numbers.

The problem is when individual managers decide that their special circumstances warrant dramatic price discounting to achieve their financial goals. Of course, pretty soon, every manager claims special circumstances.

Prior to the symptoms appearing, the salespeople might have been trying hard to prove the prices being charged are fair. They've been negotiating well with customers. But the customers know that this disease, while deadly to the firms that catch it, is actually quite beneficial to them. So they hold their orders, encouraging the onslaught of the illness.

As the dreaded "end of quarter" days come to a close, sweat appears on the brows of senior managers. They know in their hearts that they will have to become the heroes of the hour, jumping on their white horse, riding out into the wastelands of customers, and close deals to save the day.

The problem comes with how they close deals—they use price discounts. Lots of them. Do they make their numbers? Maybe. But along the way they show the customers how smart they are to hold their orders. They show the salespeople they might as well be playing golf, because they aren't going to close any orders until the senior managers show up.

The White Horse Syndrome leads to the pricing death spiral as revenues begin to decline, profits disappear and systems are developed which actually encourage the whole process. In part because of this illness, "senior managers present the greatest number of obstacles in price setting."[1]

Sure, You Have to Meet Your Numbers

Yes, the reality of business is that managers have to meet their quarterly and yearly revenue projections. The expectation is that managers responsible for a revenue number will sell hard to meet their objective and, with a combined and similar effort from everyone, the company will make *its* numbers look good to the pundits on Wall Street.

The problem is when individual managers decide that their special circumstances warrant dramatic price discounting to achieve their financial goals. Of course, pretty soon, every manager claims special circumstances.

The willingness of an organization to sacrifice profits in terms of increased discounts to achieve revenue results may work well if the market is growing. But in mature markets or economic downturns, the strategy is ruinous. Here the result is decreases in revenue *and* disappearing profits.

In an attempt to get people to stretch to make their revenue numbers, the law of unintended consequences often causes managers to use a tool (price discounts) which actually makes it less likely they'll hit their revenue numbers. Why? Be-

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cause there are a number of market and competitive conditions that say that those price discounts will have little real effect in bringing in additional revenue.

If markets are mature, they are price inelastic. That means that customers are not responsive to changes in price. Customers have a fixed volume or amount of products and services they need to purchase. If a company drops its price, customers aren't going to buy more. In some cases, such as maintenance, repair and operations products, they are on the same budget constraints as the supplier and are actually going to purchase less, regardless of price. Price discounts mean, by definition, that they will bring in less revenue.

To make matters worse, competitors are getting more desperate. They're just as hungry and they're willing to ignore customer demand and market elasticity barometers in a desperate bid to close an order. If one firm drops price, the competitor is often going to meet or beat that price with discounts of their own. Thus begins the dreaded price discount death spiral that has killed so many companies and industries. What's a manager to do?

Price for Profits

When asked for a price discount, managers need to ask a simple question: what's it going to get us? If it is just going to put them into a competitive situation they can't win anyway, they shouldn't waste their time. If it's with a high-value, loyal customer, they have to ask why the customer is asking for a discount. If it's because the product is overpriced for their needs, they need to develop a lower-value flanking product that better meets their needs—that's certainly better than reducing the price of a high-value offering. If it's because a competitor is in there, they need to ask what the competitor is doing that creates more value.

Managers need to begin to treat price discounts as a strategic resource. A discount is an investment to achieve something—a profitable increase in revenue. If they can't tie a pricing action to increased profits, then they shouldn't do it.

This is a scary proposition that many managers dismiss as not being realistic in their world of commoditized products and services, smart customers, and desperate competitors. That is denial, plain and simple. Fortunately, the reality is often considerably better in terms of both profits and revenue.

Asking why a discount is offered to a customer forces managers to begin to understand the complex series of interrelationships that price discounts have with revenue and profits. Using discounts impacts the human behavior of customers, salespeople and senior managers alike.

As with all addictions, the addicted deny what is really going on (desperation) and the long-term impact of the behavior on the firm (lower profits and commoditized high-value offerings). Becoming more strategic about pricing is about learning where your discounts are buying you something and, perhaps more importantly, where they aren't. The question is: where to start?

Put a Stake in the Ground—Anywhere

The best place to start correcting unnecessary discounting is to identify where salespeople are giving discounts where they don't have to. It may be with small accounts, it may be in specific regions, or it may be with specific high-value products that don't have real competitors.

It's a good idea to start with a plot of discounts given for all accounts, grouping the accounts by size. Managers will notice several things. First, the plot appears to be a random distribution of points. Second, there are several small accounts that are actually getting lower prices than large customers. Both of these are indications of uncontrolled discounting.

Managers are going to hear all sorts of reasoning why the discounts are needed. Regardless of the reasons for the discounts, it's important to recognize that excessive discounting to small accounts puts at risk the prices that are being charged to large accounts. Eventually, the prices at the larger accounts will begin to decline to the lowest price point as both salespeople and customers begin to discover the lower prices. They always do and with devastating results.

Firms are better off losing the business of a small account than cutting a deal that puts prices at larger accounts at risk. Managers soon find out that they don't lose as much of the business at smaller accounts as they think.

> Firms are better off losing the business of a small account than cutting a deal that puts prices at larger accounts at risk.

When they try the same thing with higher value products, they will hear similar justifications and similar results when they begin to eliminate the discounting—they aren't going to lose as much business as you think. High-value specialty products need to be priced to reflect their value. Firms that discount them do so for a variety of reasons, but those that chose to reconsider find that, despite the protestations of customers, they are still able to sell those products when they eliminate excessive discounting.

Put a stake in the ground where managers decide they aren't going to discount any more. The process of eliminating some discounts tests the organization's ability to eliminate more price discounting and eventually move to a more sophisticated and strategic approach to pricing.

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If a manager can't perform this first step, they are better served figuring out how to eliminate some discounts than spending resources on fancy pricing software and more strategic processes, because they will be exposed to the same discounting pressures. In other words, those efforts will be a waste of time. Once they have learned how to eliminate some discounts, it will then be a productive process of developing more effective and strategic pricing systems.

The Value of NO

Managers often make the mistake of wanting to do business with all accounts in an industry. Irrespective of the firm's footprint, be they large or small, it is unlikely that the offering will meet the need of all customers. This is especially true of low-value products and services that in fact often perform poorly. When this happens, managers try to force fit high-value offerings into customers that want a low-value product and a low price. Or they fall prey to customers that use low-value suppliers as a bluff to get high-value suppliers to lower their price. Research has shown that 80% of BTB firms and 70% of services firms make this mistake of responding to all customers.[2]

In their desperation for sales volume, managers often load their operations up with customers that are expensive to service and are actually losing money for the business. In fact a good rule of thumb is that 20% of a firm's business creates 225% of its profits.

Consider the implications of that number—this means that some percentage of customers pull that number down to the final 100% of customers. In fact, 70% of customers tend to "hover around the break-even point." It is the final 10% of the customers that actually cause the 125% drop in profits.[3]

The trick is to identify the 10% of the customers that cause the big loss. If a manager is uncomfortable doing that, they can start with 5% of their customers. This process forces them to begin a more strategic process of identifying customers that are good to do business with and match the value offering of the firm. Further, it gives the "bad" customers to competitors and permits more time to do a better job servicing and supporting profitable customers. It leads to a more satisfied work force and helps further define profitable customers that the firm can pursue.[4] It's important to remember that those "bad" customers are often created by uncontrolled discounting.

> Senior managers are far better served to focus on making sure that everyone understands and believes in the value relative to the competition that their firm provides customers.

Manage Value, Not Price

Senior managers are far better served to focus on making sure that everyone understands and believes in the value relative to the competition that their firm provides customers. Further, that their focus extends beyond understanding to constantly figuring out how to create more. If they find themselves managing prices, they will surely be part of the problem when prices spiral downward.

Sure, there are times that they have to get involved in pricing a big deal with an important customer. But, even then, are they more focused on the price needed to close a deal or the value that they're providing to the customer and whether that price is right considering the value?

If they can be honest, they'll find that they are suffering from a level of desperation that reflects the tricks that buyers are playing. That desperation always leads to unnecessary discounting. The best antidote is to understand, leverage and eventually manage the value of the firm—that's leadership.

Endnotes

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How to Serve Your Largest Customers … Profitably

The key to an effective customer focus is the ability to identify key clients and react to their needs. However, despite the importance of segmenting customers by needs and profitability, many management teams draw a blank when asked about their key account management plan. In this article, the authors outline steps for servicing key clients profitably. Coauthor Hong-May Cheng MSc. is a senior director at Simon-Kucher & Partners in Amsterdam, and specializes in the areas of innovation, pricing strategies, price setting and value selling. Coauthor Jos Eeland MSc. is a consultant at Simon-Kucher & Partners in Amsterdam, and specializes in service frameworks, price setting and customer profitability, including the organizational change process. They can be reached at amsterdam@simon-kucher.com.

When asked to name their top 20 customers, many management teams draw a blank. How is this possible? After all, top-level managers also need to have insight into their customers' situations and need to know where to focus their resources. What is more, the key to an effective customer focus is the ability for the entire company to know exactly who their most important accounts are and to react to their needs accordingly.

Key account management is a sales approach often used to differentiate customers. The challenge starts with the definition of a key account. Can you outline your definition of a key account? Do you know their needs and wishes? And most importantly, are you able to serve them profitably, allocating investments and scarce resources to where they matter most against the best possible price?

Too often practice shows that it is not as straightforward as it seems to answer these questions. If you define your key accounts too broadly, you will end up with an overwhelmingly large customer base that undeservingly receives privileged services. **Without a clear understanding of what your customers really need, you will likely end up in overpromising the unexpected and under delivering the bare essentials.** Perceived key accounts will get what they need, key account managers will get things done based on who shouts the loudest, and alignment of internal resources will be done based on ad-hoc issues rather than strategic direction and importance. All of this comes at the expense of customer satisfaction and key account profitability. How can you improve your key account management? Here are five steps towards higher profitability:

Step 1: Narrow your focus—define and segment your customers

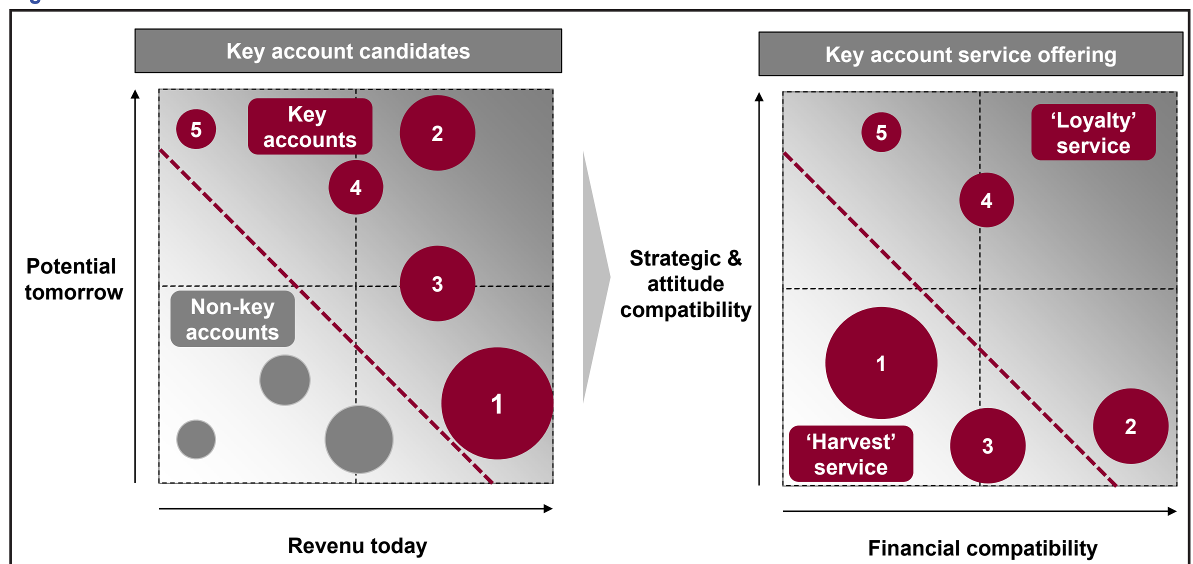
Effective key account management should be based on a careful identification and definition of your key accounts. This requires answering one simple question: What makes a certain customer key to your business? While sheer size is a basic indicator, it does not provide a solid basis for building a sustainable segmentation process. **A strong segmentation process is driven by three factors that combine both hard and soft criteria: the customer's compatibility in terms of finance, strategy and attitude.**

Assessing the *financial* compatibility involves looking at basic quantifiable criteria that indicate the customer's current performance and potential. This includes factors such as revenue, profit and growth potential.

The *strategic* compatibility indicates whether the customer's position and growth direction are compatible with your capabilities and priorities. How strong, for example, is your customer's market and innovation leadership? This is a good benchmark for measuring companies that have a specific focus on new product development.

When we talk about *attitude*, we mean factors such as loyalty, willingness to share information and desire to engage

Figure 1



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in a working relationship. You must also know whether your customer buys your services based on the price or on their loyalty to your company. Because in the end, a key account relationship involves a mutual commitment in which both sides grow together. (See figure 1 on previous page.)

To assess these criteria, sales, marketing and finance must work together to efficiently evaluate each account. If you have a large customer base, it makes sense to first assess the financial compatibility. Based on this assessment, the key account candidates above the financial thresholds can be selected for a more detailed and manual classification.

A true challenge in this process is to determine the thresholds for revenue, profit and potential. This final step in the segmentation process is decisive for the customer classification. If your minimum thresholds are low, you will end up with a high number of key accounts and sales volume, but you also might endanger the quality and feasibility of service levels. The decision where to draw the line depends on how you would define the ideal key account service model and the cost-to-serve involved.

Step 2: Differentiate your services—design the right service model, for the right customers

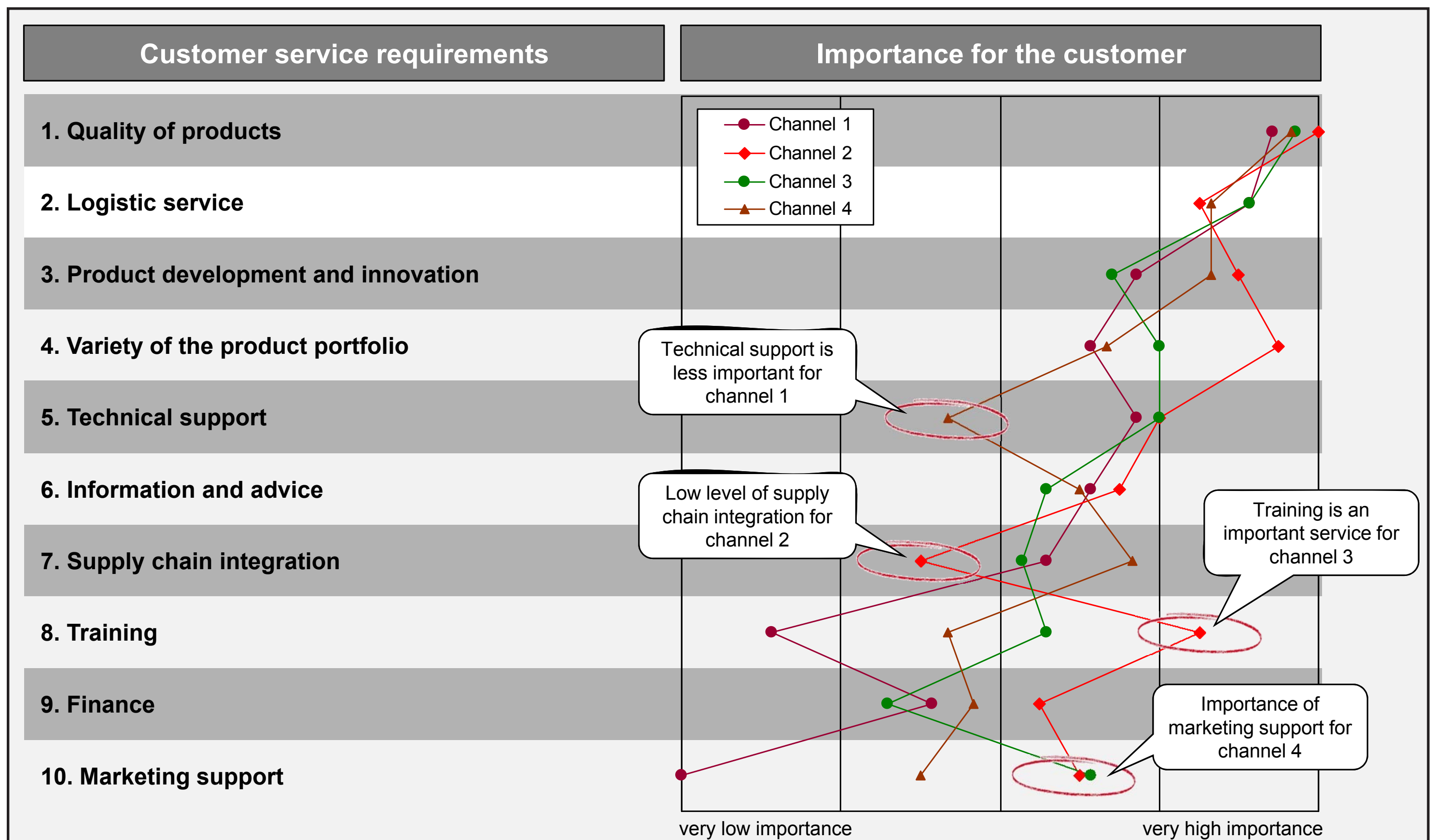
Not every key account is the same. For example, price-oriented buyers and loyalty-oriented buyers may require very different service offerings. Loyalty-oriented buyers should be accommodated with joint innovation programs, contact persons for each function, shared marketing material, etc. On the other hand, price-oriented buyers are generally reluctant to pay a premium for these services and only seek a low price. They are better served with a minimal and more standardized service package to ensure that both revenue and the bottom line are satisfactory.

The same rationale applies when you differentiate between channels and sectors, large key accounts and small key accounts, international and local, stable and fast growing. You must find out what each customer segment needs and design the best service model accordingly. (See figure 2.)

It starts with defining the requirements of each segment based on your internal knowledge and sales insights, validated with key account interviews. These insights need to be translated into critical success factors and key enablers: What is necessary to establish the best possible relationship with your customers?

These enablers can be grouped into service packages or bundles for each customer segment that serve as anchor points for your sales force. They will tell your sales force what to promise (and what not), what to include in the key account offering, and which services should be charged separately.

Figure 2



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Step 3: Steer growth—have a key account plan

The importance of a basic key account plan is often ignored in daily sales practice. Writing a key account plan is perceived as a paper exercise without any real consequences or benefits. Why? A key account plan is often regarded as overly complex and time-consuming. It is often perceived as a bureaucratic obligation instead of as a vital tool for driving business. Moreover, an average sales manager is not very comfortable with writing a key account plan.

Nevertheless, a key account plan is an essential tool for steering your business growth. It is vital that the overall growth targets set by management are applied explicitly and made tangible on a customer-specific level by the account managers. The plan also supports you in making smart decisions in which customers to invest in or not. Moreover, the key account plan serves as a common platform for allocating scarce resources from all business areas involved. A key account plan represents a holistic corporate view that goes beyond the sales force level. While it is driven by the key account manager, it is owned by every department involved.

In essence, a key account plan needs to capture the growth opportunity for a specific customer and the investments required to capitalize that. To do so, every key account plan should include (at least) the following seven aspects:

1. List customer and market baselines of main financial indicators, key challenges and ongoing projects
2. Summarize the current account relationship, including its strengths and weaknesses
3. Indicate and quantify growth opportunities and targets
4. Define required actions and the desired customer solution
5. Estimate the value of the solution for the client
6. Estimate the investments and the cost-to-serve
7. Create an action plan and prepare the deal

Step 4: Build profitability—balance price with cost-to-serve

Not all key accounts turn out as promising as expected. The potential is not realized, the market declines or sales managers have been overly optimistic. True insights into costs-to-serve and price build-up per customer are essential ingredients to manage the relationship profitably.

On the one hand, these insights will help you be well-equipped and prepared to boost negotiation prices. On the other hand, they will help you to know when to cut down on offered services and thereby on the cost-to-serve.

As key account plans are typically focused on volume and growth potential, they often do not focus on profitable growth. Yet increasing profitability is a main challenge for successful key account management. After all, your largest clients are usually the ones that generate the smallest margins. They negotiate the best prices, enforce the highest service levels and drive up the cost-to-serve.

Mastering the precarious balance between the right price and the right services should be a core skill of every key account manager. They should know precisely which services they offer, the cost-to-serve, and what the price premium and build-up are. This is the difference between being just a price-oriented seller and a value-oriented seller.

Step 5: Make it happen—ensure a structured process and true team effort

The last success factor in the key account approach is to gain support and joint ownership of an account relationship throughout the entire company. Key account management requires a true team effort.

From an organizational perspective, this backing is necessary to ensure that all business areas involved understand the needs of the key account and the implications of the services provided. From a customer-oriented perspective, this is necessary to ensure that the improvement initiatives and relevant expertise of every business area are mobilized to serve the customer in the best possible way. The key account plan serves as a platform for solidifying ideas, investment and profit opportunities.

To make it happen, you must incorporate a key account plan into the annual planning cycle. Make sure that the key account plan has the signature of every business area involved. To support the process, include speed-date sessions in which the key account manager gains the buy-in of every stakeholder. In doing so, the company maintains an overview of the account plan's impact and the resource support involved. In essence, it bolsters the entire company's focus on the customer.

The Result

Key account management is not only about selecting a number of customers and assigning sales managers to tend to their needs. It also involves a mindshift throughout the entire company: resources should be allocated to where they are needed most. To grow joint and long term relationships with customers who have the highest fit with the strategy and direction of the company. To create a customer base that serves as a platform for further growth and innovation.

The biggest and most important challenge is to manage these relationships in a profitable way. This in turn poses the dual challenge of managing the cost-to-serve while achieving the best possible price. It all remains a matter of persuading your customers to buy a service for its value, not for the price.

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Groupon: Beware of Furballs

The success of Groupon.com has garnered international attention and raised the eyebrows of many businesses looking for ways to tap the company's massive customer base. However, despite the potential for attaining new customers, the Groupon model is not necessarily a profitable one for every business. In this article, the author outlines a process to help companies understand the Groupon pricing model and make an informed decision about the site's potential benefits for their business. Author Avy Punwasee is a Senior Consultant with Pricing Solutions, a PPS CPP Faculty Member, and a frequent PPS contributor and presenter. He can be reached via www.pricingsolutions.com.

An increasing number of companies have been evaluating the Groupon model and trying to assess whether it is right for their business. This is a difficult question that often leaves high level executives perplexed. In order to make an informed decision it is essential that you approach this decision in a process oriented manner.

Step #1 – Brand Assessment

How established is my brand? Obviously, if you are totally new to the marketplace and have little funds to advertise, this service may make sense. There is not a week that goes by that you do not see companies like "Chez Pierre Cafe" being promoted. With Groupon's massive advertising reach and related volume impact, what could be better?

However, if you are an established market player substantially more risk exists. **Your existing customer base is used to paying full price. At best your savvy loyal customers will feel cheated; at worse they will begin to question your regular price structure and push for concessions.** Depending on the success of the promotion and how sophisticated your competitors are, you also run the risk of depreciating prices in the market when others try to win back lost volume. Finally, depending on the positioning of your brand and the related value equation, you could cause long term damage to your offering.

Step #2 – Financial Assessment

Usually Groupon deals are very attractive, with retailers offering discounts from 30 to 50%+. In addition to the discount paid by retailers, Groupon keeps roughly half of the revenue it collects from selling the coupon. Assuming you offer a 50% discount on Groupon, this would entail that you realize a mere 25% of a regular price sale. As such, only high margin businesses (or businesses with open capacity) will make money during a Groupon (promotion). Of course, this profit picture drastically changes if retailers are able to up sell and cross sell customers once they are onsite.

Step #3 – Long Term Returns

So what happens if you do not fall in the enviable position of having high margins – is Groupon not for you? Well not exactly, a lot of apt marketers and salespeople will make the case that the promotion will attract incremental long term customers.

To evaluate this, look to historical data. When you have run promotions in the past, how successful were you in generating long term customers?

Intuitively, do you have an offering that will capture repeat customers after an initial trial? How many competitive offers are available?

Remember, this customer came to your door based on a price promotion which sets their reference price; before they buy again they will most likely evaluate the market.

Step #4 – If you decide to leap measure, measure and measure some more

It is important that the measurement of the effort go beyond the discount duration to truly measure the long term impact. Did customers stop buying for 3 months after the offer ended, i.e. we pulled ahead sales? Did we ever see Groupon customers again? Did we get any service complaints due to lack of capacity? What was the impact on our loyal customers? The list of questions goes on and on making it essential to have an upfront measurement plan in place.

It is important that the measurement of the effort go beyond the discount duration to truly measure the long term impact.

Although Groupon, or any other deep promotion, can be very seductive from a sales perspective, it is important that executives treat the effort as any other promotion and undertake a detailed analysis before electing to proceed.