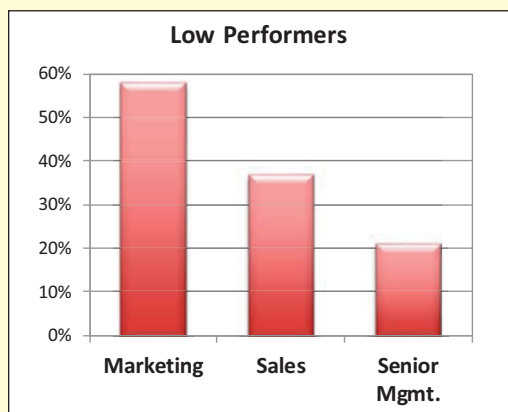


Pricing in the New Market Reality



A recently completed year-long study of more than 200 pricing managers clearly demonstrates that, although a majority of pricers have found pricing to be more difficult now than before and even during the recent recession, there is hope on the horizon. A small, but growing number of firms are finding ways to grow profits by making pricing a core pillar of their corporate growth strategy. In this article, the authors outline the findings of the survey, highlight strategies that are working and explain how companies that are giving pricing “a seat at the table” are finding success in this challenging market. John E. Hogan Ph.D., Co-founder Value Management Advisors, can be reached at jhogan@valuemanagementadvisors.com. Jamie Rapperport, Co-founder of Vendavo, can be reached at jrapperport@vendavo.com.

“Our world has changed and so must we.” This is the conclusion reached by more than two hundred pricing managers participating in our year-long study of how firms are adapting their pricing strategies to post-recession markets. Managers in virtually all industries we studied report that market conditions remain challenging as customers exert more power to extract price concessions and as sellers increasingly compete on price to protect or gain share. The outlook for the future, seemingly, is not much better as managers expect these challenging market conditions to continue into the foreseeable future.

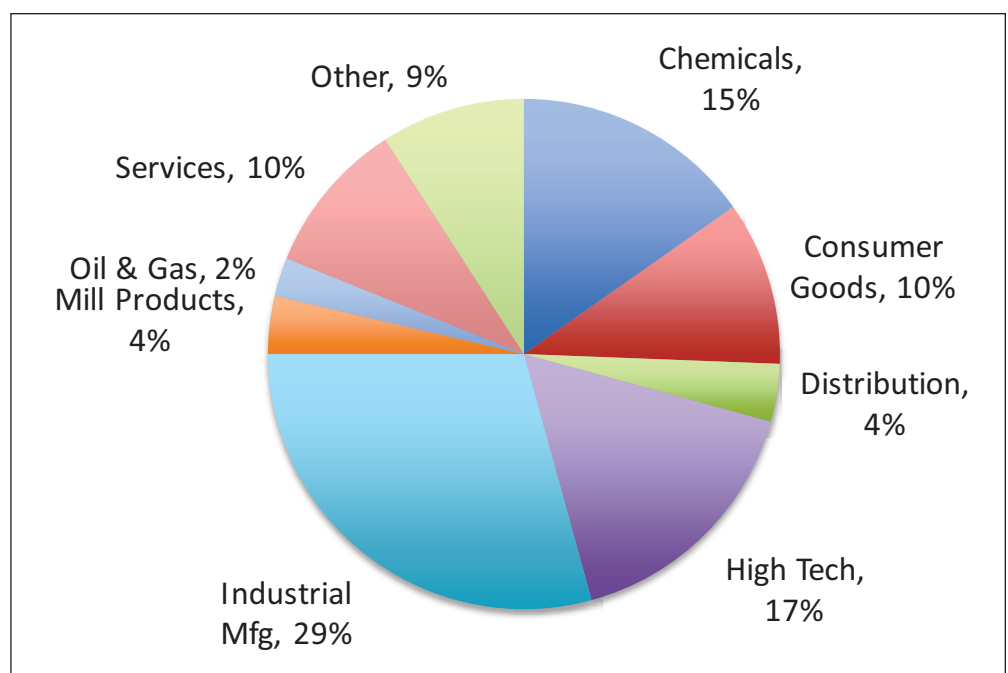
There is good news on the horizon, however. Our findings reveal that a small, but growing number of firms are finding ways to grow profits by making pricing a core pillar of their corporate growth strategy. The results demonstrate a widening gap between firms that use pricing as a strategic lever for profitable growth and those that approach pricing as tactical function within marketing or sales. The data shows that firms grow faster and more profitably when pricing decisions become a strategic priority shared equally by marketing, sales and senior management. Profitability increases even more when those priorities are centered on creating and capturing value for customers rather than simply growing the top line or covering costs.

The results of the study suggest the Pricing Profession may be reaching a crucial tipping point in which Pricing becomes an increasingly central focus of overall business strategy. The purpose of this

article is to share some of the critical insights gleaned from our recent study and to answer key questions such as:

- How have markets changed following the recession and when, if ever, might conditions get back to “normal”?
- How are successful firms adapting their pricing strategies in the face of increasingly challenging market conditions?
- What types of investments are firms making to improve pricing performance?
- What steps should pricing managers take today to prepare for

Figure 1: Participant Profile for Survey



the new market reality of tomorrow?

Figure 2: The Pricing Environment

Our hope is that we can help pricing managers make thoughtful choices about how to manage pricing in their firms and lead their organizations to a more profitable future.

Study Overview

The senior executives who participated in this research came from a broad spectrum of industries including manufacturing, high tech, distribution, chemicals, services, and consumer products among others. The data was collected in two ways. First we conducted a quantitative survey of over 160 senior managers with pricing authority (Figure 1) to understand the nature of their pricing strategies, market structure, organizational performance (profits and revenue growth), pricing capabilities, incentives and the like.

Second, we conducted over 100 interviews with managers from a range of functional areas including pricing, product management, marketing, sales, customer support and finance to explore how firms are adapting their approach to pricing in rapidly evolving market conditions. The results of the quantitative and qualitative studies reveal a future in which the role of pricing becomes increasingly central to the profitability and growth of the firm. Indeed, some leading edge firms are rethinking the role of the pricing function entirely. Instead of a functional responsibility residing within marketing or sales, these firms view pricing as a strategic business capability that is tightly integrated into critical business functions such as strategic planning, product development, marketing, sales and channel management. This emerging approach to pricing has major implications for pricing strategy and the managers who shape it.

The Post Recession Pricing Environment

Few would argue that the global recession of 2008 and 2009 created substantial pricing challenges for Western businesses. According to the U.S. Bureau of Labor Statistics the consumer price index fell by 0.4% during the recession reflecting the loss of pricing power experienced by manufacturers and retailers alike. More surprising, perhaps, is that the pricing environment has not rebounded despite nearly a year of positive G.D.P. growth. When we asked managers to describe the post-recession pricing environment in their market, 73% indicated that pricing is more difficult today than it was prior to the recession (Figure 2). This number approaches 90% when we exclude healthcare and energy companies that experienced less downside impact from the recession.



Further investigation revealed that many markets are caught in a vicious cycle in which customers, whose businesses are also under duress, exert continuing price pressure on their vendors who, in turn, respond with increasingly aggressive price competition. Over 70% of the survey respondents said that price competition was increasing in their markets while 83% indicated that customers have become more aggressive in demanding price concessions. These statistics, of course, are not surprising to anyone managing pricing today – we all know the game is getting tougher. The critical question is when will the pricing environment return to “normal”? Unfortunately, the evidence suggests that the answer may be never. While the impact of the global recession should not be underestimated, it is, in many ways a red herring distracting us from fundamental shifts in market structures that are reshaping the nature of competition now and into the foreseeable future.

Global Competition

One only has to consider a few of these shifts in the global landscape to reveal a future competitive environment profoundly different from anything in recent business history. Consider the shift in global market power, for example. In many ways, describing the economic downturn as a global recession is a misnomer. While the GDP in the Western economies fell by over 5% at the bottom of the recession, the effect was quite different in the “Third World” economies of Brazil and China. Indeed, these economies never went into recession at all. While the U.S. and Europe were struggling with the financial crisis, China maintained a healthy 5% growth rate in its GDP. While Brazil’s growth slowed significantly, it never reached negative growth that defines a recession. Today, companies in these countries are profitable and able to finance continued expansion into Western

markets. As a result, the heightened levels of price competition we are currently experiencing are not only likely to remain – they are likely to increase.

Rapid Innovation

Historically, Western companies relied on research and development to produce innovative products that commanded price premiums and helped maintain market leadership. This ability to create new value for customers was an essential ingredient in the recipe for growing profits. But here again, the picture is increasingly challenging. A recent BCG study¹ ranked the U.S. eighth on its ability to innovate new products and services falling behind Nordic countries such as Sweden and Finland as well as Asian competitors such as Korea and Singapore. As the technology gap closes, Western firms will experience increasing rates of commoditization and more instances in which their products underperform the competition. Once again, the implications for pricing are profound. Managers used to pricing in high value (and high margin) markets will have to expand their skills to price across a portfolio of products many of which will have little or no differential value.

Raw Material Volatility

Finally, the last several years have witnessed dramatic swings in basic material prices such as aluminum, oil and basic chemicals due to increased demand from developing nations. The Producer Price Indexes for primary and intermediate goods fell by 45% and 15% respectively in 2009. By March 2010, however, these indexes were rising at rates of 33% and 8%, respectively.² This price volatility for key inputs creates significant challenges for sellers, especially when they are selling into competitive markets where it is difficult to make price increases stick. All forecasts suggest that demand for raw materials from the developing nations will continue to rise, maintaining ongoing upward price pressure on key inputs.

Thankfully, not all the news is bleak. The explosion of new technologies in communications, nanotechnology, energy, biomedicine and more are creating tremendous opportunities to generate profitable growth. In this exciting, but faster paced, environment pricing will become increasingly central to corporate business

strategies. There is a tremendous opportunity for pricing managers that have the foresight and skills to lead their organizations through these tumultuous times.

Pricing in the New Market Reality

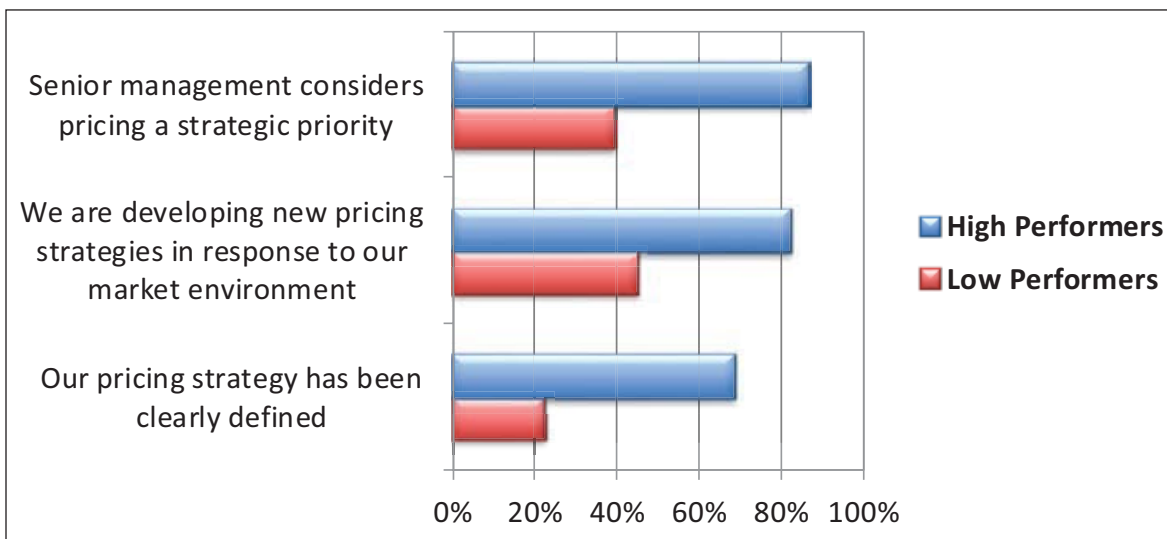
A key goal of this study was to understand how leading firms are adapting their pricing strategies to the ongoing shifts in the competitive environment. Are they becoming more aggressive to defend share? Are they conceding share to protect margins? Are they changing the way they make pricing strategy decisions? To address these questions, we categorized survey respondents based on their operating profit relative to their competition. Thus, manufacturing firms were compared to other manufacturing firms, consumer durables were compared to other consumer durables, etc. in order to eliminate the results being driven by industry specific effects. We then compared the top quartile (high performers) and the bottom quartile (low performers) to understand differences in their approach to pricing strategy formulation and execution.

A Strategic Focus

The results reveal dramatically different roles for pricing across firms. Nearly 85% of senior managers in high performing firms view pricing as a strategic priority that is rising on the corporate agenda (Figure 3). In contrast, less than 40% of the lower performing firms place that kind of strategic emphasis on pricing. Pricing managers understand that effective pricing strategies require marketing, sales and operations to work closely together in order to ensure effective execution. The qualitative research we have conducted underscores the need for senior management to be involved in key pricing decisions to ensure that pricing decisions are not being made myopically by one functional area or another. High performers are also more proactive in their response to the changing market environment; they are nearly twice as likely to be formulating new strategies in response evolving market conditions. But perhaps the most telling data is that high performers are more than three times as likely to have invested the time and effort to formulate clearly defined pricing strategies. The data indicates that we can ill-afford to be complacent about how we approach pricing in today's turbulent markets. As the pricing environment becomes more challenging over time, it will be

essential to place pricing much higher on the corporate agenda.

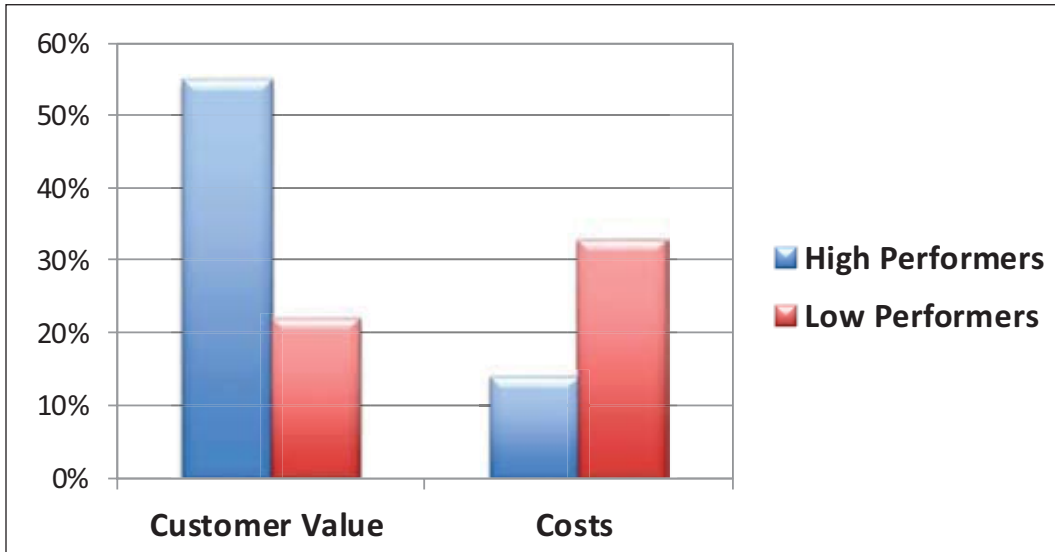
Figure 3: Pricing as a Strategic Priority



A Value-based Approach

One of the prominent characteristics of high performing firms was the consistent focus on customer value to determine prices. High performers were more than twice as likely to make customer value the primary driver of their pricing strategies (Figure 4). This focus on customer value makes sense in an environment in which

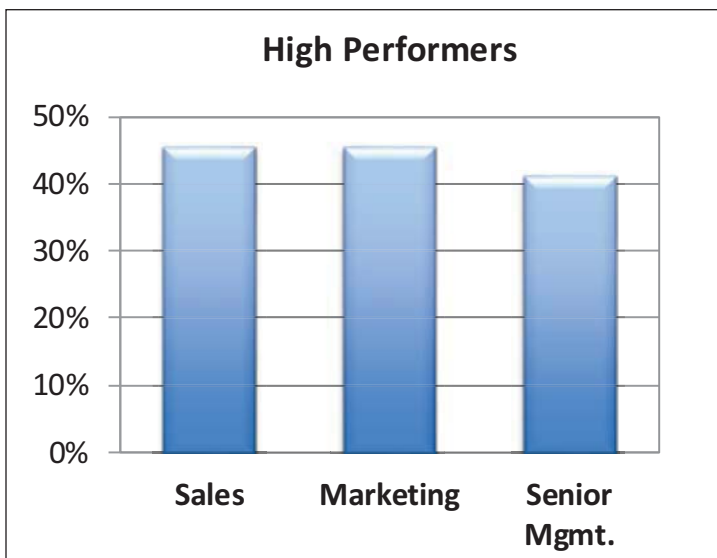
Figure 4: Drivers of Pricing Decisions



customers are actively working to accelerate commoditization and foster price competition. Failing to defend your value proposition through effective communication and value-based prices rewards aggressive procurement tactics and encourages customers to push ever harder for price concessions.

Low performers, on the other hand, were much more likely to price based on costs or to achieve a predefined target margin. The focus on cost is surprising because the shortcomings are so well documented. Cost-plus pricing inevitably misses profit opportunities by leaving money on the table for high value customers that would

Figure 5: Pricing Decision Makers

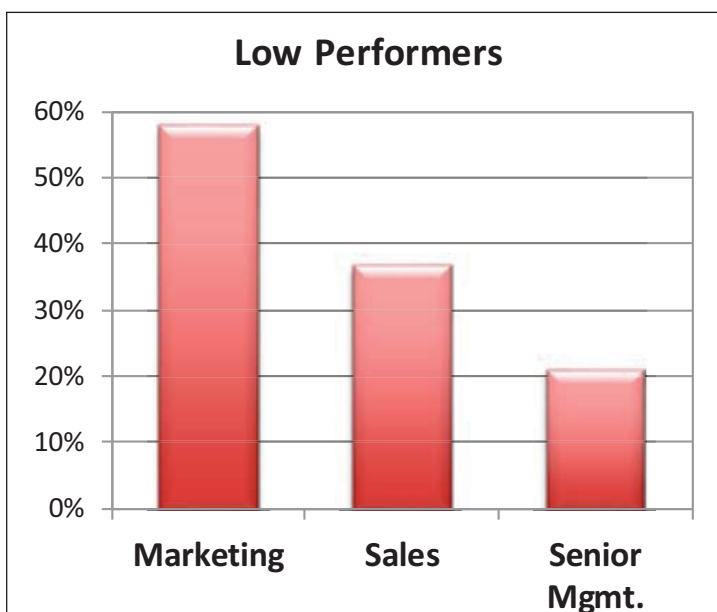


be willing to pay more and misses opportunities to increase volume with lower value customers that might be willing to purchase significant volume for a lower price. Cost-driven strategies are based on the premise that the most effective way to set profit-maximizing prices is to turn away from the market, look internally to understand your cost structure and then mark-up that cost by some pre-determined amount. The data from this study provides additional evidence that allowing costs to be the primary driver of pricing decisions hurts profitability.

Shared Decision-Making

The differences between high and low performers are not limited to the types of data that drive pricing decisions. There are also important differences in how those decisions get made. When asked who are the primary decision-makers for pricing strategy choices, high performing firms indicated that decision-making was shared equally between marketing and sales with a high degree of senior management involvement. This division of labor makes sense for firms pursuing a value-based pricing strategy (Figure 5). Whereas marketing typically captures and synthesizes customer value data to support pricing decisions, it is up to sales to defend those prices with effective value communications. Senior management plays an important role in adjudicating the inevitable conflicts between sales and marketing as well as ensuring that prices are set with a balanced consideration of the broader strategic objectives of the firm. Nearly 70% of the high performers indicated that their pricing strategy is closely integrated into their overall business strategy — an accomplishment that can only be achieved by working closely with senior leadership. In contrast, only 38% of the low performers indicated that their pricing strategy was closely linked to their overall business strategy.

Figure 6: Pricing Decision Makers



An examination of the same decision-making data for the low performers revealed a very different approach. Pricing decisions in low performing firms tend to be made within the Marketing function (Figure 6). On the surface this would appear to be a prudent approach; Marketing collects and synthesizes market data related to customers and competitors and should be well equipped to make pricing decisions. A more nuanced picture emerged, however, when we interviewed several sales managers from a manufacturing firm that was struggling with its pricing performance. Prices

in their market were negotiated and the pricing data that marketing provided was often dated and could not support the value discussion. The experience of this company was all too common in the interviews that we conducted. In today's markets, effective pricing requires close alignment between sales and marketing to ensure that accurate and timely data is being collected, synthesized and leveraged in the negotiation process. Neither sales nor Marketing can accomplish those tasks in isolation.

The notion that Pricing can become a mechanism for aligning functional areas has important implications for how we manage commercial operations. Consider the example of a global high-tech firm headquartered in New England. The company is a market leader in signal processing equipment and yet was struggling to maintain profitability even though demand had remained steady through the recession. The cause of the trouble was all too clear. One senior executive described the situation by observing "Pricing is broken – completely and utterly broken. We don't know how to set a price, we don't know how to manage discounts, we don't know how to negotiate."

Many managers, when confronted with this situation, would take a piece meal approach that identified a series of projects to close the most egregious profit leaks in the pricing process. But the leadership at this global high-tech firm adopted a more strategic approach in which effective pricing became the organizing principle for all of their commercial business processes ranging from strategic planning to product development to customer support and sales. For each business function, they asked one simple question: "What needs to happen at this stage of the commercial process to ensure that we can get paid when this offering gets to market?" When the question was applied to product development, it led to an understanding that product managers had to have high quality data on customer value to help them choose which features customers would pay for and not just want for free. It also demonstrated the need for better competitor pricing data so they could make more realistic pricing estimates and build more accurate business cases for new products. In the end, they opted to re-engineer their entire development process and arm their product managers with a strategic pricing toolkit.

This example, combined with the survey data, illustrates a potential future for pricing that is very different from today. It also raises some intriguing questions for pricing managers. What is the role of the pricing manager if pricing is an integral part of virtually every business function? What types of skills will pricing managers need to lead their organizations in the changing environment?

Executing on the Pricing Strategy

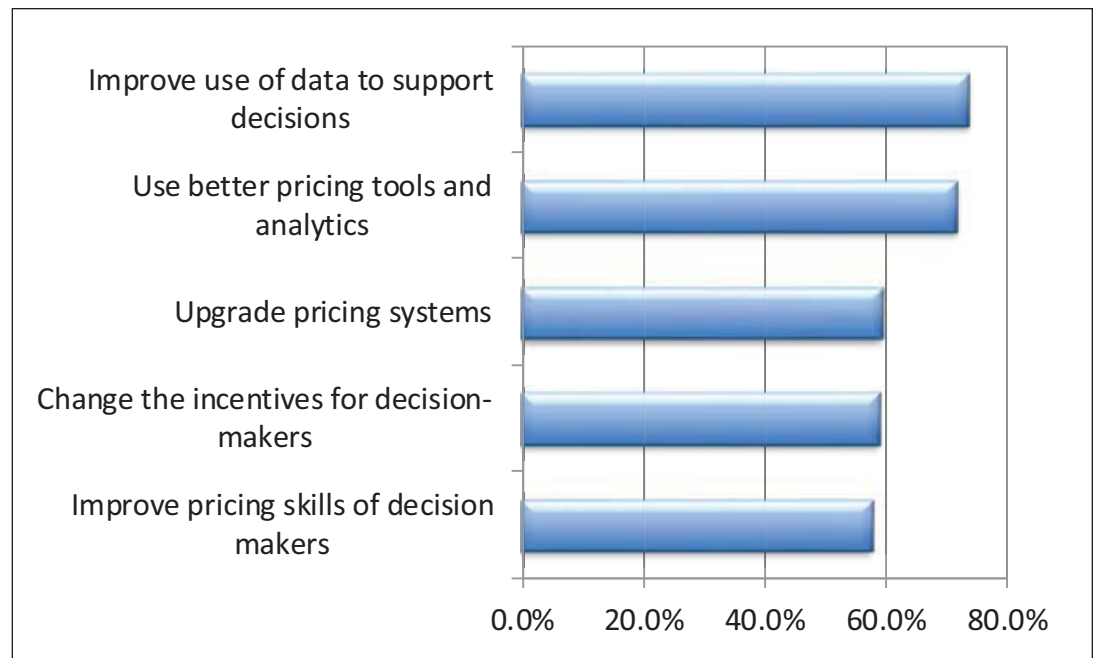
Even when a solid value-based

pricing strategy has been developed, many firms struggle with implementing that strategy in the field. Over 75% of the managers in our research were unsure of how to execute their firm's pricing strategies effectively. As one executive noted, "Given the attention we pour into pricing our products, why do the outcomes seem like a random walk?" There are many reasons why so many firms find executing on their pricing strategies difficult. The inherently cross-functional nature of pricing provides many opportunities to derail the strategy because there is often no clear ownership and responsibility for pricing outcomes. Even when there is a formal pricing organization tasked with managing pricing, final decisions are often made in the field by product managers and salespeople negotiating with aggressive customers and channel partners. It's hard to be strategic when facing a professional procurement organization tasked with making sure your strategy doesn't work.

Only 35% of the executives participating in the survey believed their firm was executing effectively against their pricing strategy. With that as a backdrop, we asked participants to identify the types of changes that would most improve pricing execution (Figure 7). Their responses indicate that the three most important factors to improve execution are the acquisition and use of better market data (customer value and competitor prices), better tools and analytics, and upgrading pricing systems. Effective pricing requires a balance between analysis and strategic judgment. While analysis alone is never sufficient, the survey respondents underscore its importance as part of the process. Increasingly, firms are recognizing the need to integrate those tools and data into Enterprise wide pricing systems that ensure comprehensive access to the necessary information to make effective pricing decisions.

The final key to improving price execution centers on the incentives and skills of the managers making pricing decisions on a day-to-day basis. Only 27% of respondents indicated that individual incentives are aligned with the pricing strategy in their firms. We saw numerous instances in which compensation plans were encouraging

Figure 7: Building Pricing Capabilities



managers to undermine the pricing strategy. In one manufacturing company, the incentives of virtually every functional area worked at cross-purposes so there was little, if any, chance of achieving consistent execution of the pricing strategy. Sales was incented to grow the top-line and thus, found it difficult to fight for an extra margin point if that meant risking a deal. Marketing was measured on its ability to grow share, a task most easily accomplished by cutting prices. Finance was evaluated, in part, on how well they maintained average margins and, not surprisingly, were constantly accusing Sales of being too quick to offer discounts. This research suggests, and experience dictates, that allowing pricing decisions to be made by managers with conflicted incentives is one of the surest ways to derail a pricing strategy. Add the fact that many commercial managers lack sufficient pricing skills to make good pricing decisions and it is not surprising that improving price execution is an essential key to improving profitability.

The Future of Pricing

Pricing managers struggling to improve profits in their firms should carefully consider two major findings from this research. The first, at the risk of stating the obvious, is that the world has indeed changed as a result of shifts in the global economy and increasingly constrained resources. The nexus of future growth is moving from West to East accompanied by rapidly commoditizing markets occasionally disrupted by radical innovations in products and business models. There can be no doubt that future markets will be challenging for Pricing professionals.

The second finding relates to how a small, but growing group of leading edge firms are responding to the new market reality by actively testing new approaches to pricing and, in the process, experiencing positive results. We do not have a crystal ball to foresee the future of pricing, but the snapshot of leading pricing strategies and tactics in this article provide some insights into how the Pricing profession might evolve. These insights are summarized into the following three pricing trends.

Raising the Bar for Price Execution

Ever since the publication of the seminal 1992 Harvard Business Review article, “Managing Price, Gaining Profit³,” firms have been finding incremental profit improvements by sealing the leaks in their pricing processes with the aid of tools such as the pocket price waterfall. Over the last decade, the impact of these tools has been dramatically enhanced through the use of Enterprise software applications to conduct pricing analytics, enforce compliance with pricing policies, and support the price setting decision and more. Historically, the C-suite treated price execution projects as just another capital project fighting to make it onto the corporate “to do” list. All too often, it didn’t make the cut.

The increased competitive intensity of tomorrow’s markets will move price execution much higher on the list of corporate priorities. Faster product lifecycles will narrow the profit window for new products and profit leaks due to poorly managed pricing processes will become unacceptable. Instead of an incremental profit opportunity, excellence in price execution will become table stakes in a very competitive game.

Value is Crowned King

Michael Porter observed that there are two generic strategies for winning in competitive markets: low-cost and differentiated

value. For most Western companies, the low-cost strategy has long been ceded to China and India where labor costs are but a fraction of those in the U.S. and Europe. This was not overly concerning because of the West’s advantage in innovation and technology. Today, that technology gap is closing rapidly due to the massive investments in research and development being made in the developing world. As a result, differential value will become an increasingly rare gem whose worth can only be captured through value-based pricing.

The evidence from this research is clear – firms that practice value-based pricing are more profitable. The bad news is that value-based pricing isn’t easy. It requires a real commitment to understanding the customer’s business and must be implemented cross-functionally across Development, Marketing and Sales. The good news is that value-based pricing isn’t easy. Those firms that successfully implement it gain a competitive advantage that can last for years.

Pricing Wins a Seat at the Table

Let us be honest: Pricing has traditionally been treated as the proverbial redheaded stepchild of the corporation. All too frequently, pricing was managed as a tactical function embedded in marketing or sales and not as a strategic lever for growth. That will change as pricing becomes increasingly central to profit growth in tomorrow’s markets. As pricing becomes more proficient in understanding and monetizing customer value, the services of the pricing manager will become increasingly in demand. Product managers will need to understand the value of choosing features that create value for customers and can generate a premium upon launch. Marketing will need to focus its messages around value and create product bundles to improve profits. Sales will need support to defend prices from aggressive procurement groups. The pricing manager will increasingly be drawn into these decisions and pricing, at long last, will have won a seat at the commercial table.

Conclusion: Ride the Wave

This study shows how leading edge firms are exploring new approaches to Pricing that can drive profitable growth even in today’s challenging business environment. The key learning from their efforts is less about the specifics of their strategies than it is about the importance of becoming more proactive and strategic as we manage pricing in our own firms. Over twenty years ago, procurement underwent a transformation as senior managers learned about the profit potential of strategic sourcing. A similar transformation has begun in Pricing that will move through the profession like a huge wave. The question for each of us is whether we will be ready to ride the wave or get tossed in the surf.

Endnotes:

¹ BCG, National Association of Manufacturers, and The Manufacturing Institute innovation indexes, 2008.

² U.S. Bureau of Labor Statistics, Producer Price Index report, July 2010.

³ “Managing Price, Gaining Profit,” by Michael Marn and Robert Rosellio, Harvard Business Review (September 1992).