Pricing Moves You Can Make NOW To Improve Your Bottom Line

Vistaar White Paper

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Introduction

According to the Bureau of Labor Statistics, over 3.6 million jobs have been shed since the start of the recession in December 2007; about one half of the job losses occurred in the first three months of 2009. Your company, like all others, is looking at a myriad of cost cutting actions to adjust to falling revenues. Real leverage, however, comes from making strategic pricing moves in concert with cost cutting actions. In this white paper, Vistaar Technologies presents proven tips and pricing techniques you can use NOW to improve your bottom line. The paper is intended to serve as a guide to help a broad range of organizations, whether B2B, B2C, distribution or service, take advantage of best practice pricing techniques.

This information was also presented in a webinar which was held on March 18, 2009. A full recording of the webinar is available at Vistaar.com and StrategicPricingPartners.com

Five Proven Techniques

1. Analyze your business at a transaction level to identify and plug revenue leaks
2. Aggressively manage customer profitability
3. Update price sensitivity research
4. Resist lowering price by using other tools at your disposal
5. Deploy advanced pricing technology

At the conclusion of each section we will provide a brief summary that provides specific steps you can take to benefit from the technique within your organization.

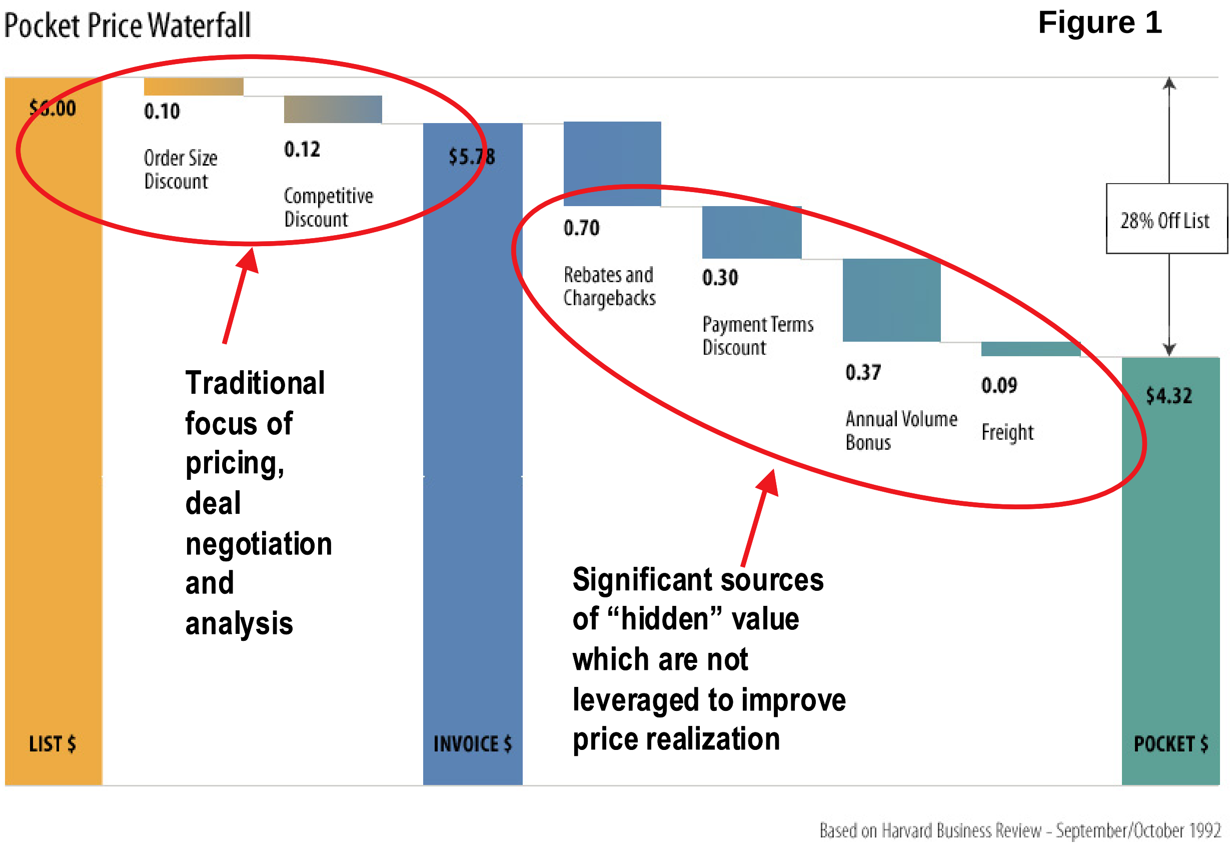
Analyze Your Business at a Transaction Level to Identify and Plug Revenue Leaks

As written in the introduction of this paper and reinforced in the headlines virtually every day – we are in the most challenging economic environment of our professional lives. Despite the economic times, organizations can still outperform their competitors and even thrive by focusing not only on expense management, but also on revenue, pricing and overall profitability. This more comprehensive focus not only supports survival during difficult times, but also positions organizations for growth and market share gains as the economy begins to recover.

In order to execute this tactic effectively it is critical to have a clear understanding of your revenue components and leakage points at a detailed transactional level. A primary tool to support this concept is the standard price waterfall. In the following illustration (figure 1), extracted from a

1992 Harvard Business Review, we provide examples of common elements of price leakage. While this level of analysis may seem elementary, in our combined experience, fewer than 50 percent of organizations have a price waterfall in place to clearly identify key revenue leaks.

Figure 1



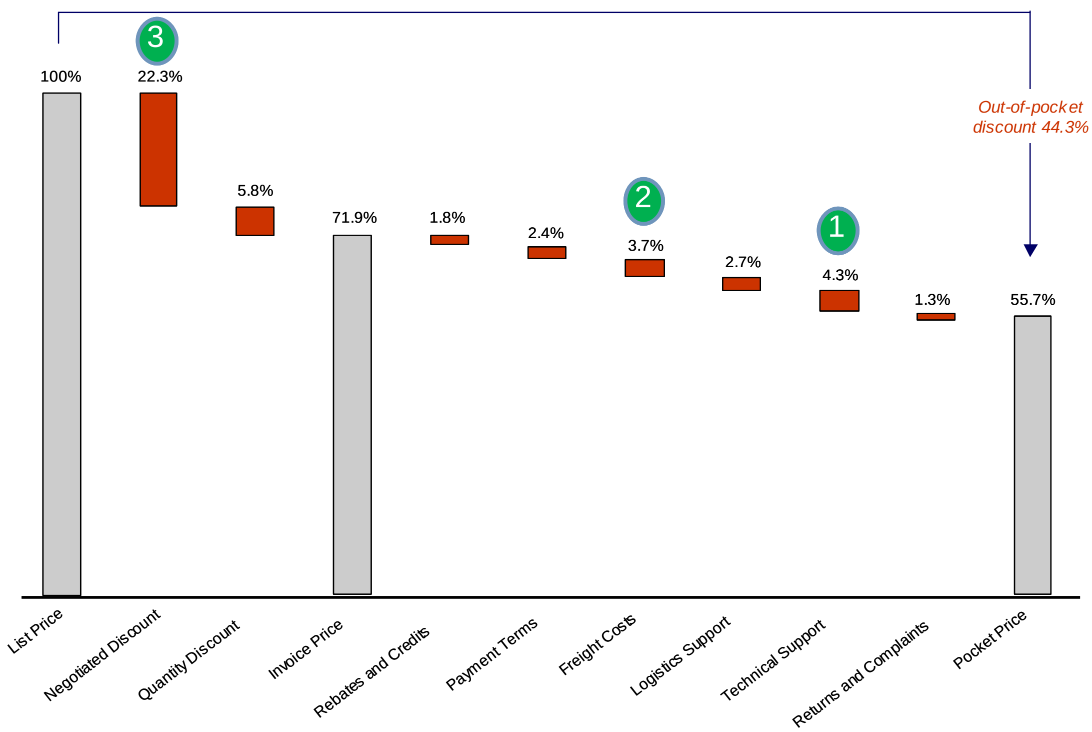
Throughout this paper we will draw on our experience to present real-world examples that help illustrate certain points we feel should be emphasized.

In our first example (figure 2), we'll demonstrate the opportunity associated with exposing elements of a price waterfall. Our example company is an industrial B2B manufacturer who, not surprisingly, did not have a price waterfall in place. After co-developing a waterfall, we uncovered a number of opportunities that were previously overlooked: onsite technical service, freight and undisciplined discounting at the point of sale.

This organization realized that significant dollars were invested in on-site technical support. In many cases there were no charges at all for the service and in others the services were vastly undercharged. In fact, over 20 percent of the transactions we examined were with unprofitable customers where on-site technical support was *given away in order to close a deal. Another key element that was poorly understood was the cost the organization incurred to ship items to customer locations. This organization was only capturing about 2 percent of their freight expenses through customer charge backs.*

The client was able to significantly reduce leakage in these two areas by implementing a series of new business rules and approval authorization processes. While they may seem trivial, these two components together represented over 20 percent of the total "discount" provided to their customers. Finally, the introduction of a price waterfall also exposed a serious problem with undisciplined discounting at the point of sale. The data showed that this organization's defined discount structure was poorly enforced, as virtually all price escalations were approved without question of profitability, strategy, or competition.

Figure 2



How to Build Your Own Price Waterfall to Plug Revenue Leaks

In order to analyze your business at a transaction level and identify opportunities to plug revenue leaks, follow these steps:

1. Develop your own “pocket price” waterfall
   - Set up cross-functional teams that incude all appropriate stakeholders. Many organizations fail to leverage waterfalls because they hide them within finance or pricing. The waterfalls should be available to all teams and thus provide value to other functional areas including sales, marketing and product management.
   - Determine goals for your price waterfalls.
   - Develop the waterfall structure, including the definition of the waterfall elements. Do not allow incomplete data to prevent you from moving forward. Start with basic elements that can be reasonably captured and move forward as appropriate.
   - Train, implement and measure.

2. Plug your revenue leaks with a triage mentality
   - Identify key revenue leaks.
   - Use a sampling methodology to identify root causes. Validate root cause hypothesis with your cross-functional team.
   - Address the critical and easy to plug leaks first. Success will breed success!
   - Measure and inspect. As improvements are delivered, communicate the success broadly across the organization to increase momentum.

Aggressively Manage Customer Profitability

The next technique focuses on aggressively managing customer profitability. To pursue this opportunity, pricers need to recognize that all customers are not created equal and as a result, organizations provide different degrees of service at a wide range of prices. As a result, the profitability of one customer versus another of similar size may swing dramatically. One of the most common traps pricers fall into is focusing too much attention on price realization and gross margin yields and not enough on the true profitability of the customer. They become further entrapped if they focus exclusively on traditional price levers to improve the performance of low profit accounts. As virtually all pricers come to realize, price increases can be quite difficult to deliver due to competitive market pressures, current conditions or restrictive terms and conditions that govern purchasing agreements.

To start down the path of managing customer profitability, it is imperative to build a customer profitability waterfall. Conceptually, the same as the transaction-level waterfall discussed above, this waterfall may have additional elements that take it from pocket price to customer profitability. Many organizations stumble through this initial endeavor, as they strive to achieve the “perfect” customer waterfall – often replicating a version they have seen at a pricing conference or reviewed in one of the many books on this topic. In order to be successful, the waterfall must be credible, but it does not have to be perfect. There may be certain cost elements that are difficult to assign to customers due to source data systems. Do not become paralyzed and spend unnecessary resources on elements that typically do not have significant variance across customers. Rather, focus your time and energy on available cost drivers and in particular those with large swings from one customer to another.

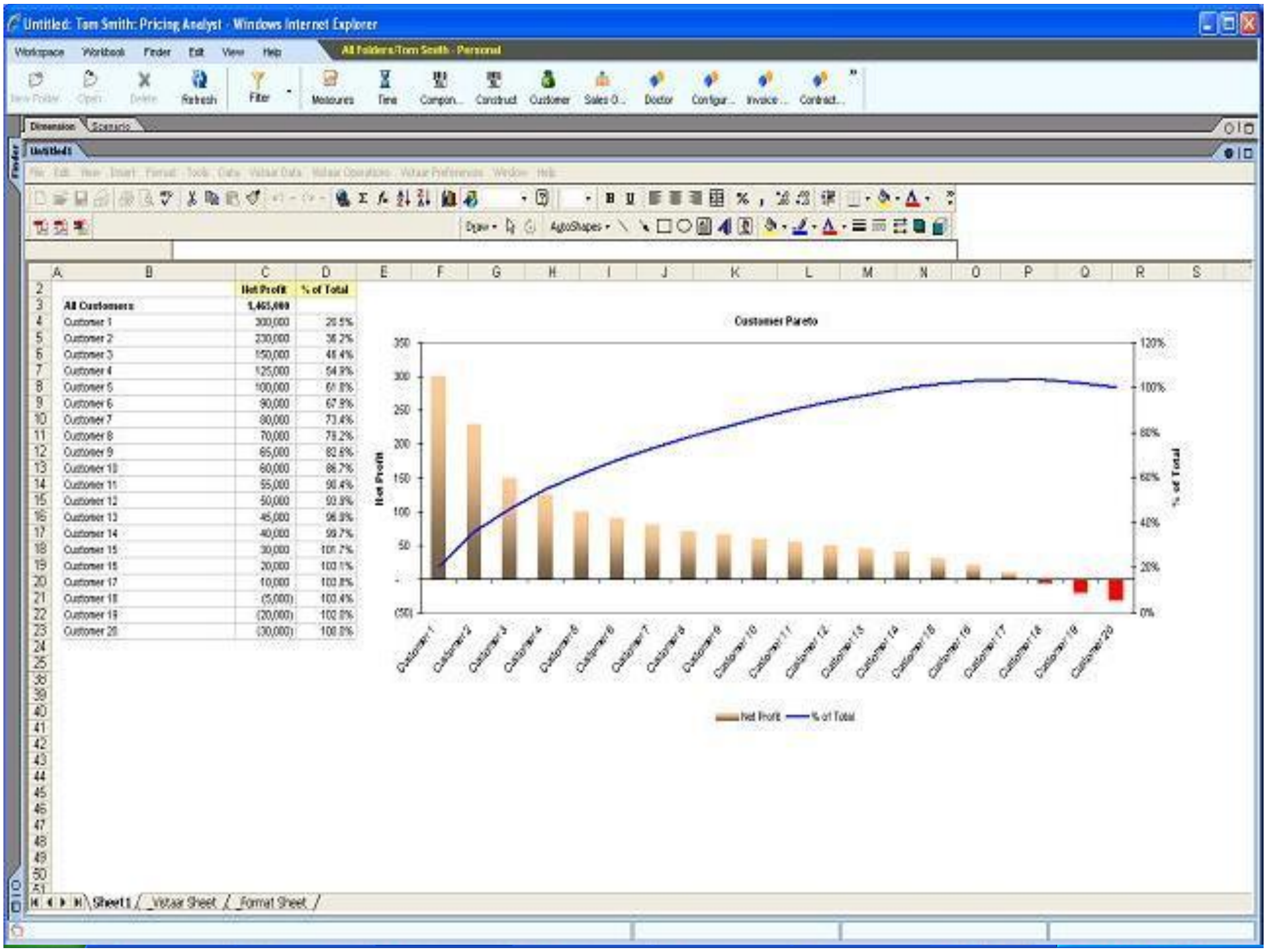
Once you have identified the appropriate profitability components and secured the necessary data to assess profitability from one customer to another, it is time to make the information actionable. There are two primary items to keep in mind when leveraging customer profitability:

- Develop a methodology to prioritize accounts that have significant opportunity. There are a number of methods to help accomplish this. A Pareto chart that shows customers' contribution towards profitability can be very helpful. Additionally, it can be quite useful to sort customers based on their opportunity; where opportunity is defined by the gap between the customer's actual performance and the profit the account would generate if it had an "average" profitability rate.
- As you are reviewing the account profit waterfall, compare it to either similar type accounts that operate at higher profit levels or to averages for segments of similar type customers. This allows you to easily identify areas where you can focus corrective actions to improve performance.

To provide some context of how important this information can be in managing your business, we will share another example from past experience:

> *When a sales leader was asked to approach a customer to capture rather significant cost increases, he responded, "How can I ask for increases when the customer is threatening to take our business out to bid if we don't reduce pricing".*
>
> *After some negotiating back and forth, the sales leader agreed to seek a moderate increase. Shortly after this conversation, after introducing the customer profit waterfall and realizing the customer was only marginally profitable and absorbing significant resources for the organization, the sales leader took a significantly different position. He understood the costs associated with the special services provided to the customer, coupled with the clear value the customer was receiving, therefore the sales leader felt confident approaching the customer. The customer was given an option of a more standard service offering (more typical in the industry and the basis for their price comparisons) or to accept the price increase. The customer recognized the importance and value of the incremental services and agreed to the full increase.*

Account Profitability Pareto



How to Manage Customer Profitability through a Profit Waterfall

1. Develop an appropriate methodology for measuring customer profitability
   - The measurement does not have to be perfect. Often organizations become paralyzed by trying to exactly replicate a waterfall they have seen from another organization. Focus on the relative performance of one customer versus another and the waterfall elements that are relevant and available.
   - Focus your attention and resources on the areas of profit erosion that have the most variance across customers.

2. Rank accounts by descending or ascending profit performance to easily isolate target accounts for improvement opportunities

- A Pareto chart (shown above) is a useful tool for identifying accounts that are not appropriately contributing to the organization's profitability.
- Create visibility by ranking account profitability performance at the sales rep level to identify trends relative to discounting or other profit impacting behaviors.

3. Prepare customer profitability waterfalls for targeted account
   - It can be extremely beneficial to provide sellers with prescriptive account improvement plans. This is particularly important in the early phases of an organization's account profitability efforts.
   - Review all areas of account performance – pricers often err by focusing too much attention on traditional components of price.

Update Price Sensitivity Research

Private wage and salary disbursements decreased $25.8 billion in January 2009, compared with a decrease of $27.0 billion in December 2008. The financial meltdown has sapped more than 18 percent of U.S. households' wealth, according to the *Wall Street Journal*.

> *"This economic crisis doesn't represent a cycle. It represents a reset," Jeff Immelt, CEO of General Electric, said recently. "It's an emotional, social, economic reset and businesses that understand that will prosper in the future and those that don't will get left behind."*

Companies that utilize advanced price optimization software are often advised to update their price sensitivity research once or maybe twice a year at most. The logic behind this traditional thinking is that customers' buying patterns don't change too dramatically and to see these subtle changes you need a larger data set. The same advice has been given to companies that do their own price sensitivity research. However, this advice no longer applies. We've come to realize the market situation is dynamic – things are changing rapidly and parameters are being reset at ever shrinking intervals. Your customers are changing too. They change what they value, how they buy and their relationship with all their vendors. In order to capture these changes and adjust your pricing strategies you need to:

1. Update price sensitivity data at appropriate frequencies
   - Recognize that in today's volatile economic environment annually or semi-annually may not be sufficient.
2. Study your transaction data to identify any significant shifts in price structure
3. Couple market trend analysis with transaction data analysis

Resist Lowering Price by Using Other Available Tools

The early sections of this paper focused on how organizations could improve processes and leverage information to improve the profitability and price realization from existing customers. We understand that in a number of situations, you will be faced with scenarios where a customer will be pushing hard for price concessions. This section provides a framework for approaching this situation in a way that will help you avoid emotional and opinion based responses and equip you to deal with the negotiations in a logical and data-driven method.

The first step of any pricing negotiation is to review the current customer dynamics and assess whether a price concession is appropriate based on the Value Equivalency theory. This assessment assumes that based on the value you are providing to the customer, there is a narrow range of prices that are appropriate for the particular customer situation. Keep in mind that this evaluation should be done from the customer's perspective rather than your internal view. The following chart (figure 4) illustrates the concept of value equivalency.

Once you have completed your existing customer value review and concluded that some concessions are appropriate, it is time to objectively analyze the relative leverage your organization has in the negotiation. When determining the leverage, be as objective as possible and attempt to measure costs and benefits from both your company's perspective as well as that of the client. Make sure to consider softer costs such as switching costs and risk. When companies take an objective approach and make an effort to quantify the negotiating power on each side they are often surprised by the value they are bringing to the table.

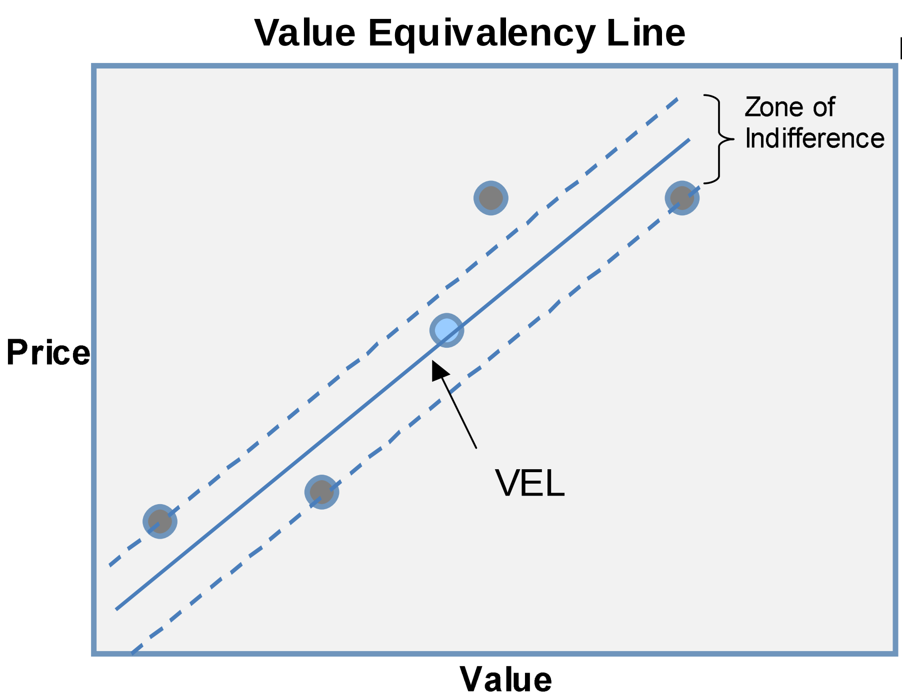


Figure 4

Source: The Price Advantage

The final step of this process is to choose the appropriate levers to adjust during the negotiations. For simplicity these tools can be categorized as pricing tools and all other tools. Pricing tools would include items such as discount levels, customer rebates, and payment terms. Each of these items results in corresponding reductions to the net Pocket Price defined in the waterfall. The non-price tools include options such as switching to lower priced product (i.e. private label), adjustments to deliveries or service levels, or changes to services such as training or technical support. As a general rule it is preferable to adjust using non-price tools, but there are certain deal circumstances where price is your only option.

How to Leverage All Available Tools During Negotiations

1. Review all available data so you are negotiating from an informed position. Those with the best information and most objective approach to the negotiation process will usually achieve the desired result. Use this information to assess whether change in pricing, value or terms is required. Often customers ask for concessions because they are trained to do so. These same customers will often readily accept a value-based rebuttal.

2. Measure your leverage in the negotiation process using an objective and quantified process.

3. Review the account profit waterfall prior to making any decisions.

4. Carefully choose from all available tools to accommodate the customer requirements and meet your company's profitability and pricing objectives.

Deploy Advanced Pricing Technology in Your Organization

It may seem illogical in these economic times to consider significant investments such as integrating pricing technology into your organization. Conventional wisdom suggests that businesses will be less willing to embrace the risk and short-term costs that come with innovation. Paul J.H. Schoemaker, research director for the Mack Center for Technological Innovation, suggests that, for some companies, the economic crisis can actually provide an innovation platform.

> *"The crisis has multiple impacts," Schoemaker says. "Loss of revenue and profit will at first instill a cost cutting mentality, which is not good for innovation. But if the patient is bleeding you need to stop that first. Then, however, a phase starts where leaders ask which parts of their business model are weak (and perhaps unsustainable) and that, in turn, can lead to restructuring and reinvention."*

The reality is that this type of investment can be transformational to your company. There may be no better time for leaders to assess their strengths and weaknesses and determine where investment can deliver fundamental change and positively impact the business. From this perspective, we believe that investment in pricing capabilities and pricing technology are timely and appropriate.

There are three common roadblocks to tackle if a company wants to transform their pricing capabilities. The first roadblock is the overreliance on ‘incremental’ versus ‘disruptive’ innovation. In innovation circles, the two have come to be differentiated as "little i" and "Big I" innovation. The largest gains in business often come from innovations that challenge the paradigm and the organization. One of the most critical assets an organization can possess is company-wide recognition that disruptive innovation is actually important. In a company that's already successful -- or one with layers of bureaucracy that hinder new ideas -- this can prove difficult.

The second roadblock is something Wharton management professor Mary Benner calls "stick to our knitting" syndrome. This is where embarking on an innovation path, such as pricing transformation, can seem to executives, employees, shareholders and securities analysts like too great a departure from their expectations for these firms. In a sense, by 'sticking to their knitting’ companies feel like they can minimize risk. This is evidenced by the fact Microsoft Excel is still the most widely used pricing tool. With this inaction, companies limit their ability to react to competitive threats or create separation from their competitors.

The last roadblock we call ‘the curse of knowledge’. For companies that want the "secret sauce" to always come from in-house sources, previous success can present a huge roadblock to innovation. The problem is that success creates a virtual construct, a paradigm of "How to Do Things," inside of which new thinking cannot flourish.

Disruptive innovation is a theory that can be used to describe the impact of new technologies (a revolutionary change) on a firm’s existence. This concept was first originated by Clayton Christensen in 1997. He showed that time and time again almost all the organizations that have ‘died’ or been displaced from their industries, because of a new paradigm or customer offering, could see the disruption coming, but did nothing about it.

The following table (figure 5) differentiates incremental or sustaining innovation versus disruptive innovation from a pricing perspective:

Figure 5

Sustaining

- Approach
  - Gut feel or instinct
  - Reactive
  - "I've done it this way for 30 years"
  - Lack of ownership – everyone owns it
  - Volume and revenue focused
- Process and Tools
  - Manual
  - Spreadsheets
  - ERP systems
- Visibility
  - Tactical initiative
  - Little visibility at executive level (unless there is a problem)

Disruptive

- Approach
  - Data driven and fact based
  - Proactive
  - New innovation driven best practices
  - Owned by pricing group or function – specialists
  - Profit-driven pricing approach
- Process and Tools
  - Automated workflow
  - Sophisticated technology
  - Best-of-breed solutions
- Visibility
  - Strategic initiative
  - Executive ownership

We believe businesses are at risk of repeating history. Companies that ignore advanced pricing technologies are in danger of being displaced. Pricing technology is a transformational opportunity that will reward those organizations that have the foresight and the intestinal fortitude to implement it during the early adopter or early majority phases. AMR Research, a research and advisory services firm, has stated *"Price Management will be the second most strategically important customer management investment by 2010".* Another leading research firm, Gartner Inc, has stated, *"The results of organizations implementing pricing optimization have been significant. Margin uplifts of 10% and profit enhancements of 15% or more have been the norm rather than the exception."*

How to Deploy Pricing Technology

To summarize the process of evaluating pricing technology:

1. Assess your organization's pricing capabilities against high performers in your industry. Call in the experts if you don't know how to do this.
2. Get senior management buy-in and support for the initiative. Make the initiative strategic and company-wide.
3. Review your current technology to identify need and fit for specialized pricing technology.
4. Evaluate options within the pricing technology marketplace. Leverage sources including AMR, Gartner and pricing consulting firms. Assure fit to your organization's unique requirements.
5. Build an achievable business case to justify investment and secure funding.
6. Make sure the decision to move forward has broad senior level support.
7. Commit and don't waiver.

Summary

Forward thinking, innovative leaders understand that guiding their organizations through these turbulent times takes a balanced approach – one that makes the necessary cost-cutting moves but also invests in capabilities that prepare their organization to take full advantage of the market when the turnaround occurs. We have outlined five proven techniques your company can implement now to improve profitability and position your organization for long-term growth. It is our hope that you will be able to take some of these practical techniques back to your organizations and implement them in a way that fits your organization's pricing environment.

About Vistaar

Vistaar is an innovator of price and revenue management solutions. Vistaar's pricing software enables companies to achieve pricing best practices through price analytics, price optimization, price list management, and deal management. Vistaar is working with companies such as AMD, Beam Global, Cisco, Ford and GE to transform pricing operations into a strategic advantage. For these companies, Vistaar pricing software drives measurable price and margin improvements that deliver profitable growth and maximum shareholder value. Vistaar's operations include six offices across North America, Europe and South Asia.