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Ethics and hidden greed

by Rob Docters

How do we protect ourselves and our business interests from the unethical behaviors of others? In this article, the author connects time-honored ethical principles to real-world cases and offers the building blocks and counter-strategies you need to fight unethical actions in your organization. Rob Docters (rdocters@abbeyllp.com) is a Partner at Abbey Road Associates, where he leads the ethical pricing and customer strategy practice. Among other C-Suite roles, he is a former Senior Partner at Ernst & Young, LLC, and has led BCG's Pricing Practice in Southeast Asia and Pricing Center in Singapore. This article is adapted from chapters in Rob Docters and Hans Gieskes' "Ethics and Hidden Greed" (Emerald Group Press, 2023). You can purchase the book from Amazon here.

Hunters are attuned to the subtle, in order to detect their prey. Similarly, in promoting ethics, ethics champions must become aware of the small violations before they become major violations. This requires effort and skill since ethical violations are not always obvious. That effort is worthwhile since conducting oneself ethically is the best way to foster a long-term, profitable relationship. Ethics are the antecedent building block to establishing trust and loyalty. Comparing the "World's Most Ethical Companies" survey to the S&P 500 over time suggests that ethical behavior is rewarded. The most ethical companies outperform other similar-sized companies by 7.1% over a 15-year period.[1] Among the reasons for this is that there is considerable evidence that ethical behavior improves customer relationships"[2] and ethics simplify management.

Higher Standards

The idea that ethical guidelines are relevant to business success is not new.[3] However, ethical understanding is one thing. Actual practice is another. It is important to understand your opposition and counter unethical behaviors with your strengths.[4] This is how corporate top management can efficiently ensure compliance to ethics.

There are several benefits to adhering to a higher ethical standard. For one, it can mean higher revenues. This raises the question: "What is the ethical standard?" There are many articulations of ethical standards and the focus of ethics has varied over the years. However, some of the basic principles remain unchanged. We recommend using the list of standards published by Professor Henry More of Cambridge University, UK, a while back, which suggests in simple terms some nineteen ethical principles applicable to most businesses.

Professor More called the standards by the Latin term "Noema," and we believe the failure to accord with Noema, essentially ethical failures, leads to business reverses. Five examples of principles, and corporate results, follow:

1) Quality of Service
Ethical Principle: Live by promises.[5]

Example: A leading systems developer rolled out a new billing system for telecom providers in the U.S. and Canada. However, the $65 million system did not function according to specifications. In Canada, the system was sold to Bell Canada Mobility. After attempts to fix the system failed, the developer abandoned the project. Bell Canada cancelled the contract and communicated the failure to all telecoms and other leading businesses in Canada. In the next year, the systems developer was forced to close all but one of its Canadian offices as its customer base collapsed based on the Bell Canada experience. In the U.S., however, sales continued for over two years.

Management actions: In the U.S., the developer had gotten away with the failures, as customers did not communicate with one another. Management failed to address the problem. As a result, there was a material revenue contraction in Canada.

Ideal Management Strategy: Work to stand behind promises and product. A good example is LEGO's customer satisfaction policies, which contribute to its position as the world's most valuable toy brand.[6]

Benefit: Many markets reward high quality of service or product. If the developer had secured Bell Canada Mobility as a satisfied client, it would have locked in that client for another five years and gained at least three more Canadian telecoms as clients.

Risks: Risks of standing behind the product would include costs of further development, and complaints of delay, with perhaps adverse effects in the market.

2) Misrepresentation
Ethical Principle: Treat customers candidly. Be sincere. Share issues with them.[7]

Example: A leading tax service provider found that a competitor was materially undercutting published prices and standard industry rates. The provider experienced a slow erosion of its most profitable clients who defected to obtain lower prices.

Rationale for behavior: Tax provider did not want to alert customers that there were price variations, for fear of provoking questions of its own pricing.

Ideal Management Strategy: Management contacted the competitor's older, best customers and let them know that other, new customers were obtaining a much lower price. This incensed the older customers who complained to the competitor.

Benefit: The competitor ceased undercutting prices immediately. While none of the angry customers defected, several extracted deep rebates. No further defections occurred.

Risks: There was some risk of a broader price war, but this did not happen as it was to neither provider's benefit.

3) Bullying Customers
Ethical Principle: Do not bully, ambush, or lock in clients.[8]

Example: During the 2000s, a leading internet service provider set its pricing to retain customers. There were penalties for cancellation outside a narrow time band, and alternating periods of limited and unlimited usage, which led users to incur excess usage charges.

Rationale for behavior: This pioneering internet service provider, a dial-up, was facing rapid share loss as broadband and lower-priced providers entered the market. Management compensation depended on retaining customers. Many subscribers were not adept at exiting.

Ideal Management Strategy: Management should have addressed the problem, particularly in the face of overwhelming subscriber hostility. It should have updated its technology rapidly to retain older subscribers.

Benefit: As a result of a focus on retaining its existing client base through penalties and other ambush tactics, the provider failed to develop alternatives under consideration, such as nationwide wireless service ("WiMAX"), which might have given it renewed leadership and revenue gains.

Risks: Sometimes pursuing a "harvest" strategy can produce the most profits for a company (for example, mainframe computing and print photography),[9] and simply riding the existing technology and customer base might have been the best shareholder (if not management) option.

4) Embedding behaviors
Ethical Principle: Integrity brings benefit.[10]

Example: In 2007, Coca Cola Company received an envelope from an employee at a competitor containing information regarding the competitor's product development programs and market focus. Coca Cola immediately sealed the envelope and sent it back to the competitor's management and included the name of the employee who had sent it.

Rationale for behavior: Coca Cola did this as a reflection of its ethical culture. It also was confident it could succeed in the market without using a competitor's confidential information.

Ideal Management Strategy: Coca Cola did exactly the right thing.

Benefit: This action reinforced its world class reputation and set an example for employees.

Risks: Sometimes success depends on learning the other side's secrets.

5) Discrimination not reflecting costs
Ethical Principle: Show fairness and social equity to all.[11]

Example: In some cases, buyer perception of the seller's brand is linked to a broader, perhaps controversial, conflict, such as gender, race, age, politics, nationalism, or rights such as abortion or gun possession. For instance, auto insurance pricing for males runs about 14% higher than the

same insurance for similarly-situated females. Of course, it should be higher based on accident rate differentials which cost insurers more. However, suppose costs for female services and products are higher? Indeed, many services and products bear a "pink tax" and are priced higher for women than for men. Average prices of haircuts and laundry services, for example, are higher, although these may reflect higher costs or women's preferences for higher quality.[12]

Benefit: Either costs or differential positions of customers may prompt differences in price, but sometimes management may underestimate the long-lasting harm from price discrimination.[13]

Risks: Some fear that failure to reflect cost differentials may harm profitability. Note that often, costs were not properly examined. For example, Colonial Penn found that elderly drivers were lower cost because they drove fewer miles and so used price to become the leader in the senior automobile owner market.[14]

Stupid Discrimination

The last principle suggests a basic contemporary management truism. There is often no reason to base differential pricing on race or gender — they are crude screens.[15] Generally, there are more sophisticated behavior criteria. For instance, rather than differentiate car repair prices based on gender, it is much more effective to base them on the history of car ownership and prior repairs. This will distinguish the price-insensitive from the knowledgeable who may not be able to evaluate costs. Doing this by gender — especially in an age of social media — may generate anger and backlash.

If only one identifiable group has been subject to a unique set of factors, it can be easy for marketing managers to reach confident conclusions regarding potential actions. But this is almost never the case. For instance, confronted with low Net Promoter Scores, many line managers simply undertake the program they wanted to execute anyhow and say — usually incorrectly — that it will cure the low score in the market.[16]

Implementation

How do you implement an ethical pricing program? A key question is who will be the champion of such a program? It may take effort to convince some managers that ethics increases profitability. Some market-facing managers who have obtained short-term revenue hikes from unethical actions may be uninterested in the longer-term consequences. In other cases, there may be unethical actions which, while highly annoying to customers, are important to a small budget. For instance, a shift from billing via USPS to online-only has a 2% to 20%+ impact on billing operations, or less than 1% to 5% of total costs, but this may alienate buyers who are not computer facile. Thus, in the short term, there is some money to be saved. But over the longer term such savings may be overwhelmed by customer defections.

Trials are a common means for testing market response to changes in policy/customer offers. Ethics-based initiatives differ from general marketing initiatives in that there should be no trials regarding ethical value. Trials suggest that the company has some doubt about whether an ethical practice is the right path. The use of a trial leaves open the possibility that the company could, in effect, say: "Oops! I guess we won't be ethical in that way!"[17] Trials are acceptable as long as they are clearly operational trials, such as testing out a new supervisory approach.

An ethical pricing trial cannot be a consensus-based process. There must be complete confidence in the ethics. The vast majority of employees look for strong leadership from top management in dealing with ethical issues.[18]

For many companies, the notion that ethics may be a powerful driver of annual revenues is a novel concept. For some, this is a foundation for longer term growth. In fact, all may benefit from applying ethical rules broadly.

Mergers and Acquisitions

Mergers and acquisitions (M&A) can serve as the ultimate test of a company's management ethics. While M&As are consistently found to not boost long term shareholder value,[19] M&As do benefit a narrow group of participants, particularly advisors, investment bankers, accountants, and top management. Often, the board of directors and, in particular the CEO, end up with a huge gain. This is sometimes based on adjusting the CEO's compensation because the new entity is bigger.[20] Advisors enthusiastically support these deals because there is a lot of money at stake. For example, when AB InBev merged with SABMiller, advisors collected fees of $1.5 billion. The merger was later described as having "unimpressive" results.[21]

With an army of lawyers, the legality of these transactions is not typically questioned. But are these transactions ethical? Are they moral?

There are arguments on both sides. As the *Financial Times* noted, after a merger, life is often easier for top management.[22] They pick up a lot of money, usually a troublesome competitor is eliminated, and stockholder returns improve.[23] This part of the outcome accords with Professor More's first Noema in that it makes their lives "more pleasant and agreeable."[24]

"MERGERS AND ACQUISITIONS (M&A) CAN SERVE AS THE ULTIMATE TEST OF A COMPANY'S MANAGEMENT ETHICS."

But there are a number of Noema that do not accord with M&As depending on whether the longer-term outcomes are positive or negative for consumers. The two guidelines which speak most eloquently against such activity are 1) the stricture against "excess wealth," and 2) the stricture against "cupidity."[25] These two characteristics are inarguably linked to most M&A activity and so condemn it. Few people would argue that large incomes and greed are not part and parcel of M&As.[26]

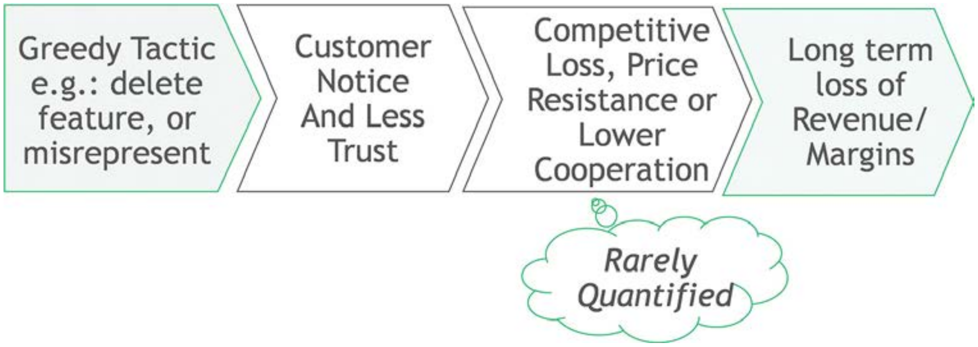

Figure 1: Assessment of Greedy Actions

Roles

Institutionally, it is worth distinguishing management roles. As the chief financial officer (CFO) of one bank observed, some "C" titles are inclined to defend the institution (CFO or Chief Counsel, for example) while others are more focused on short term revenue (CEO, head of sales, product management).[27] In general, the more institutionally-oriented management will be more willing to make a short versus long term trade-off in migrating to more ethical practices and so may be the better initial champions of these efforts.[28] Later, after the practices are successfully established, the leadership efforts might be taken up by revenue-oriented titles.

Often employees/managers may also resort to questionable ethics/greedy actions not in direct response to explicit CEO requests but based on how they interpret a CEO's unspoken wishes or "wink and nod." In bigger companies, CEO wishes/preferences are handed down through multiple management layers and often lose context in translation. A company's general counsel will advise the CEO on what actions could be viewed as illegal, but what is greedy or ethically questionable is not generally within the counsel's scope of advice. It would be highly unlikely for employees to tell a CEO that his suggestions were greedy/unethical.

What to Do?

• Have advanced tools and measures (shown as a cloud, in Figure 1) to show the harm in some greedy tactics. This way, management will know the sequence of the harm. Few companies or marketers have reliable links among the steps. Few have really quantified the value of the ancillary service quality. How long does it take customers to respond when, for example, 5% of the market value of a good or service is removed, but the price remains the same? What channel events happen after the change in price/value? What is the lifetime Net Present Value (NPV) of such a move? Without provable benchmarks, the decision will be up to whoever is in power within the firm. Unfairly, without support in financials, the more ethical players may not always win.

• Make incentives include long-term results. There are many ways a smart manager with the wrong motivation can succeed in the short-term but leave chaos in later years.[29] Fortunately, there are early warning signs of greed, such as lack of candor about proposed actions.

• Monitor competitors more closely. In many competitive industries, the competitors may be the ones who will notice short-term impacts first. Their actions, if called out, may be a good early-warning signal if the market frowns. The market will often punish poor behavior. For example, creating extra customer accounts hurt Wells Fargo,[30] and violating privacy at Facebook has led to user hesitancy.

• Pre-emptive ethics and transparency. This has worked well, both for signals to the market and signals internally. See the Embedding Behaviors example above.

Ethical Strategy[31]

Perhaps the best way to encourage ethical behavior is to build an ethical culture. With the right culture, it is more likely that employees will notice unethical actions and act accordingly. But for that to happen, most or all employees need to be part of the ethical culture, and that can take 18 months or more.

The alternative to relying on building a culture is to rely on rules. However, relying on rules is often inadequate because there are too many types of marketing and pricing initiatives and because these rules work only under certain circumstances or contexts. If the task of ferreting out violations of rules is left to top management and the legal department, the number of violations will not be curtailed.

On the other hand, if management knows precisely what the ethical threats are, it can counter them effectively. This is why our outline of greedy tactics/strategies is helpful. This enables top management to ask the right questions, to make sure the right screens are in place, and to have a strategy for stopping unethical actions before they start. This is the most strategic ethical approach. See Figure 2 on the next page.

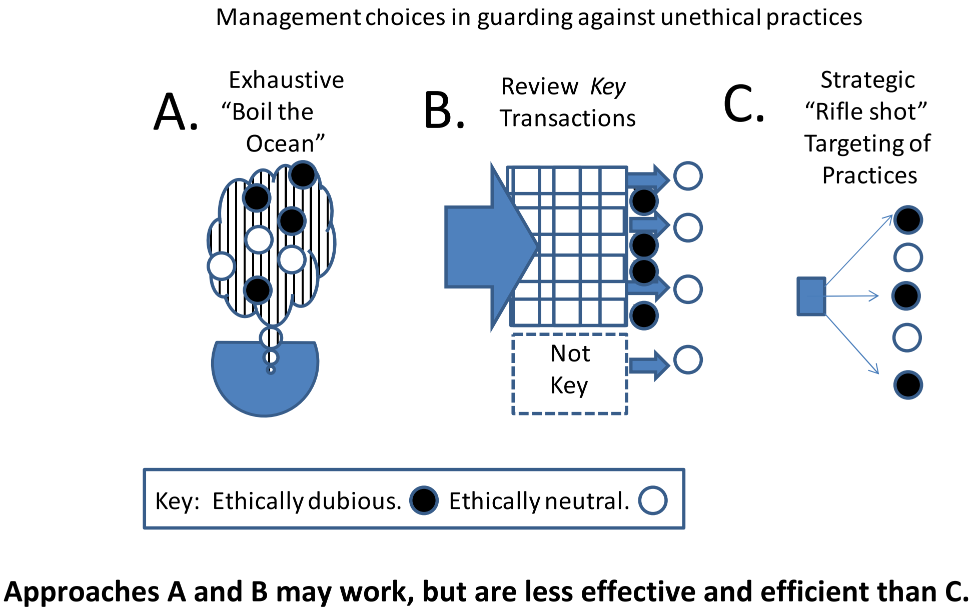

Figure 2

A Case Example

An example of the evolution of management behavior can be found by examining a leading manufacturer of Aerial Work Platforms (AWPs), also known as "cherry pickers." The salesforce had become proficient in switching allowable discount amounts from one account to another. In this fashion, a salesperson could exceed the allowed account discount set by finance. This was a violation of their condition of employment, and so, in the absence of any overarching contrary principles, was unethical.

In addition to excessive discounting, this practice also made it difficult to penetrate new market segments via discounting since intended discounts were transferred to accounts that the salesforce felt comfortable with. When the huge differential in discounts across accounts became public knowledge, customers were angered and went elsewhere.

Management was aware of this practice, but had no idea of its extent. Because management believed the practice was infrequent, it did not want to punish random sales people. Management was reluctant to spend great effort to correct the behavior. The abuse ended only after the AWP manufacturer installed a new accounting system which tracked cash discounting. The shell game ended abruptly.

The benefits were apparent. There was a 5-7% increase in revenues. Customers were no longer outraged to discover discounts of much as 40% to others and not them. And sales people were educated on more scientific bases for discounting. This process took about 18 months.

A Chief Ethics Officer

One approach used by a number of companies such as Target, Salesforce.com, Boeing, and others is to appoint a Chief Ethics Officer (also called a Chief Trust Officer). They operate on different charter, including one which is "To develop a strategic framework for the ethical and humane use of technology." The Chief Ethics Officer has a variety of reporting relationships, often to the CEO or CFO.[32] To be effective, they must also work closely with the company General Counsel and legal staff.

The key decision in designing the function is what ethical issues to target. Are they the large collection of line practices, some identified in this article? Or are they matters which have reached the board? In part, this shapes what the ideal manager's credentials will include. We believe that some connection with ethical theory, moral practices, and legal rules is important. But there is the need to have an officer who can understand the increasingly complex unethical practices at a line level. Many will not detect — or know how to prevent — the unethical strategies mentioned in this article. This means that their company will not address some ethical issues until they blow up, because they are not recognized. These include pricing and information technology, which are often not familiar to top managers. This is likely to grow into a larger problem as pricing and information technology, e.g. Artificial Intelligence (AI), grow in sophistication and use.

Often, a robust financial analysis is important to fight unethical decisions. In 1970, an internal memo was said to have circulated to top Ford management members. It was reported that the memo estimated that there would be 180 burn deaths and 180 serious burn injuries in Pintos without fuel tank modifications. It estimated that this would cost Ford $200,000 per death, and in total would cost $50 million.[33]

In fact, the NHTSA found that nearly 9,000 people burned to death, and tens of thousands suffered severe burns. A 50x mistaken estimate. The cost per death was also underestimated, and other damages (e.g., to company reputation) were omitted. A good ethics officer would have challenged the initial estimates and used better financial and outcome estimates to persuade the board to correct the problem. As usual, only poor financial skills and poor judgement reinforced a drive to the unethical approach. If done properly, an ethics officer would have been able to stop the unethical process from the beginning.

What is clear is that the ability to spot and prevent greed and unethical behavior from the top is usually difficult. Top management must exercise effort to ensure policies are ethical and that an ethical culture is enforced. ❖

Endnotes

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12 When Brooks Brothers moved from selling only men's apparel, they discovered that women returned and exchanged purchases more frequently than typical male customers. There was also more rapid evolution in styles.

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21 Ibid

22 The CEO of a top-3 information firm commented that one advantage of M&A is that the analysts could not easily track if she was making progress on promised improvements.

23 Ibid.

24 The counter-argument is that such mergers can make consumers less well off. The counter-counter-argument is that mergers can finance innovation which benefits consumers. These factual outcomes determine whether Noema X which says the present good must be weighed against future good in respect to "weight and duration."

25 More, Chapter II, section XII.; Chapter 8, section VII. In particular, cupidity is opposed to gratitude.

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Make value realization a strong competitive advantage

by Stephan Liozu, Ph.D.

It is no longer a question of if and when we will face a recession. It is a matter of how bad it is going to get. One of the recession busters is to make a decisive and bold move in customer value management (CVM). This is step number one, and it is a matter of investing in the right process and platform in the next 30 to 60 days, as the author explains. Stephan Liozu (sliozu@gmail.com) is Founder of Value Innoruption Advisors, a consulting boutique specializing in industrial pricing, XaaS pricing and value-based pricing. He is also the Co-Founder of Pricing for the Planet, which specializes in pricing for sustainability. Stephan has 30 years of experience in the industrial sector with companies like Owens Corning, Saint-Gobain, Freudenberg and Thales. He has authored and edited 13 books on value and pricing management. Stephan sits on the Board of Advisors of Professional Pricing Society.

It is no longer a question of if and when we will face a recession. It is a matter of how bad it is going to get. It is hitting the tech and software space extremely hard. It is a major reset that forces companies to rethink their business model, their go-to-market strategies, and how they support their customers as they also go through turbulences. Much of the published content these days touches on how to prepare for the recession, how to manage sustained inflation, and how to go through turbulences without losing too many feathers. There are many tips, best practices, and busters on how to both survive a crisis and also continue growing. One of the recession busters is to make a decisive and bold move in customer value management (CVM). This is step number one, and it is a matter of investing in the right process and platform in the next 30 to 60 days. Part of the CVM process is the management of realized value to show customers the real and concrete impact you bring to them.

Value Realization (VR) in the CVM Process

If you have not read about CVM, I strongly recommend you discover the space and get familiar with the CVM discipline. Part of CVM is an increased focus on demonstrating the concrete and tangible value that your company and solutions deliver to your customers day-in and day-out. Many companies fall short of explaining in a crisp and clear manner how they improve their customers' profit and loss performance. They focus on the beginning of the customer value management process. Which, in a nutshell, means that they create lots of customer value, calculate that value, and capture some of that value through pricing. See Figure 1 on the next page.

It is a particularly good start, but it is not enough. Right now, there is a potential economic hurricane coming our way, and customers need much more information. They might agree with your value models or your business case, but they need demonstratable proof that the value is being delivered to their business and realized to their bottom line. Remember that your customers have to make difficult choices right now. They may be laying people off and cutting expenses right and left. Your goal as a preferred vendor is to stay top-of-mind, to become an indispensable part of your customer's success, and to move from the discretionary to the must-have spending category. You will not achieve that by just telling your customer to trust that you are delivering value. They need to see it in writing. They need validation from their internal teams that the value is real. They need you to bring more value and help increase their performance.

Imagine right now, two sales representatives visiting the same customer to check on their business and see how they are preparing for the recession. Here is the scenario.

The sales representative for company 1 visits the customer to discuss the state of the business: pains, and gains, and how they can help the customer during this recession. The sales representative is a trusted advisor and communicates to the client how well they work together, the legacy relationship they have, and their value creation initiatives.

The sales representative for company 2 visits the same customer and cuts to

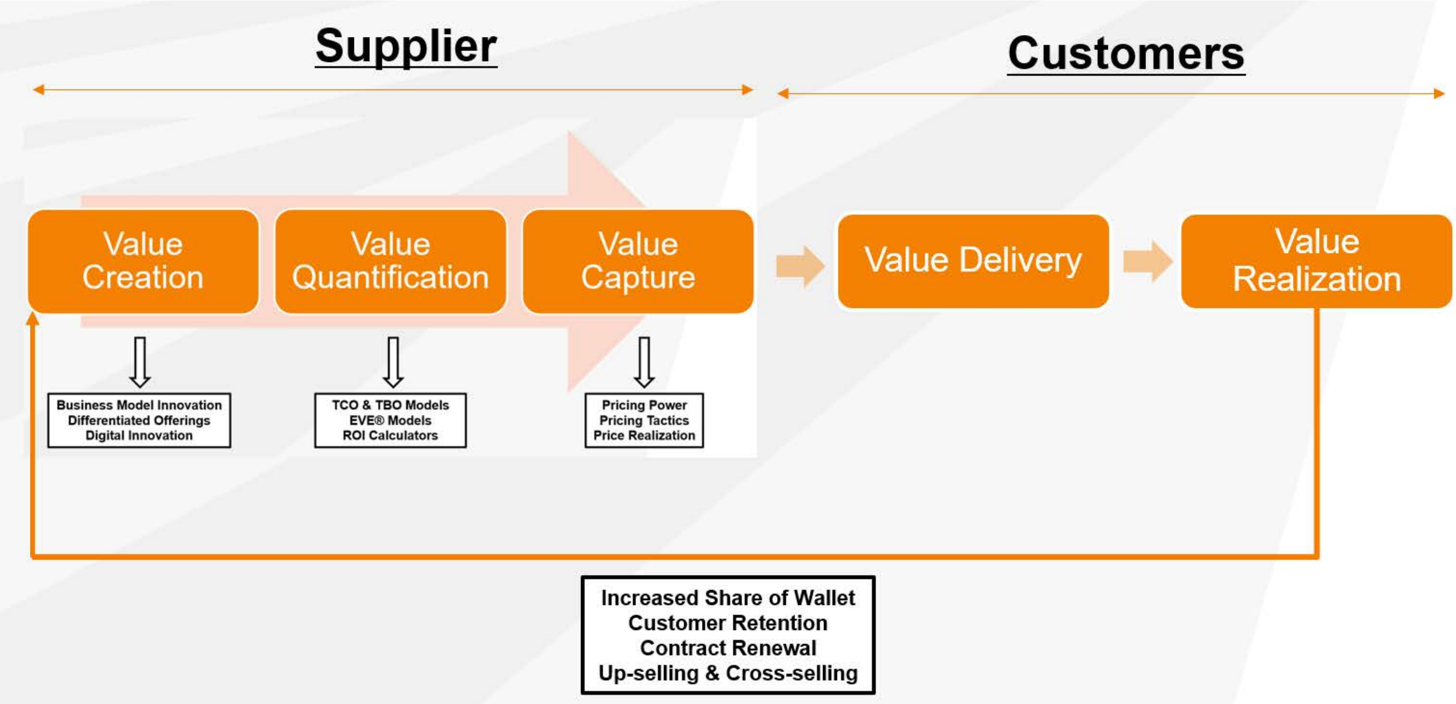

Figure 1

the chase. She brings a Value Realization Brief showing year-to-date realized value and concrete progress towards annual value and business KPIs. They get an action model to deliver even more economic value and deepen an outcome-based partnership.

Now, who do you think is going to churn and who do you think is considered a critical partner to the customer business? The bottom line is that customer value does not really exist until the customer realizes it fully. It must be demonstrated in numbers using the KPIs customer live and breathe on a daily basis. In a time of recession, this is what is expected from trusted advisors.

Value Realization: The Fundamentals

Value realization has become a hot topic these days with the current focus on tangible results and the rapid emergence of the customer success function. At the same time, value realization is a novel topic compared to value creation. There are fundamental differences between value creation and value realization. While researching the topic, I came across this passage from a 2017 blog on Salesforce.com:

> *"Value creation is effort that creates a quantifiable benefit. Value realization is effort that creates a quantifiable benefit that accrues to a stakeholder. An example of value creation would be creating greater efficiency within a department. An example of value realization would be creating greater efficiency that leads to a noticeable improvement in profitability for the whole company. The former only benefits a few people, whereas the latter benefits many more people in a tangible way"*

That is a pretty straightforward explanation. Value creation is the beginning of the value management process, while value realization is the end of the process. Doing both well is essential. Value realization is 100% about business outcomes. It is not about esoteric and high-level discussions on how to work together. It is about facts, numbers, and performance improvement in monetary terms.

Here are five key considerations on value realization:

1. Who is it for?
Frankly, value realization strategies can be designed and deployed no matter what products, services, or software you are selling. There are not limitations per se. Right now, value realization is gaining in popularity in the B2B SaaS space. It is also commonly used in IT managed services where companies decide to outsource services to third-party providers in exchange for outcome-based fees. It can be applied to products and equipment to track performance and impact on the customer operational process and P&L.

2. Who manages it?
In the B2B SaaS world, customer success teams are the value realization experts. Because they care about customer success, they must show

outcome and impact, and focus on adoption of the solution to reach the impact potential. This is the major difference between customer support and customer success. In more traditional sectors, Strategic Account Managers and Sales Managers would play that role as part of the consultative selling process using basic tools and managing the process manually.

3. What are the key metrics?
What matters is to focus on the right metrics customers care about. This is part of the value discovery process when building customer value models. In general, there are three metrics to consider, as seen in Figure 2.

You could also track percentage of the population who have adopted your solution and percentage of planned versus expected usage of the solutions. The ROI calculation is essential of course. So is the percentage of realized value which is accomplished versus target.

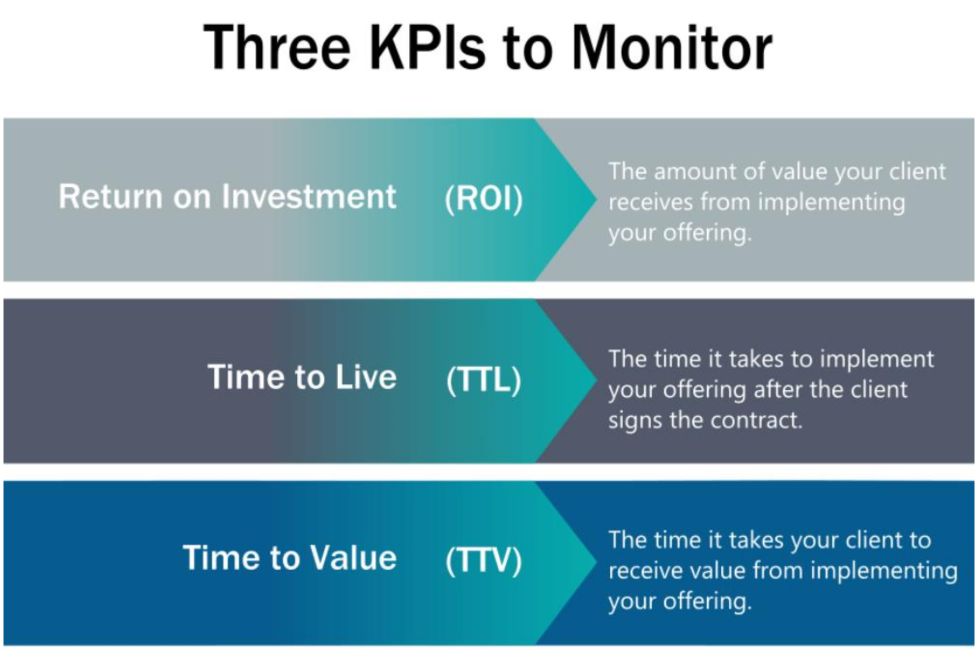

Figure 2

4. What are the outcomes?
The outcomes of the value realization process are documents that can be used during quarterly business reviews or value discussions with your customers. They include value realization briefs, full value realization reports, value dashboards, and value action trackers. Solutions such as ValueCloud® automate these deliverables so that you can spend less time preparing and more time engaging with the customers on action planning to increase adoption and impact.

5. How do you engage customers?
Value realization is an ongoing process. You design your customer value management strategy with the end in mind. The end is all about outcomes. Early on the process, you invest in value conversations with your customers and understand what drives their P&L or their growth trajectory. During the process, you continue to engage until your customer success team is mobilized to track the right outcomes. Every step of the customer value management process is connected. Think of it as a learning value loop focused on the customer.

Value Realization: From Manual to Automated

I have been in the customer value management space for more than fifteen years. During these years, I have designed and executed value-based strategies as a practitioner and helped other companies as a consultant and value coach. Part of these strategies is a strong focus on value-based selling. Of course, value-based selling and value realization are two different concepts. Without realizing it, companies start the value realization process without really getting into concrete, credible, and compelling outcomes. They project value messages that are not fully quantified or that are partially documented.

I usually run into companies using traditional value realization tools supporting the value-selling process. These tools help with the documentation of customer value, the reminders that value is being tracked, and the manual management of all the data input with customers. Figure 3 on the next page lists some of the most common tools in the value-selling toolbox.

There are many issues with conducting value realization and value-based selling efforts manually:

1. Lack of consistency from offer to offer: When done manually, there might be lots of variations in what is calculated, how it is calculated, how it is communicated, and how it is managed with customers. That leads to many inconsistencies and potential human errors across the board.

2. Involved manual tracking in Excel: Tracking actions, activities, and realized value in Excel is a good start, but it is not sustainable. There are issues of accuracy, version control, cyber security, and quality. It is good to get you started, but you need to think about automating right away.

3. Lack of structure, professionalism, credibility, and impact: Customers expect stable, consistent, and relevant engagement. They cannot be on the receiving end of an unstructured and unprofessional customer success process. They want to see robust analyses with credible impact that can be shared internally to other stakeholders.

4. The time consumed for the various parties involved: Doing things manually takes time and effort from both the vendors and the customer teams. You want your sellers selling and not filling value realization reports to enable value-based selling. Similarly, you want your customers to focus on adoption and critical initiatives and not digging for information for your reports.

5. It requires tracking in multiple systems and from various sources: Because manual processing is not integrated, you will have to go to a dozen of data sources to find relevant information to build a solid value realization report or customer value file.

6. It requires chasing of input from internal stakeholders: Similarly, the lack of connection to internal systems will cost you hours in meetings and discussions about relevant reports, where to find them, how to read them, and how to interpret them. That might drive your customer success teams crazy and will use a lot of their bandwidth. That is assuming you have customer success teams in place!

7. Sometimes it is one-sided and done with customer input: Because of the time it takes to create supporting value-selling documents manually, you have to sacrifice some of the required customer interactions. Manual work is often one-sided and internally focused due to lack of time and resources. The end result is a lack of customer orientation in the reporting.

8. It is poorly packaged and communicated to customers: We all try to use the best branded material available. However, this is not always the case, which causes trouble with the "brand police." When value realization is not systematic and automated with embedded templates, you are opening the door to poorly branded reports and plain documents to share with customers. There goes your customer experience!

Figure 3

The conclusion is simple. If you want to scale value-based selling and value realization initiatives, you cannot do this in a fragmented and manual manner. You have to leverage technology and automate to be able to fully scale and bring your entire salesforce on board. It is unthinkable that you can bring all of your customers and salesforce members on board while producing manual documents that might take between 30 to 60 minutes each to produce. Technology and good integration can help with speed and scale.

Value Realization: Data Is the Fuel of Automation

A customer value model is the heart of the customer value management process. It is a quantified customer value proposition that lists all the great things you do for your customers versus what your competitors do. It expresses a clear statement of your competitive advantage focusing on product, service, and software. In order to track and measure all the things you do for the customers and to package that in the form of a Customer Value File, a Value Tracker, a Value Realization Brief, or any form of value reporting, you will need to extract the data from various sources. Figure 4 on the next page shows the extent of the work your marketing, sales, and customer success teams put in to get the relevant data.

Your sources of customer value are located across your organization in systems, employee hard drives, people's heads, and paperwork in filing cabinet, to name a few. I have built incredibly detailed Customer Value Files in my previous lives and, although it is time consuming, the outcome is enormously powerful. The extent of the manual work makes it impossible to do this for all customers. So, we had to prioritize strategic distributors and end-users only.

With a formal and automated value realization engine, you can accelerate the extraction and calculations of customer value across multiple sources. There might still be a few manual steps, but the vast majority of the work is done automatically. The customer success or customer support teams are the chief conductors of all the critical activities in the value realization plan. Strategic Account Managers also play a leading role. They will use all relevant systems to connect the dots and extract the right information. Here are some of the steps and sources:

• CVM platform estimates data based on **projected** growth: Your CVM platform is the single source of truth when it comes to tracking customer value outcomes. This is the most significant component of the value realization strategy.

• **Customer Success Manager** (CSM) estimates data: Other data might be needed to finalize the calculation or complement the value realization report. The CSM is in charge of this work. They compile all data and make sure the data set is complete in the customer value platform to publish the relevant reports.

• Strategic Account Managers or Sales Managers **interview** customers and get their best guess data: Prior to quarterly business reviews, the team and the customers will have discussions on quarterly outcomes in order to be fully aligned. When the data is not readily available internally, you have to go outside and ask customers for input. This serves to get the customer's skin in the game and create alignment around the outcome.

• Customer has **systems** in place and customer provides the actual data: This is part of the 10% manual work that needs to be done by account teams. You might ask customers to share some of the data so that you can upload that into the value realization engine.

• CSM has **systems** in place and through the integration into the CVM platform, that data is automatically populated into the platform: This is the ideal state. If you can connect your customer value platform to customer operational data in their systems, data is extracted automatically. You might think of service performance data, usage data, win/loss data, or product operational data.

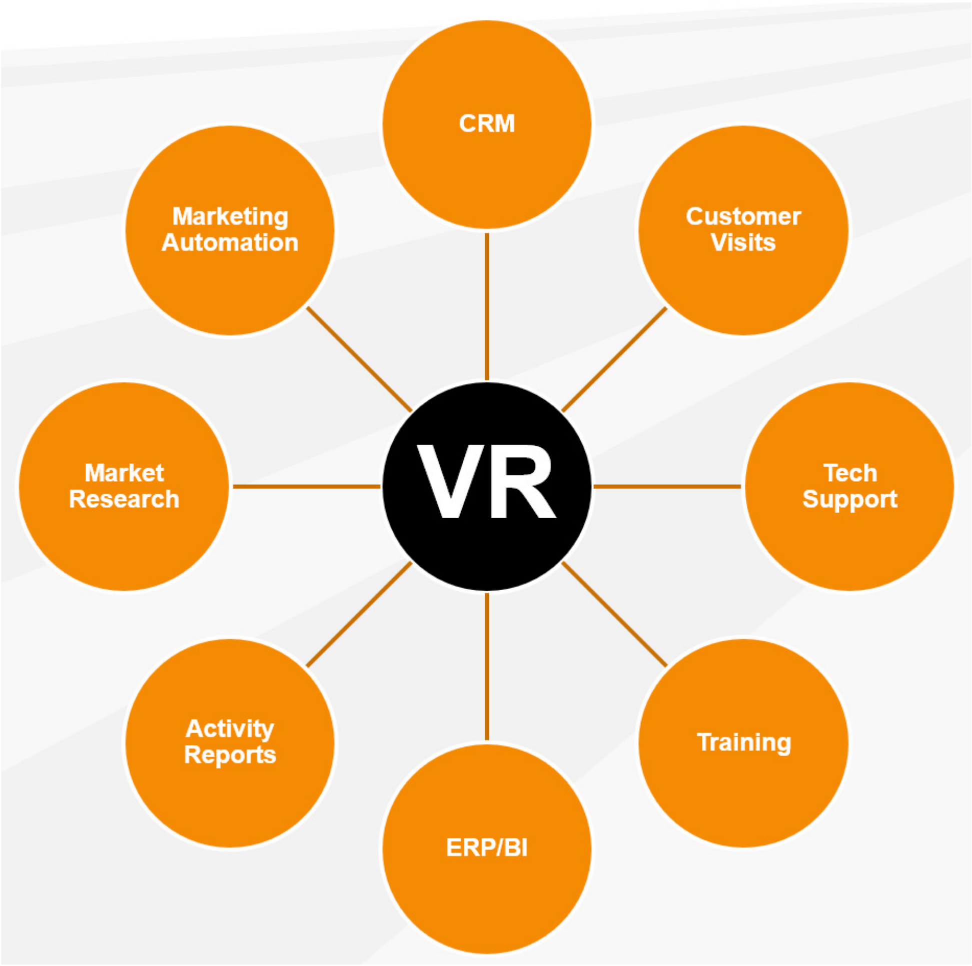

Figure 4

Whether you are in SaaS or in traditional sectors, value realization reports bring documented proof to your customers that you are positively impacting their business operations. The key is to get to the right data. Some of the work might be manually tracked and integrated into final outcome report. The ideal stage is to have the work 90% automated so that customer success managers spend more time interacting with customers and less time doing clerical work. A powerful value realization engine can make a significant difference to bring all your customers on board and accelerate their growth at scale.

Value Realization: A Transformation of Your Go-To-Market Process

With the current recession and the ongoing disruption, a focus on value realization (VR) is a no-brainer. What could be more important than to show to customers what impact your solution brings to them? You move from trusted advisor to a true financial partner. I often refer to value realization as consultative selling on steroids!

When done well and fully implemented, a customer value realization program can transform your go-to-market approach regardless of what industry and geography you work in. Putting customer financial success at the heart of your mindset is a transformational approach. I propose there are eight implications to your go-to-market approach as shown in the summary visual in Figure 5.

Let us briefly review all eight:

1. VR to **differentiate** from competition: Rise above the noise of all your competitors and create true competitive advantage. Right now, your customers want impact and outcome. No more blah blah blah. The discussion is all about staying relevant in the mind of all customer stakeholders. Therefore, your value realization program must be formal, crisp, and impactful.

2. VR to **automate** your value-based selling efforts: With automation and integration, you can seriously boost the speed and impact of your value-selling programs. No more manual work. No more inconsistent impact numbers. Everybody is fully aligned with the same professional approach to demonstrating value.

3. VR to move from value-based pricing to **realized value-based pricing**: Here as well, your pricing and marketing teams are going one step further. They help justifying price premiums through value modeling and quantified value propositions. But that justification is reinforced if it is validated on the back end. Value realization does that. It closes the pricing loop.

4. VR to connect with your **price realization**: value realization externally cannot be disconnected from your price realization objectives. If you cannot demonstrate tangible and concrete financial impacts, you might not be able to fully realize your pricing power potential. Value and price go hand in hand.

5. VR to maximize **Customer Lifetime Value**: Customer success is 100% about customer lifetime value. The objective is to delight customers over time so that you can retain them and expand your share of wallet.

6. VR to create **customer success** processes: If your firm is thinking about setting up a customer success organization or beefing up the existing team, think about the value realization process and a value realization platform to give them the right tools right away. It is the faster growing functional categories and companies are invested in this area while laying off in others.

7. VR to bring **credibility** to your value strategies: The customer value management process is a sequential process. It is materialized through value-based strategies touching all go-to-market functions from sales to pricing to marketing to innovation and to product. Focusing on tangible outcomes and financial impact brings enormous credibility to your strategies. It is the significant part. Without the outcome, value-based strategies are just words and promises. Are you keeping these promises?

8. VR to **professionalize** your go-to-market process: Finally, a professional value realization process with full functional alignment, the right systems, and the right mindset is a strong step toward superior value management maturity. Do not forget to inject a good dose of user experience thinking to show how professional you are!

❶ VR to **differentiate** from competition
❷ VR to **automate** your value-based selling efforts
❸ VR to move from VBP to **RVBP**
❹ VR to connect with your **price realization**
❺ VR to maximize **Customer Lifetime Value**
❻ VR to create **customer success** process
❼ VR to bring **credibility** to your value strategies
❽ VR to **professionalize** your GTM process

Figure 5

Learn to Crawl Before You Run!

Reaching value realization excellence does not happen overnight. There are critical parameters to consider and include in your value realization and customer success roadmap. These are usually related to people, process, and system. For each of the three dimensions, it is essential to start the development process by conducting stakeholder interviews, by mapping the existing value realization and customer success processes, and by knowing the state of the current tech stack.

This initial "crawl" phase is essential in identifying the internal gaps and design requirements that will drive success in the following stages. See Figure 6 on the next page. A thorough crawl stage might last 45 to 90 days depending on the complexity and size of your organization. It leads to a second stage of value realization and customer success maturity.

In this second stage, called the "Walk" stage, we focus on design and testing various dimensions of the program including metrics, KPIs, customer pilots, systems pilots, etc. In this second stage, we put the foundation in place for the next step when we accelerate the deployment and scale. This transition phase is a necessary step to get all the basics right on the process and systems fronts. Remember the "garbage in, garbage out" expression. This

	Crawl	Walk	Run
People	Identify all relevant stakeholders	Train relevant stakeholders on value realization	Scale program with all customer success teams
	Engage key stakeholders with plans	Design appropriate adoption protocol with team	Train customers and partners on value realization
	Conduct stakeholder interviews	Activate the Customer Success Council	Promote and reward value realization heroes
	Identify and contact potential Sponsor	Define value realization KPIs for success	Incentivize customer success on value realization KPIs
	Add value realization in customer success roles, responsibilities, and job descriptions	Communicate internally and externally on value realization	Share value realization success stories to the world
Process	Map a blueprint of current manual value realization activities	Develop hypotheses to be tested through pilots	Track against process metrics at scale
	Conduct an audit on who does what in value realization	Test and validate revised process maps through pilots	Improve customer process based on KPIs
	Identify internal management systems and documents to be modified	Engage pilot customers with new value realization approach	Continuing survey customers for future needs
	Map a revised & ideal customer success process with value realization	Adapt customer success and value realization processes by verticals	Focus on full adoption of your solution
	Socialize potential changes with key stakeholders	Fully integrate value realization content in QBRs	Deliver projected customer success impact at scale
System	Conduct a tech stack inventory	Identify & select CVM technology	Scale value realization technology at scale
	Identify current systems in place	Implement technology pilots for 3 to 6 months	Continuously integrate new value realization features
	Identify required integration points	Prepare for full integration in tech stack	Extract value realization insights through customer data
	List IT gaps for customer success roadmap	Assist in full ROI calculation of value realization technology	Design and deploy new automated value realization assets
	Engage the IT & Engineering teams	Design value realization technology to proper metric extraction	Manage a value realization tech community

Figure 6

is also relevant in value realization. We must test and validate with customers before we go full speed ahead. This phase might last for three to six months. Some leaders might consider this too long, but we posit that it is essential to prepare scaling the right way. The time spent in this "Walk" phase to get things right is recovered tenfold when things go well in the last phase.

The last phase of the deployment process is the "Run" stage. This is operationalizing and industrializing value realization across the organization with sales and customer success by using all the right tools. The process is tested. The systems are in place and fully integrated in the tech stack. People are training and embracing the approach. This is a stage of full acceleration to reap the fruit of all the hard work done in the "Crawl" and "Walk" stages. Depending on the maturity of your organization especially in the customer success area, the deployment of the three stages might last between four to six months. It is worth the investment in time and resources to get things right. If you can go faster, do it but consider people, processes, and systems.

Concluding Thoughts

Promised made, promises kept! That is the heart of value realization strategies. These days, CEOs focus on EBIT, net retention rates, customer lifetime value, and return on assets. They are investing heavily in customer success program to achieve their financial goals. Do not let these teams do the work manually. Give them an integrated platform to do value realization at scale. Make your customer success teams successful as well. Value realization will separate the leaders from the followers in and out the SaaS space. Excellence in the field is a true competitive advantage. ❖

Pricing in an era of turbulent supply chain headwinds

by Sudipto Banerjee, Himanshu Mishra and Z. Maria Wang, Ph.D.


Sudipto Banerjee


Himanshu Mishra


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Supply-aware dynamic pricing enables companies to meet demand and protect margins in a new and shifting landscape, as the authors explain. Sudipto Banerjee (sudiptobanerjee@kpmg.com) leads the Commercial Excellence and Pricing practice for KPMG. He specializes in commercial transformation, including pricing (strategy, execution, and enablement), sales growth (demand drivers, sales force effectiveness, channel management), and marketing effectiveness (ROMI, promo effectiveness). Himanshu Mishra (hmishra2@kpmg.com) is a leader in KPMG's Commercial excellence practice. He has supported clients across technology, media, and consumer goods industries, on commercial transformation, including pricing, and broader Go-to-Market strategy. Z. Maria Wang, PhD (zmariawang@kpmg.com) is a Director of Pricing and Commercial Strategy of KPMG US. She has more than 15 years' experience in management & strategy consulting and technology.

Demand surges and an extraordinary breakdown in global supply chains are raising the cost of everything from fertilizer to silicon chips. Even before the emergence of the Omicron COVID-19 variant, supply chain disruptions were worsening, driving U.S. inflation to 40-year highs, resulting in direct pressure on profits. Even Amazon, one of the world's largest retailers, reported slower growth recently due to higher supply chain costs. (Source: Sebastian Herrera, "Amazon Earnings Suffer as Growth Slows, Costs Rise," *Wall Street Journal*, Oct. 28, 2021.)

Repairing and restructuring supply chains will take many months and major investments. But companies can use strategic pricing now to manage rising costs, product shortages, and severe delays—and maintain or even expand margins. It's a big leap for many organizations, especially some consumer-facing and many B2B companies that still rely on unsophisticated approaches such as cost-plus or simple index-based pricing. These and other blunt pricing methods can leave money on the table, erode brand value, and create openings for competitors.

Using a new approach that we call supply-aware dynamic pricing (SADP), companies can adapt to shifting supply chain realities by adjusting the price of every SKU on a monthly, weekly, or even daily basis. Informed by SADP's forward-looking view of supply conditions and demand dynamics, companies can avoid near-sighted pricing mistakes, shape demand across products, customer segments, and geographies, and deliver more to customers and shareholders.

In this brief paper, we describe how SADP can help companies navigate today's unfamiliar and volatile landscape and set the stage for step-changes in pricing excellence, including organizational changes that will pay dividends for years to come in good times and bad.

Supply-aware pricing shapes demand, reflects supply-chain realities

Various forms of "dynamic pricing" are in wide use today. Rideshare pricing can change by the hour, for example, and airlines and hotels adjust prices several times a week based on supply and demand. The SADP framework goes further. It accounts for likely supply disruptions and helps companies

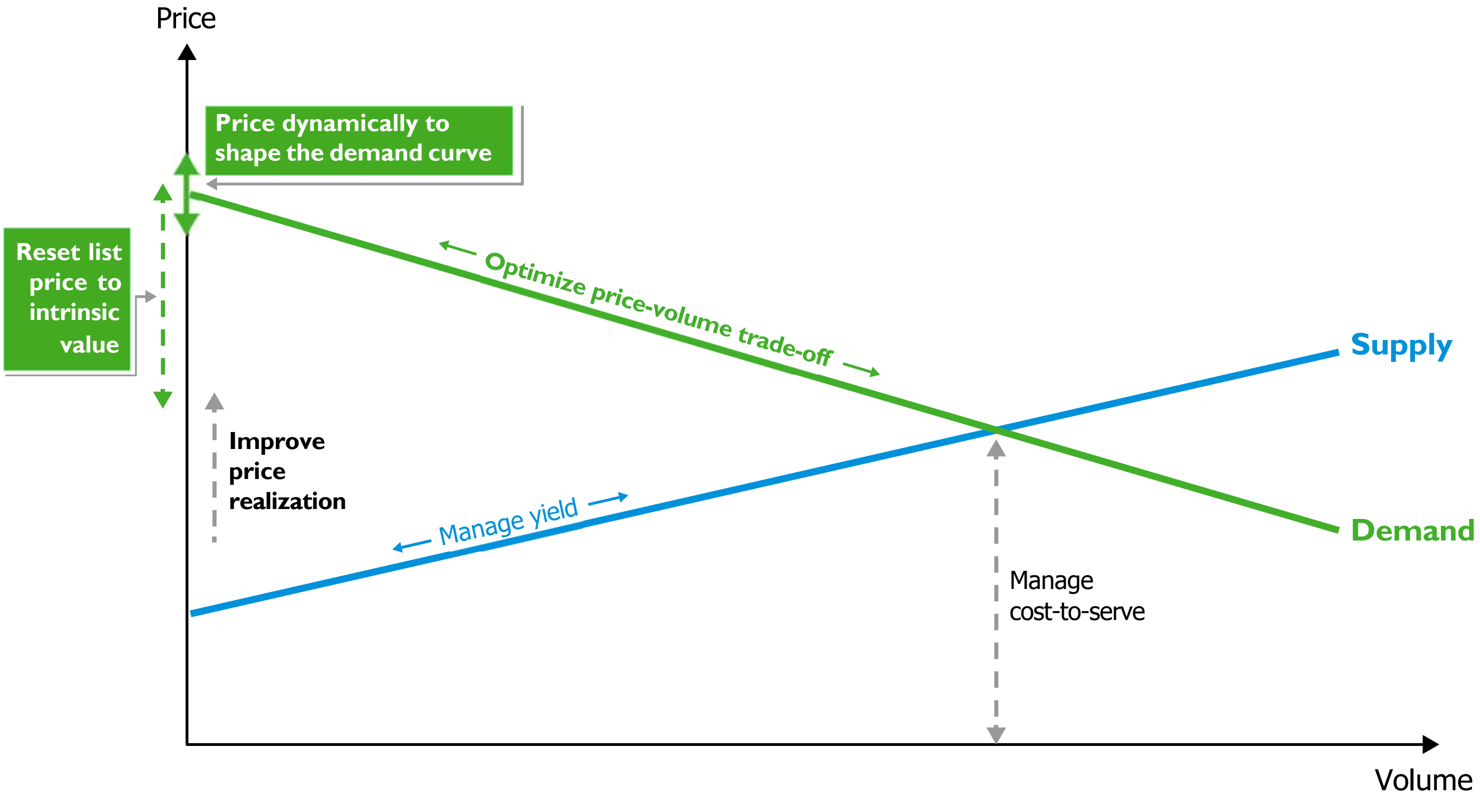


Figure 1: SADP focus within the supply-demand equilibrium

adapt their pricing and product offering decisions accordingly. A comprehensive set of data and advanced analytics are applied to model the market and optimize pricing choices. The factors include product hierarchies and substitution options, customer segmentation, likely competitor moves, inventory conditions, supply outlook, and inflation.

This pricing framework is new because it aims to dynamically redirect demand through pricing (see Figure 1), and avoids common pricing pitfalls (see Figure 2 on next page). The latter is an important step in building pricing maturity — developing the processes and organizational foundations for pricing excellence.

Supply-aware pricing shapes demand, reflects supply-chain realities

Supply-aware dynamic pricing includes three key elements:

• **Shaping demand based on deep supply awareness.** Traditional pricing and promotions shape demand, but SADP goes deeper, incorporating inventory position, production capacity and supply forecasts in optimizing price and promotion cadence and depth by category, product line and SKU. Used in conjunction with customer hyper-segmentation, it can keep price changes in line with value for each customer. Optimization includes reducing stockout risk while preserving margin without aggressive inventory hoarding.

• **Managing customer expectations and price perceptions.** Managing price perception is important in every B2C and B2B environment, but it's even more crucial today when prices are shifting quickly. Collaborating with merchandising, marketing, and other functions, pricing teams can use SADP to manage items and categories to protect price perceptions in line with the brand, channel, and overall business strategies.

With or without supply constraints, SADP can account for item and category role shifts and brand repositioning when setting prices for key and super key value items.

• **Using data-driven insights to guide product substitution.** In normal times, product substitution can be a zero-sum game. Under today's supply constraints, however, it can become a source of demand that bypasses stockouts and takes advantage of demand transference across a brand or product line.

The SADP framework forecasts the impact of pricing on substitute products at the SKU level. It also ties product assortment management into pricing based on surgical examinations of the viability of SKUs, driving revenue and profitability at the portfolio level.

Dynamic pricing programs are essential for most large companies in today's fast-changing marketplace—and those with the most sophisticated ap-

Prices speak to customers, suppliers, and competitors. Getting them wrong can damage perceptions, relationships, brands and the bottom line. Every company should be wary of common missteps:

1. **Letting concerns about short-term issues, such as temporary stockouts or supply shocks, drive price changes that could have negative long-term effects**
2. **Blanket increase of list prices across the board without offering promotions, trade terms or other direct or indirect demand-shaping measures**
3. **Approaching pricing only from the top down at an aggregate category or brand level**
4. **Seeing price changes as separate from product portfolio considerations including assortment, innovation, and SKU and service offering adjustments**
5. **Making pricing a purely business process without investing in technology, training and new and more integrated ways of working.**

Figure 2: Avoiding the top five pricing pitfalls

proaches will hit their quarterly and strategic targets and outperform peers more consistently.

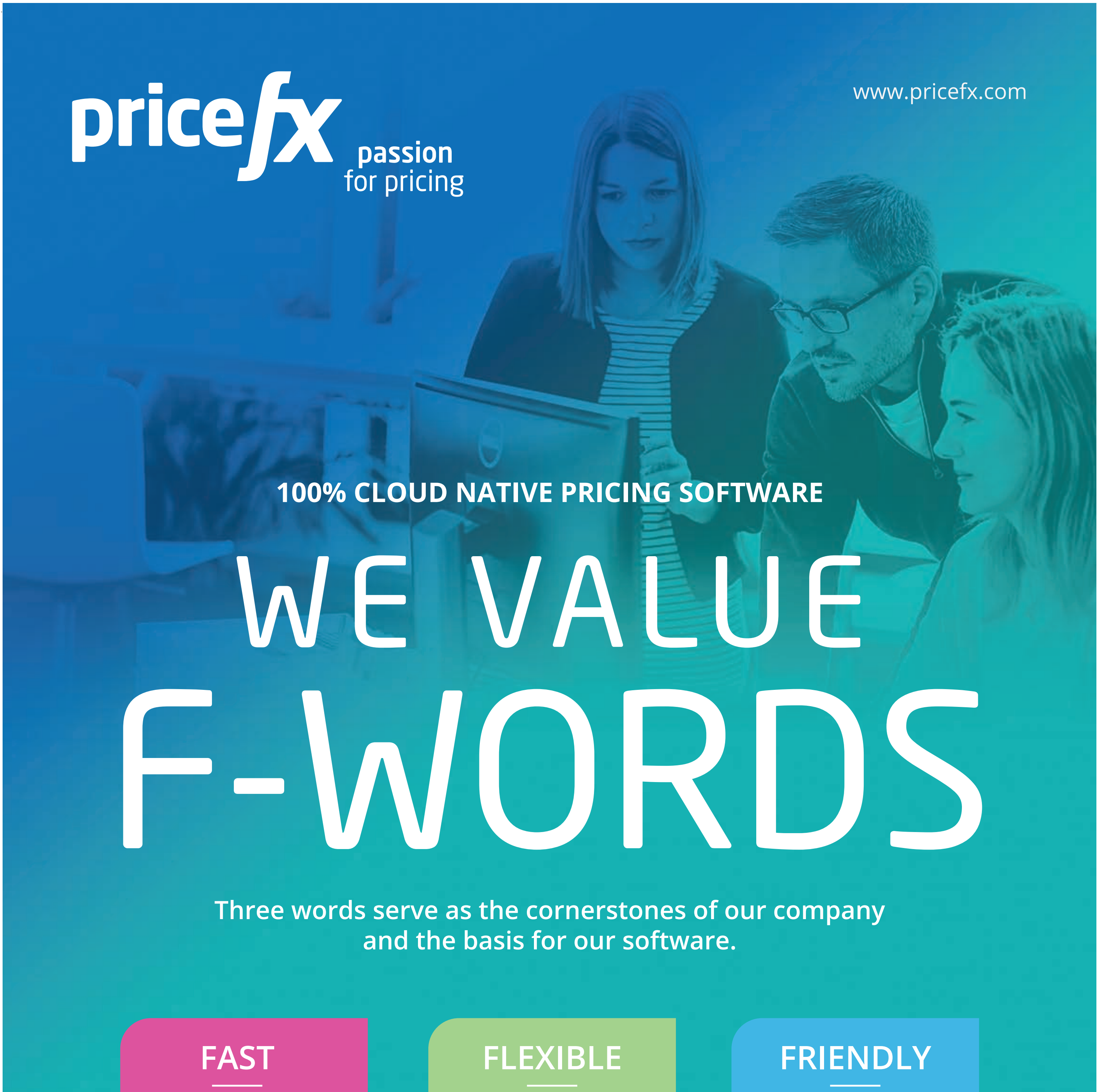
The next step: pricing maturity

Across industries and around the world, we have found that companies can improve their pricing maturity with new tools and capabilities, along with organizational and mindset changes. A pricing function using SADP requires a steady stream of input from procurement, manufacturing, logistics and store operations. Pricing also works closely with strategic planning, finance, and product development, and informs the activities of branding and marketing, sales and trade promotions, and customer operations.

Cross-functional teams can gain valuable insights into supply, channel activities and macroeconomic data—as well as traditional customer and product data. But this requires connected workflows, integrated business planning and the right enterprise-level technology.

Pricing maturity also requires changes in mindsets. Today, that means thinking of pricing in terms of both supply and demand. Building a mature pricing function takes time and investments in tools and training, but the benefits are clear and enduring. Few corporate initiatives, from cost-cutting to R&D, can drive performance as quickly or reliably as pricing.

As supply chains, customer behavior, and markets continue to move quickly and in unexpected directions, companies with superior pricing strategies will outperform. They will adjust prices in the right directions, on the right items, and at the right moments to build their brands, improve margins, and sustain customer loyalty. ❖



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Make pricing your ally: How to put value back on the menu

by Benjamin Garden

When building a high impact pricing strategy for a restaurant business, the goal is to optimize overall long-term profitability. The right pricing strategy, backed with the right model, increases overall returns by improving the complex interplay between guest count, menu design, and ticket size, as the author explains. Although focused on the restaurant industry, this article provides pricing strategy and best-practices that can be employed by pricers in multiple retail, consumer goods, and related industry sectors.
Benjamin Garden is the Global Vice President of Pricing Analytics at Iris Pricing Solutions. He also leads the company's Restaurant Pricing Practice. He can be reached at bgarden@pricingsolutions.com.

Nothing ruins great food more than bad pricing decisions. That maxim is particularly true along the ultracompetitive spectrum of restaurants — from quick service (QSR) to family and casual dining. You have invested heavily in developing your unique brand of food taste and quality, established an in-store presence attractive to your target segments, and anchored it with a compelling brand image. That is the visceral, perception-driven side of the value equation. But the "money" side of value equation — driven by pricing — is a challenge more vexing in restaurants than in almost any other industry.

The money side is murky and messy, but the real concern is that pricing is preventing restaurants from realizing their full potential. Even in the best case, pricing seems like a complex nemesis whose easy answers are risky and whose hard answers require too much time and effort for an uncertain reward.

It doesn't have to be that way.

It's time for restaurants to make pricing their ally, not their nemesis. The power and peace of mind that comes from balancing both sides of the value equation have a huge financial upside in terms of improved profits, without sacrificing the integrity of the menu and the reputation you have worked so hard to establish. This is especially true in an industry which typically operates at net profit margins in the range of 10-15%. Weaving together a great menu which balances value and price means threading the needle on six challenges that all restaurants along that spectrum face:

1) Optimizing Guest Count vs. Average Check
The simplest calculation of revenue is average check size and guest count. The simplest and prevailing logic in the business tells us that higher prices can reduce traffic, while lower prices and frequent promotions (discounts, value menus, etc.) can drive higher traffic, especially at a time where overall traffic in the industry is flat[1]. But a restaurant which is packed from open to close may not be generating the amount of revenue it can and should. How do you find the right balance between ticket size and guest count?

2) Minimum Wage
Margins are sensitive enough in the restaurant business without the cumulative effects of all the pressures they face. Competitors' moves and the allure of higher traffic put downward pressure on prices, while federal, state, and in some cases local governments are setting higher minimum wages. How do you reconcile downward price pressure with higher costs?

3) Power of POS data
Restaurants collect a tremendous amount of rich data through their Point-of-Sale (POS) systems.

The potential to recognize patterns, make dynamic adjustments to menus, and predict traffic and ordering patterns is just as tremendous. But until you find a way to analyze and interpret the data reliably, and turn those analyses into action, the potential remains just that: potential. How do you leverage your very rich transaction data without becoming a slave to algorithms or black boxes, or so myopic that you lose sight of what drives your customers to your restaurant?

4) The Millennial Revolution
The growing presence and buying power of Millennials has shifted the

market away from standardization. Custom-built items have become the new normal in the industry. Even chains known for their excellence in standardization (such as McDonald's) have introduced "Create-Your-Taste" offers (see Figure 1). Instead of embracing the standardization and consistency which defined their parents' and grandparents' restaurant experiences, Millennials have grown up accustomed to getting what they want, how they want it, and when they want it. In light of guests' desire for more control, how do you balance the increasing demands for customization with powerful value drivers such as consistency? How do you price your custom items relative to your standard ones?

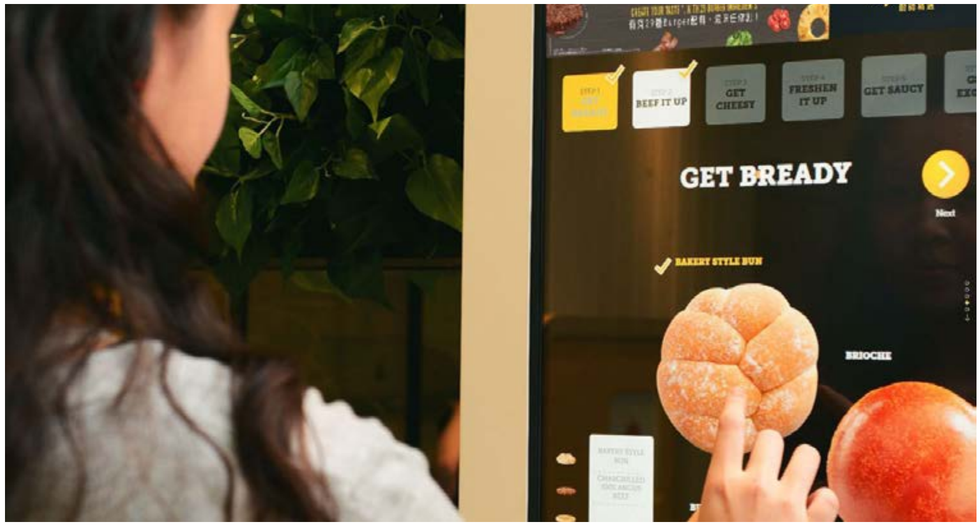


Figure 1: McDonald's "Create-Your-Taste" kiosk.[2]

5) Rampant Promotions
More players and more categories (e.g., the growth of fast casual) mean more competitive pressures, which have triggered an almost knee-jerk reaction from restaurants: discounts, coupons, promotions, just about anything to keep guests walking in the door. The truth is that over- promoting is like an addiction which undermines your restaurant's health, i.e., your brand and your bottom line. Resisting that temptation is a key success factor in today's restaurant environment. It boils down to this question: How do you know when to be proactive and when to be reactive regarding promotions?

6) Apps, not Appetizers
No business has escaped the overwhelming technological advancements of the last decade. These advancements create vast new opportunities for restaurants, such as delivery services, loyalty programs, and mobile ordering through apps. Mobile apps bring two clear advantages. First, they extend the reach of your kitchen and brand. No longer must restaurants rely solely on foot or drive-through traffic, reservation counts, and tables turned to generate their profits. Second, mobile apps collect a vast amount of data (e.g., geolocation, delivery fee pricing, ad and offer responsiveness) well beyond what the restaurant can collect at point of sale. Just look to the successes of Starbucks (see Figure 2) and McDonald's.

How do you capitalize on those opportunities to create a new relationship with guests by crafting a superior guest experience and by capitalizing on the new pricing opportunities these technologies bring?

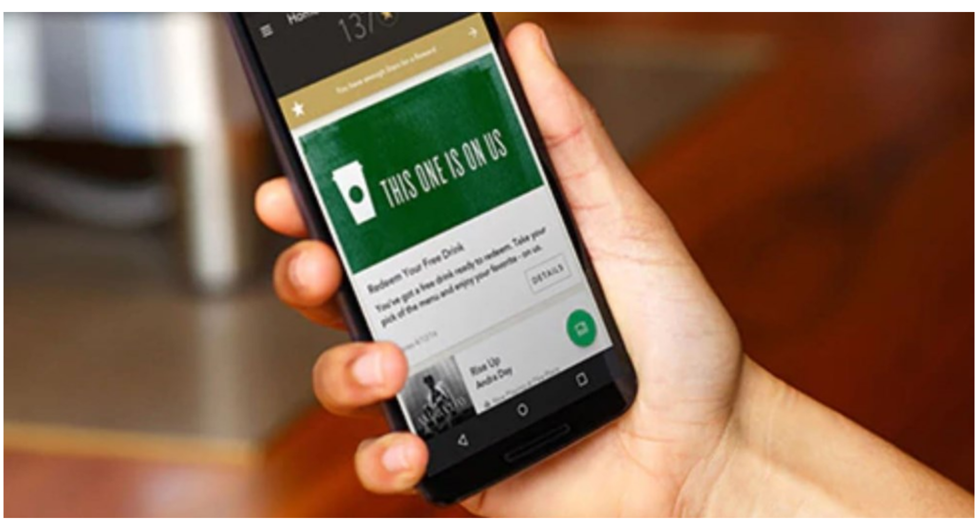


Figure 2: Starbucks app for iPhone.[3]

Determining The Maturity of Pricing

The good news — and the huge opportunity — is that restaurants can put a pricing strategy and pricing processes in place which offers the guidance, if not definitive answers, to create and preserve an equilibrium between value and price. That powerful and valuable equilibrium comes from understanding where you currently stand relative to each of the six challenges above, then defining, prioritizing, and executing the steps to address them. But how do you establish that baseline, decide where to begin, and determine how to balance expectations between investment and outcomes? After all, significant price and menu changes are expensive and risk alienating guests.

It all starts with knowing your current level of pricing process maturity and

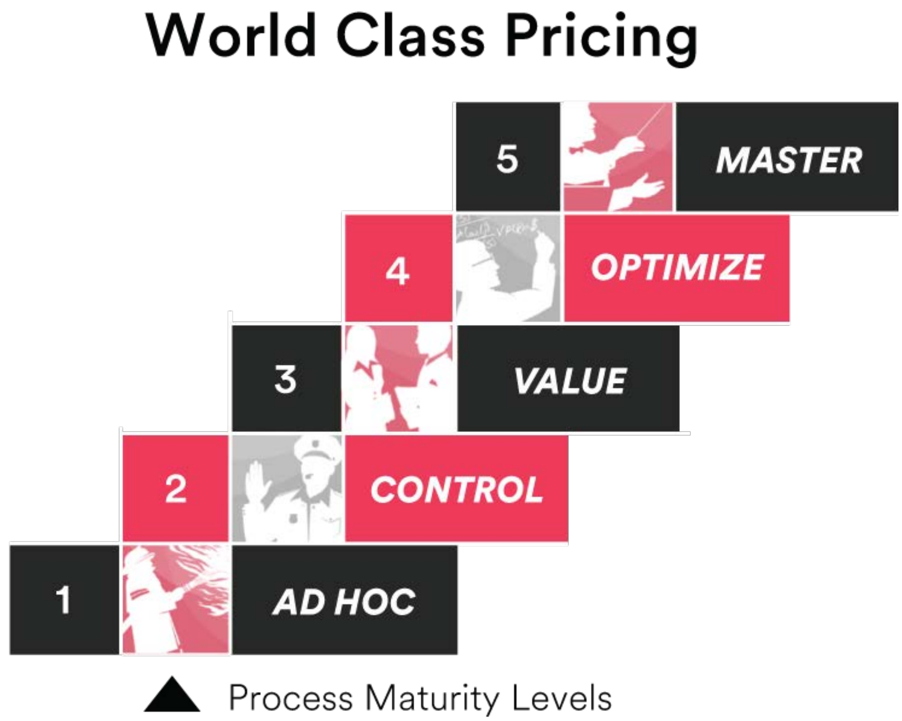


Figure 3: World Class Pricing ™ takes a company step-by- tep toward optimization and ultimately to mastery in terms of pricing.

determining the realistic and the aspirational levels to aim for. The World Class Pricing™ system (see Figure 3) comprises five levels. Where a restaurant starts and where it ends up in terms of pricing depends on its maturity level, which we assess using that progression.

Roughly 70% of all restaurant chains fall into either Level 1 or Level 2. This illustrates the nature of the opportunities for restaurants. Rather than needing to catch up to peers, they have a chance to carve out a clear advantage, both commercially and financially, when they make pricing their ally.

The levels differ in terms of the intensity of the challenges, their root causes, and the steps a restaurant needs to take in order to reach the next level and aspire to progress further. See Figure 3.

Level 1: Lack of Strong Controls

Restaurants at Level 1 show the weakest controls over the discounting addiction. They rely too heavily on promotions, and they are slow to weed out the unprofitable stores which contribute to the vicious cycle of promotions. But the lack of controls extends beyond discounting and promotional behavior.

Challenges:
- Overpromoting
- Cost-Based Pricing

Level 1 restaurants use simple rules of thumb instead of grappling with the six challenges. They make across-the-board price increases (say, 3% on everything) instead of targeted ones. They suffer from menu proliferation ("more is better") instead of focusing on balance. They also use costs as the basis for their price setting (cost-plus method) rather than using value as the basis.

The response of one restaurant chain in the face of minimum wage and food cost increases shows the risks of being at Level 1. The company implemented a large, across-the-board price increase to offset these costs. But this price increase bore no relation to the underlying value in its menu. The result was a lower guest count compounded by lower volumes or tickets from the guests who did come. The restaurant fell short of its financial goals. What could the restaurant have done differently?

The solution lies in adopting the practices from Level 2. It starts with revisiting the core value proposition and reinforcing what the brand truly stands for. The chain needs to put controls in place that limit the extent and frequency of promotions and close its unprofitable stores. Finally, the chain needs to pull back from a "more is better" philosophy and ensure that the menu closely reflects the core value proposition. In most cases, this leads to a simpler menu.

Level 2: Controls Are in Place, but Value Is Left Untapped and Underutilized

Putting controls in place and reaching Level 2 is an important achievement, but the journey is only beginning. Despite a clearer pricing process and more controls on promotions, Level 2 restaurants still behave similarly to Level 1 restaurants in some aspects, albeit to a lesser degree.

One of the key similarities is the continued reliance on simple rules of thumb. While they manage their promotions better, they still take more of a "one-size-fits-all" approach rather than targeting specific segments. They also risk sliding back into the old behavior of heavy promotions if guest

Challenges:
- Cost-Based Pricing
- Vanilla-Based Price Increases (e.g. 3% across the board)

count declines, despite their controls. In the process of identifying and closing unprofitable stores, they may have developed store tiers, which is an important step away from using rules of thumb to set chain-wide prices.

But even in that case, they are prone to use costs to define the store tiers, rather than using value, which is a better metric, but which can be harder to define. Perhaps most critically, they still make price increases based more on costs than value. Figure 2 illustrates how a restaurant can knock its price-value relationship out of balance when it uses costs instead of value as the basis for a price increase.

The diagonal blue line indicates the threshold where price and perceived value are in equilibrium. By raising the price significantly above that line, but keeping the product quality the same, the chain puts its coffee's price-value relationship not only at a disadvantage relative to the notional equilibrium, but more importantly relative to its two primary competitors. The chain used rising costs as the justification for the price increase, but Figure 2 explains why making such a move is harmful both financially and in terms of competitiveness and brand image. See Figure 4.

The solution, and the source of future improvement, centers around one vitally important word: value. One could say that the biggest difference between restaurant chains at Level 2 and the more value-focused ones at Level 3 is that they have the desire, the capabilities, and the commitment to create analyses like the one in Figure 2, and then interpret them and act on them. In other words, they start using value — both in the visceral and the quantitative sense — as their guiding principle for menu and pricing decisions, rather than costs or short-term competitive pressures. When they make this shift in focus, they start to segment their customers and redefine their store tiers based on value. They are also in a position to redesign their menu around key price points.

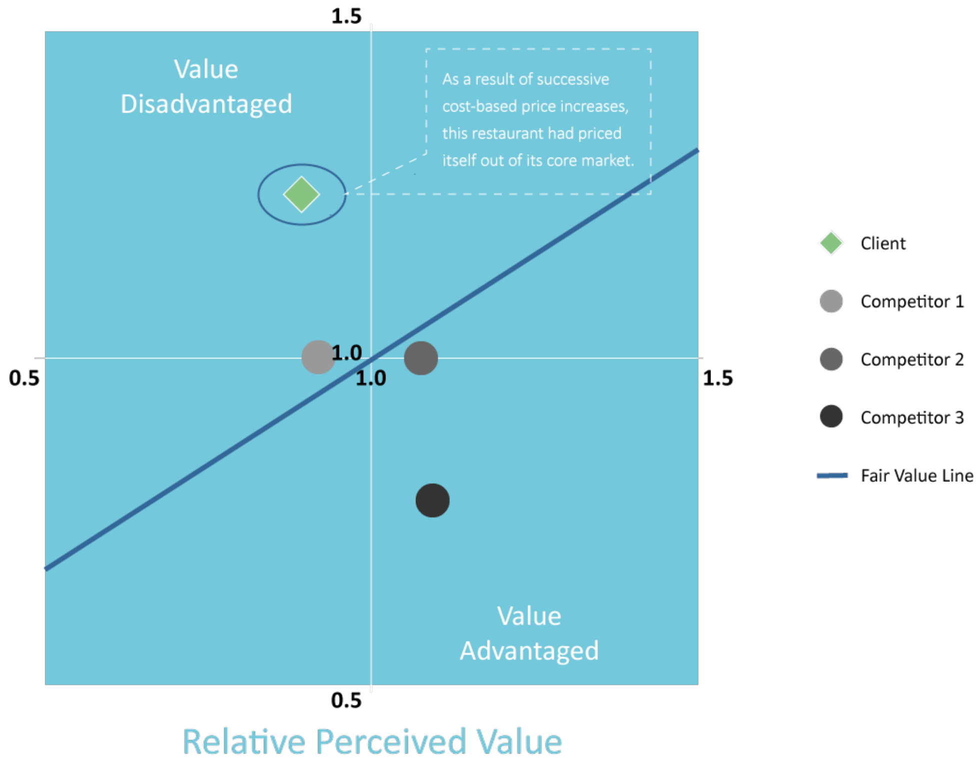
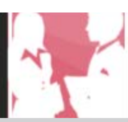


Figure 4: Price value map for coffee, core customer segment. A cost-based price increase for coffee puts this restaurant, and its core segment, at a value disadvantage.

Level 3: Add Value-Based Pricing to Your Strong Controls
The emphasis at Level 3 switches from outright improvement to enhancement, because restaurants start capitalizing on their firmer grasp of customer and competitive dynamics. They know their customers very well by conducting regular research to augment their own POS data. This helps them gain a deeper understanding of the value drivers in the markets, and how they perform relative to the competition. Our own research has found that food quality is the top value driver, ahead of price, regardless of where the restaurant competes along the industry spectrum from QSR to casual.

3  **VALUE**

Challenges:
- Competitive Benchmarking
- Store Tiering
- Deep Knowledge of Customer

This extensive knowledge base, combined with an understanding of value vs. cost, enables restaurants to make pricing decisions which are more tightly aligned to their core value proposition.

Restaurants at Level 3 undertake smart redesigns of their menu, building around key customer segments and key price points, such as breakfast deals at $5 and lunch deals at $10. These prices do not come from thin air. In our price expectations research, we use "fair price/think twice" questions to uncover customers' price thresholds. This research has repeatedly shown that $10 is a key price threshold for lunch. In the spirit of the control and discipline they fostered at Level 2, many chains at Level 3 reinforce these key menu price points but by offering discounts only to key segments of the market. See Figure 5.

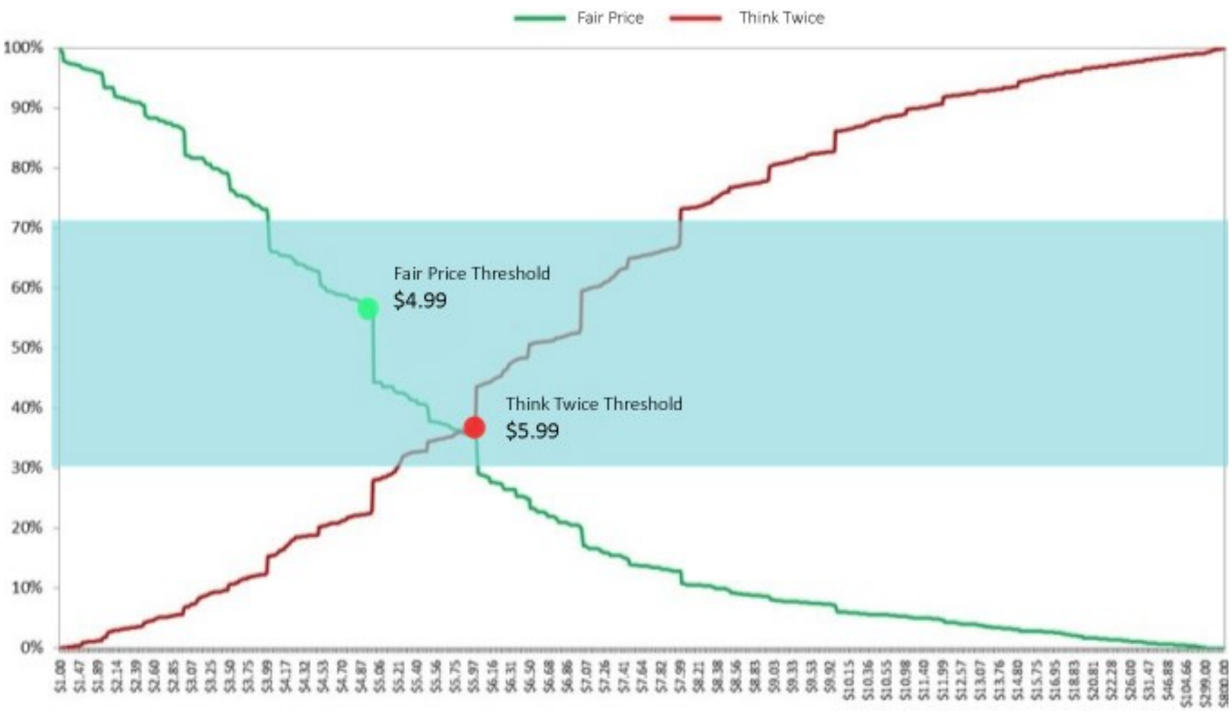


Figure 5: Example of "Fair Price / Think Twice" analysis for breakfast

A more comprehensive, value-based pricing approach also extends to the determination of store tiers. Instead of treating all stores the same, or focusing on a few simple metrics, the restaurant group takes all 4 Cs (customer, costs, competition, and conditions) into account in order to maximize value across the group. When we analyze individual restaurants across an entire system, we generally find less price sensitivity in areas where there are many travelers (customers), few nearby competitors (competition), high wages (costs), and high household income (conditions). This combination creates a set of pricing opportunities not present at stores where, for example, competition is much more intense and local purchasing power is lower.

The more rigorous and quantitative the store-tiering analysis is along the 4 Cs, the greater the chances the restaurant can isolate and seize specific pricing opportunities. An analysis we performed for a restaurant chain with over 900 stores revealed that most locations with no key competitors located within 1,000 feet could increase prices without losing volume. The extent of the changes varied from store to store based on the other Cs, but this one change alone was responsible for over $5 million in additional revenue. What made this incremental revenue possible was the underlying analysis involving thousands of data points and millions of interrelationships.

One risk that restaurants at Level 3 face comes as they make the transition to value-based pricing. The intensive focus on this new pricing approach cannot come at the expense of the discipline and controls the company has implemented to improve its revenue and profit situation in the first place. Value-based pricing should in fact build upon this discipline and control.

Level 4: Optimize Your Value-Based Prices

Restaurants at Level 4 have implemented value-based pricing, but their journey is far from over. Thanks to market dynamics as well as ongoing improvements in capabilities, technology, and data, these chains now face the challenge of optimizing their menu prices.

Optimization not only preserves the gains from previous levels, but also yields additional incremental profit improvement.

Menu optimization is an iterative, ongoing process which requires a considerable amount of data and analysis. The process starts with identifying price elasticities at the category level, or ideally at the item level. By knowing how sensitive the volume of each menu item is to changes in price (both small and large), the restaurant can develop a predictive model which shows how revenue, guest count, profits, and other key metrics move as prices change. Just as important are the interrelationships between menu items and price changes, i.e., the substitution effects and the basket effects. The model, in turn, allows the chain to make decisions on optimal prices for each menu item and bundle.

4  ***OPTIMIZE***

Challenges:
- Predictive and Prescriptive Modeling
- In-Store Testing
- Survey Testing (Menu-Based Conjoint)

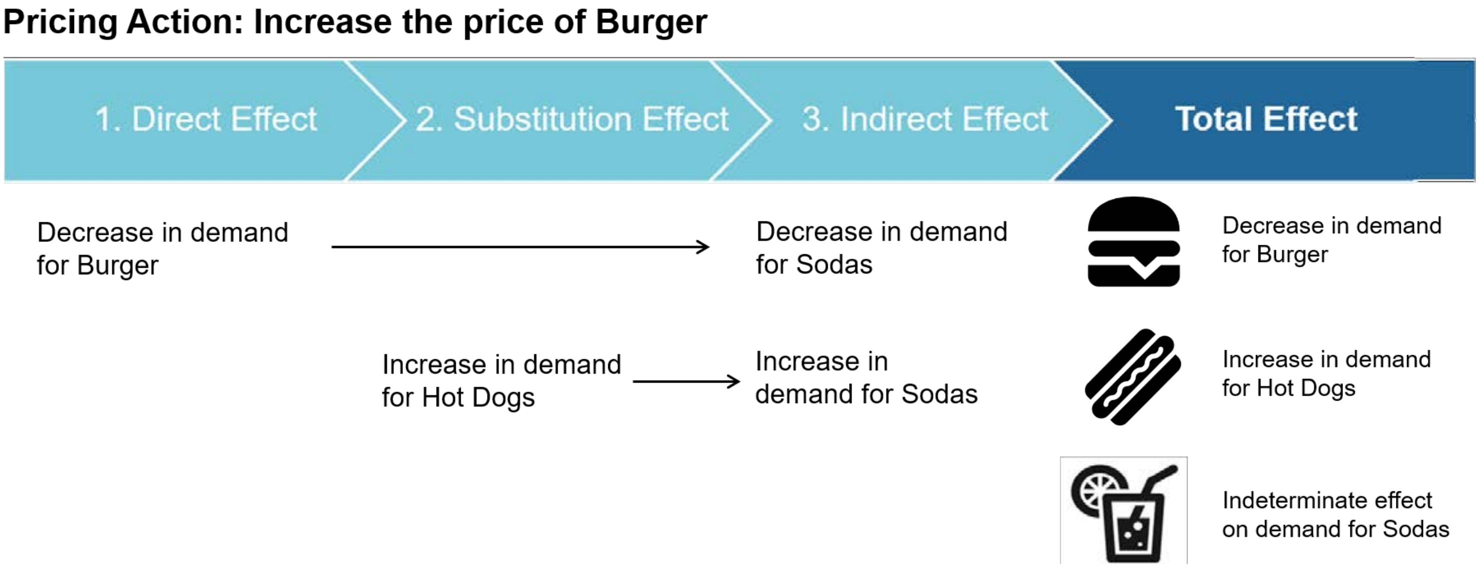


Figure 6: Measuring the total impact of a price increase on the business by analyzing direct, substitution and indirect effects.

Getting accurate estimates of price elasticities allows restaurants to identify the extent of their pricing latitude across the menu. The analyses reveal areas where the restaurant can raise prices comfortably, where changing prices would be risky, and even where lower prices would be advantageous. Generally speaking, there are many menu items that are price-inelastic, meaning an increase in prices results in only small decline in volume. Higher prices are therefore worth considering. Conversely, some products are consistently price elastic. For example, beverages — regardless of whether they are soft drinks or alcohol, hot or cold — are more sensitive to price changes than food items are. In fact, they are sensitive not only to changes in their own price, but also changes to food items' prices.

One restaurant learned that latter point the hard way with its breakfast menu. Its aggressive price increases on breakfast sandwiches inadvertently affected its coffee sales, as guests continued to buy the sandwiches but stopped buying coffee in order to keep their total ticket constant.

Three kinds of analyses provide the necessary insights for menu optimization.

Leveraging POS (and App) Data
POS data — supplemented by App data if available — is a unique, renewable resource. It is continually refreshed and increased with each guest purchase, it is visible only to the system which collects it, and it incurs no third-party acquisition costs. Once again, the analyses based on this data must capture both the direct and indirect effects of potential price changes. Calculating the direct price elasticity, i.e., the impact of an item's price change on its own volume, is the easier part. More difficult, but just as essential, is the measurement of the substitution and the basket effects.

The substitution effect occurs when a price increase on one item prompts guests to shift their consumption to other menu items they perceive as better value for money. The basket effect occurs when a price change in one item affects the volume of a complementary item (such as sides or beverages). See Figure 6.

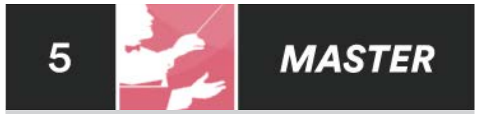
Testing (In Store)
This method is well suited for getting direct feedback from guests while minimizing the financial and commercial risks. By limiting the test to a small number of locations and/or items, and by keeping the test period short, the restaurant gains valuable insights into how guests will respond to menu and price changes, but without exposing the entire system's guests (and its competitors) to the changes under consideration. These tests generally run for 1-2 months in order to give guests multiple interactions with the changes. One chain (see Figure 2) ultimately used this approach to redesign its high-priced coffee offer, a move which drove millions of dollars in revenue and profit improvement. The method is widely used to test the effects and performance of new products. But we feel the method is underutilized as a means to test price changes, in part because of restaurants' reluctance to test prices in the market.

Testing (Online Surveys)
This approach is especially appealing when the changes under consideration are too bold or risky for an in-store test.

The best practice for these surveys is Menu-Based Conjoint (MBC). This method allows pricing departments to conduct controlled randomized experiments with prices and collect valuable data from the respondents. This method also has an advantage which both POS data and in-store testing lack: the ability to capture non-customers as well as a sufficient number of light users, who may be inclined to visit more and consume more if the price-value relationship or menu composition changed. Surveys offer a means to gather information from both of those groups and also understand the reasons behind their current behavior.

MBC is not only a powerful analytical method, but a confidence builder as well. When a QSR chain wanted to redesign its value menu and push some low-price items beyond the critical thresholds of $1 and $2, we conducted an MBC which helped them gain the confidence and knowledge needed to successfully implement the changes such that they improved business performance.

Level 5: Pricing Mastery over Time
Level 5 companies have typically honed their skills at Level 4, have superior profitability to their industry peers and the CEO sees pricing as a source of competitive advantage. Their pricing processes are optimized



Challenges:
- At Least 3 Years at Level 4
- Pricing Fully Integrated Into Business Strategy

machines which are "well oiled" with a constant inflow of valuable data. Level 5 companies have completely integrated pricing into their business. The pricing function is often led formally by a Chief Pricing Officer reporting directly to the CEO. Given the dynamic nature of the restaurant industry there are very few companies that can claim to be Level 5.

Conclusion

When building a high impact pricing strategy for a restaurant business, the goal is to optimize overall long-term profitability. As a restaurant makes the upward progression from Level to Level, it becomes better and more confident in addressing the six challenges which make pricing in the restaurant industry so difficult. It also abandons one-size-fits-all thinking, simple rules of thumb, and reactive tactics, in favor of a data- driven approach which provides insights at the individual store, menu item, and in some cases even guest level. The right pricing strategy, backed with the right model, increases overall returns by improving the complex interplay between guest count, menu design, and ticket size. ❖

Endnotes

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