# Maximizing Pricing Effectiveness

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In February 2011, Mr. Warren Buffet told the Financial Crisis Inquiry Commission, "The single most important decision in evaluating a business is pricing power. If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by 10 percent, then you've got a terrible business."

Mr. Buffet's observation is a very astute one. Pricing power is one of the key indicators of a firm's competitive position. A premium purveyor can indeed increase prices without a prayer session, while a laggard will struggle to do so, hoping for a miracle.

The reality though is that most firms, especially in the business-to-business and industrial markets, have a poor if not vague idea about the value that they bring to their customers and the competitive pricing premiums they command in the marketplace. Consequently, they have poor pricing practices that irrevocably decrease their and their industries' revenues and profits. This condition afflicts both premium purveyors and laggards.

In mid-2009, when the global economy was in a severe recession, an oilfield equipment client and one of its distributors were having a pricing disagreement. The distributor claimed that the client's equipment was too expensive at $50,000 and that a thirty-five percent discount was needed to compete effectively in the market. A competitor was pricing their product at $30,000.

The client refused to comply, saying that its prices were justified. When asked to elaborate, the client used the "we have better quality" defense.

Both sides had opinions but not facts. They were brought together for a workshop, where the client's equipment's competitive premium could be determined. Fortunately, the distributor and the client had a common goal of extracting the maximum price from the customer.

On the designated day, both sides' teams amicably and harmoniously worked together. The workshop was based on some simple premises:

1. Simply stating that the firm's products are better is not good enough. Being better implies that, compared to competition, incremental benefits are delivered to customers.
2. These incremental benefits need to be converted into value that is monetized and expressed in a relevant, local currency.
3. The firm's product would have deficiencies, whose monetary value should also be determined.
4. The sum of the monetized values of incremental benefits and deficiencies would yield the product's premium.
5. Adding this premium to the competitive price would yield the ideal competitive selling price.

The process was simple enough to be intuitively understood by the rank and file of both firms. In this instance, the client and its distributor agreed to use this process to adjudicate their differences.

The meeting ended well because both parties discovered that the client's product had a premium of $30,800 or almost 103% more than the competitive price. The distributor could sell the product at about $60,800 and still be equal in competitive value to the competition.

Mr. Warren Buffet would have been pleased that the firm could raise its price by 10% without having a prayer session.

Another client was preparing to bid on a services contract. The general belief was that the firm commanded a 20% price premium because its services were of superior quality.

Competition was expected to bid at about €900,000. With an assumed 20% premium, the client would have bid €1,100,000 or €200,000 more than the competition.

However, after being guided in a workshop, the client discovered that the premium was actually about €740,000. The client commanded a pricing premium of 82%, substantially more than the 20% that was assumed.

The client bid and won the contract. By discovering the pricing premium, the client increased its revenues by more than 40%, which had a multiplicative impact on operating profit and EVA.

Again, Mr. Warren Buffet would have been pleased.

In a third situation, a client discovered that its services did not possess a pricing premium; its ideal competitive selling price was substantially lower than what was required to deliver expected operating profits. In this case, the client abandoned pursuit of that contract and decided to focus its resources on markets where the firm's premium services were valued.

## THE CHALLENGE

Since 2008, there has been a renewed and urgent focus on improving pricing effectiveness because it is the fastest, most effective way to increase profits at ongoing operations. According to a McKinsey & Company study, at an average S&P 1500 company, a 1% increase in price is 8% increase in operating profit; 50% better than a 1% drop in variable costs; and 300% better than a 1% increase in volume. Moreover, operational and other cost controls have limits in improving profitability.

Additionally, pricing management plays a very crucial role in new products and services. Mismanagement of initial pricing can result in reduced revenues and profitability for the firm as well as the industry, during a product's entire lifecycle.

Businesses have great difficulty with pricing their products and services, irrespective of the prevailing economic conditions. During periods of economic growth, ineffective pricing practices are forgiven by market conditions; during economic declines, especially recessions, firms with poor pricing practices are punished severely.

There are many sources of pricing pressures but some major ones that adversely affect outcomes are often internal to the business:

1. Customers define a price and vendors enter negotiations without having a reasonable, rational alternative price. When only one price is visible, salespeople/sellers are drawn to that price, like iron filings to magnets.
2. Determining a price based "on value and what the market can bear" requires excellence across many interacting domains—Technology, Customer/Consumer Behavior, Competition, Economics, Negotiation, Finance and more.
3. Participants in pricing decisions may possess at least one of these blind spots:
    a. Limited comprehension of product's/service's monetary value to customers
    b. Limited understanding of competitive positions
    c. Limited knowledge of economics
    d. Innumeracy (numerical illiteracy)
    e. Inadequate training and support in negotiation

Consequently, there are significant *profit leaks* in the market (Figure).

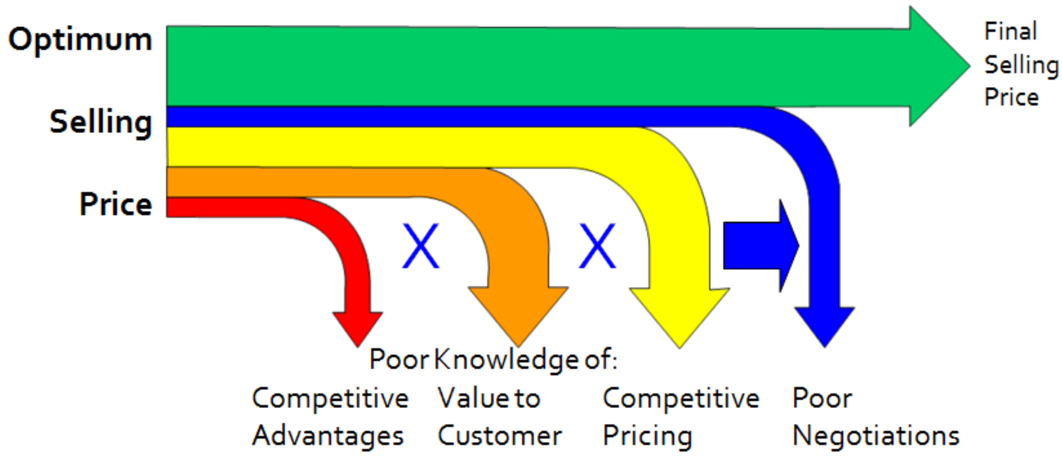


Figure: Profit Leaks

A SOLUTION

The Pricing Excellence Program enables a business to price its offerings "on value and what the market can bear". It has the following key steps:

1. Sensitize the audience about the impact of minute price increases on Operating Profit/EVA or any other significant financial measure.
2. Create a positioning statement for target customers/markets, identifying compelling competitive differences in the offering.
3. Elaborate features and benefits of these compelling differentiators. Be rigorous in identifying features and benefits across categories that go beyond functions and features.
4. Assign $ (or other currency) value to these benefits, expressed as cost reductions, revenue increases, ROI/RONCE/EVA improvements.
5. Use the formula: Ideal Competitive Selling Price=Competitive Price + Monetary Value of Incremental Benefits – Switching Costs. It is a monetary translation of "Price on Value and What the Market Can Bear"
6. Train customer-facing organizations in the details of the program
7. Negotiate to win

This Pricing Excellence Program is a simple, repeatable process that can be applied across a spectrum, from new products to very mature ones, across product lines and across global cultures.

The frontline of simple, mature products/services can learn the process in less than twenty-four hours and practice the process every day. The process takes longer for new products/services, where various kinds of information may not be readily available.

The program provides negotiation ammunition to the sales organization. This has a multiplicative effect—it not only improves margins but also success rates, delivering substantial improvements in revenue and profits.

The process also allows cross-domain teams to discover feature gaps in their offerings, thereby providing direction to and priorities for product development. This is useful for improving the effectiveness of new product development and market introduction.

The process sharpens a firm's market intelligence focus by highlighting specific, critical competitive and customer areas that are crucial for determining the ideal competitive selling price.

This Pricing Excellence Program is simple. It can be understood quickly and can be implemented swiftly for speedy results, rapid turnaround, and growth in revenues and profits.

The product-, customer- and competition-related content that is generated from the process can be used to train customer-facing organizations for improving their short-and long-term success.

Finally, this program translates very well across cultures and industries. It has been used successfully in a variety of industries and in many countries:

1. Industries: Oilfield Equipment, Oilfield Services, Iron & Steel, Construction Services, Power Plant Services, Petrochemicals, Industrial Equipment, and Software.
2. Countries: USA, Germany, UK, Canada, France, Netherlands, Belgium, Czech Republic, and Poland.

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