WORLD-CLASS PRICING

THE JOURNEY

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Overview of the 5 Levels

LET'S GET PERSONAL ABOUT PRICING.

This book is about how *you* can achieve pricing excellence, along with your company. It is designed as a pricing handbook, to help you accomplish this in a systematic way.

While there are many different routes to improving pricing, this book organizes them into an easy-to-follow roadmap, or *process*: **The Five Levels of World-Class Pricing Excellence**.

But before we start the journey, it is important to understand why pricing matters so much. In 1992, an article in the *Harvard Business Review* titled "Managing Price, Gaining Profit"[1] argued that pricing is the most important driver of company profitability (see chart below).

Pricing is the highest-leverage item a company has for impacting profitability.

The following chart demonstrates the impact of a 1% increase in price and no change in volume. The result is a 1% increase in revenue, which flows directly to the bottom line and increases profits by 12.5%.

	Baseline	1% Sub Optimization
Revenue	100%	101%
Costs (Fixed & Variable)	92%	92%
Profits	8%*	9%
Impact	(9%-8%) / 8% = 12.5%	

*Long-term average profitability for S&P 500 companies.

This relationship has been shown many times in numerous publications and conference presentations, and it is an excellent message you can use to gain senior management support for launching an initiative to improve your organization's pricing process. It gives you grounds to argue that if pricing is significantly more impactful than costs, your company should devote at least a healthy fraction of the time it spends on cost control to managing prices. The natural tendency is to focus on costs because they seem to be within the realm of what the company can control. Pricing, on the other hand, appears to be governed by the invisible hand of the market. In this book, we will argue that pricing can be managed in as disciplined and rigorous a manner as costs.

But there are some important points to consider in this relationship. First, it ignores both margins and elasticity (or volume implications). If it were really this easy, pricing managers would simply keep increasing prices and wait for the profits to follow.

Furthermore, the value of 1% is not constant over time. It varies depending on profitability. Profitability ratios erode during difficult economic times. The 8% average S&P 500 long-term average profitability drops to 4% or less during a recession. Therefore, the value of 1% of price improvement jumps from 12.5% to a whopping 25%! So pricing is even more important in tough economic times.

Pricing is a relatively new discipline. Not too long ago, if someone had told you he was a pricing manager, it really meant that he was an "estimator." Usually, the person worked in the accounting department and managed the standard cost system. He had tricky decisions to make regarding the number of units over which to amortize development expenses, or whether to include overheads from a far-away factory, but for the most part, his role was pretty straightforward. Typically, these fledgling pricing managers did not command a seat at the boardroom table, but instead were the bane of the salespeople's existence. Their work was more administrative than strategic. Equipped with an early-generation spreadsheet or a mainframe system, their ability to manage a vast number of SKUs across a large customer base was limited. Consequently, inconsistencies in legacy prices were common. Ask why a company priced product "A" 15% above product "B" in the early days of pricing, and the answer was typically: "Because that is what we have always done."

Unfortunately, this relatively stagnant corporate gene pool made managing changes rather difficult. Take "Ray," for example, who embodied this early pricing manager for us. With 30-plus years at the company and only two more until retirement, he was not about to sign up to a major process change.

Finding executive sponsors willing to take on the change management task is an important first step. But for those who have never been exposed to the potential benefits of improved pricing, it is often not an easy assignment.

The last part of the argument that we need to tackle before we can expect you to embark on this journey is that pricing can actually be managed in a proactive way, and entails more than merely accepting whatever price the market offers. Pricing is a *process*. Everything your organization does is part of a process. No matter how *ad hoc*, disconnected, and unrepeatable it is, if people are doing it, it is a process.

We remember facilitating a group of executives at an aerospace company in the late 1980s. The v.p. of sales was having a difficult time with the idea that his work was a "process." Finally, the v.p. of operations stood up and said: "Everything in business is a process. If I take this pen and hand it to you, that is a process. I can be held accountable for giving you the pen. You can measure whether I gave it to you on time. That makes it a process." His point was clear, and 10 years later, as we worked out the initial concepts of World-Class Pricing, his speech was not forgotten. Pricing has a mission, an owner, deliverables, and measurements. As such, it can be streamlined, and the results tracked and systematically improved.

Our experience over the past 20 years in pricing has been that finding segments where your value is high or where your market execution has been poor can lead to margin improvements starting at 1% to 2%, and accumulating over several years of concerted effort to deliver 4% to 6%. Any journey worth taking seems daunting at first, but you have to take the first step to get started.

In the remainder of this introduction, we will lay the foundation for pricing improvement, and focus on the following core concepts: **The Five Levels**; **The Four Core Processes**; and **The Pricing Infrastructure**. In subsequent sections, we will delve more deeply into each of these concepts. Let's get started!

The Five Levels

In the manufacturing world, the recognition of production as a process is not a new concept. As re-engineering initiatives took hold in companies during the recession of the early 1990s, benchmarking soon became part of the exercise. The search for universal benchmarks led to the development of five levels of manufacturing excellence, and we began to draw the link to the World-Class Manufacturing framework.

As we discussed it, The Five Levels began to take shape. We saw examples of firms that were stumbling along. Others had strong internal controls that prevented anything happening outside of the norm. Still others were starting to spend time understanding their value proposition. Then there were the revenue managers in the airlines and hospitality industries who changed their prices constantly. Was this quest for, in one case, value, and in the other, revenue optimization a goal that was possible for all organizations to achieve? We came to learn that it was, and that maximizing profits without tackling the challenge of advancing pricing excellence was not possible. From this, The Five Levels were born.

The Five Levels of World-Class Pricing will help you benchmark where you are on the journey to Pricing Excellence, so you will know how to systematically move forward. It begins at Level 1 with the Firefighter, followed by the Policeman, the Partner, the Scientist, and finally, the Master.

Figure 0.1

Five Levels of World-Class Pricing

Each level is distinct, with its own issues. If you are a pricing manager, you will probably relate to the titles we have given each one.

Executing various processes at different levels is possible, but overall, a company will be operating at single level based on how it executes across all of the relevant pricing processes that exist—or do not.

Level 1: The Firefighter

At this level, the baseline process is ineffective. Pricing tends to be reactive and undisciplined. In other words, the company and the pricing manager are "firefighting."

Ray, whom we introduced earlier, was toiling as a Firefighter at Level 1. He worked in a medical-devices company that had leading technologies and market share in a number of categories. Ray was responsible for running the contracting process and making sure the appropriate prices were input in the contracts and then sent out to the sales team for review. When you walked into his office, it appeared to be well organized. Once you dug a little deeper, however, evidence of firefighting became obvious. For example, Ray was responsible for contract renewals. He would send out the more than 2,000 contracts to the sales team for review well in advance of the renewal date. Then there would be a back and forth with "price requests for deviations due to competitive conditions." Ray did not have the authority to make these decisions, so the organization created a pricing committee that included several members of senior management. The problem was that almost every deal was an exception, and senior management was spending an inordinate amount of time reviewing requested price deviations. This also resulted in a constant state of emergency in which Ray, the sales force, and the pricing committee were continually reacting to the newest priority. It was not pretty!

Level 2: The Policeman

At this level, a company gains control of its pricing processes, primarily by controlling discounting. The company starts bringing structure to its pricing, and begins to say “no” to deals, rather than constantly adjusting discounts. At Level 2, the company and the pricing manager behave like Policemen managing traffic. Rules are applied, and they are obeyed. They may not always make sense from the customers’ perspective, but they do bring order.

We had one client in the financial-services industry who was a classic Level 2. Jeff was new in the job, and coming from manufacturing, he wanted to measure and control everything. He built spreadsheets of recent deals, total account volumes, and rebate programs. He knew what was going on because he could see it in his system. The sales team was unsettled by his insights, which often exposed unprofitable deals and led to the enforcement of rules; they found the system a barrier to “doing deals.” Senior management, on the other hand, counted on his analysis, but admitted that it sometimes didn’t take into account recent developments in a very volatile market. Jeff was the Policeman, but as such, knew a lot more about enforcement than strategy.

Level 3: The Partner

At this level, the company moves from an “inside-out” perspective to more of an “outside-in” customer-centered focus.

Level 3 processes are the Value processes. No longer is the pricing simply rules-based, but rather, it reflects the value of the company's product or service to the customer. At this level, the company and the pricing manager are creating a more collegial attitude towards pricing—one that everyone is more likely to agree to, since it is based on the customer's perception of value. For this reason, we call pricing managers at Level 3 the Partner.

Mike was the marketing director at a restaurant chain. Responsibility for pricing had just been dropped on his lap in the past 18 months, and we helped him gain control of pricing by putting in place tools and measurements for Level 2. Mike was a natural integrator of ideas. He had a good sense for the value of the brand, and had taken steps to keep a close eye on its evolution relative to an ever-changing consumer in the tough economic times of Q4 2008. He called one day to ask if we wanted to participate in his latest initiative—launching the Pricing Operations Council (POC), a group of a dozen store managers, area directors, and regional vice-presidents. It would be a chance for him to receive feedback from the field to ensure his pricing initiatives were on track.

Mike was forging a partnership with the field in which pricing/value was the focal point for discussion. The charter of the Pricing Operations Council is shown below.

<u>Pricing Operations Council Purpose</u>

- To share with a select group of our operations partners the work we've been doing around pricing and how it's impacting the business.
- To gain the **benefit of your perspective and experience** as we continue to improve and enhance our pricing process.
  - A need for subgroups to help with key pricing initiatives.

- Develop a partnership between Marketing and Operations on pricing strategy, tactics, and decision-making.
- To work together to develop and implement Price Testing initiatives.
- To share in the success realized from good pricing strategy.

Level 4: The Scientist

The movement to this level is often a subtler step, but its impact can be enormous. At this stage, there are two things taking place. First of all, the degree of precision around pricing sharpens, based on better customer data and insight being brought to the table. Choice-Based Conjoint analysis, pricing software, and multivariate regression models are all part of this equation.

There is also a cultural shift at Level 4. The company has created a culture of pricing excellence. The quality of discussions is different from those of companies that operate at Level 3. At Level 3, the discussions are very productive, but there is a gap in the data. At Level 4, this gap is filled. Improved data is available to the team, which leads to better questions, more robust discussion, and the ability to reach decisions more efficiently. Optimization can be a tricky topic in many industries. "We can't change prices every 30 minutes the way the airlines do" is an objection we often hear as pricing managers struggle to progress from simply managing value to optimizing pricing. We agree. Pricing optimization is defined differently in every industry. However, in each case it relies on measuring value, understanding how it changes by segment over time, and adjusting prices to respond to these changes and capture the economic rewards.

Guy was a salesman for 13 years before he took on the role of pricing leader for his company, which operated in the telecommunications market. Over the next five years, he moved his organization from Level 1 to Level 4. The key ingredients in his ascent were the implementation of value-based pricing and optimization tools, and the accomplishment of the arduous task of getting the sales force to buy in to value-based pricing. This was not an easy process, and took years of patiently implemented changes. But the results were dramatic, and Guy's company identified his division as best in class globally. He is now leading similar initiatives for other regions within the company.

Level 5: The Master

The achievement of this level is rare, but that is the goal of any pricing manager committed to excellence. Once this level has been reached, the pricing manager has indeed become the Master. We have four simple criteria for accomplishing this feat:

- Intense commitment to value, and passion about pricing;
- Integrated business systems;
- Significant financial returns from pricing initiatives;
- Innovative approaches to addressing pricing challenges.

Greg was appointed as a senior-level pricing manager at a large consumer packaged goods company. Over the next five years, he transformed pricing at his company. He began by putting his team in place and then focusing on building credibility within the organization. His strategy consisted of two core prongs: change the culture, and drive process innovation.

Greg was the change agent for the culture; he conducted numerous training programs throughout the organization to strengthen the company's knowledge of pricing. At the same time, he hired a logistics expert to drive the process improvement while he took on the challenge of changing the management system and driving cultural change across the organization. As a team, they moved sales force compensation incentives from revenue to margin, put in place key performance indicators for measuring pricing improvement, and instituted cutting-edge tools for measuring value and optimizing price. After five years, the company was significantly outperforming the competition, and the president acknowledged to analysts that it had added more than $200 million to its bottom line through pricing excellence.

Similar examples exist in other industries, ranging from hospitality to software. There are many paths to Level 5, but they all have in common dedication to analytical excellence, cultural change, and an integrated business system.

Typically, we have seen it take 12 to 18 months to progress from one level to the next, so achieving Level 5 is a long-term commitment. But the rewards along the way make it worthwhile. There are generally 1 to 2 points of margin improvement for moving from levels 1 to 3, and .5 to 1 point for moving from levels 3 to 5. In businesses like telecom, where margins exceed 80%, the goal is often volume growth without price erosion. The opportunities Level 5 companies find to segment their market and increase revenue from creating innovative pricing structures are as significant as the margin improvement for a firm working with a 25% margin.

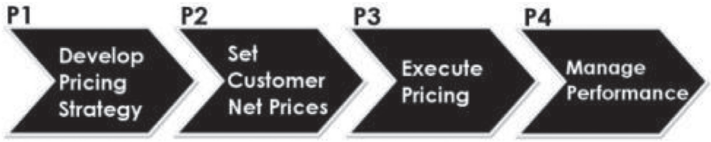
At what level do you think you and your organization are currently? If you feel as if you are operating at different levels in different parts of your business, you are not alone.

The Four Core Pricing Processes

While the Five Levels are intended to provide a benchmark of where you are today and some signposts along the way, you need to go deeper into the processes of pricing to create the roadmap you need to reach your destination.

Figure 0.2

Four Core Pricing Processes



These processes are universal. We see them in industries as diverse as heavy-equipment manufacturing, software development, food service, and financial services. No matter what you are selling, you must develop your strategy, decide how the strategy is to be applied to specific customer segments, execute transactions, and monitor performance.

In P1, you *develop a pricing strategy*. A solid strategy is the basis for achieving superior results. There is a saying, “I would rather have a poor strategy well executed than a good strategy poorly executed.” We agree that execution is critical, but so is the strategy itself. Therefore, we would add another statement: “I would rather have an excellent strategy with good execution than a good strategy with excellent execution.” An excellent strategy, if executed well, puts wind in your sails that will blow away a competitor who has merely a good strategy, even if it is executed with excellence. Strategy must be the first stage of the pricing process. To develop it retroactively based on summarizing recent transactions is like closing the barn door after the horse has gone.

Once the strategy is in place, the next task is to *set customer net prices*. This involves the application of pricing guidelines and rules that ensure fairness and enforce the strategy. Your company’s route to market has a significant impact on the sub-processes of P2. If you sell direct to end users, for example, understanding customer segments and proactively slotting customers into these segments is key to P2. In a national B2C business, this might involve understanding local and regional strategies, such as pricing higher in the business district downtown than in a disadvantaged neighborhood. When selling through distribution, you have the added complication of channel compensation and often a shortage of information about end customers. P2 also involves the processes of determining which customers qualify for particular customer programs and investments. The concepts and objectives were established when developing strategy in P1. P2 is the planned execution.

The next core step, P3, is to *execute pricing*. At this stage, the company is executing the strategy with the customer. It requires that the front line be equipped with the tools that can communicate the value to the customer. P3 also incorporates the steps to ensure that the process can generate an accurate invoice. There should be procedures to maintain accurate pricing master data, and tools to ensure a smooth and efficient work flow.

P4, the final stage of the process, is *monitoring pricing performance*. Key performance indicators (KPIs) are developed and managed to ensure that the company stays on course and the strategy is sound. As a pricing manager aspiring to move up the Five Levels, KPIs can be a tremendous vehicle for helping you progress from Policeman to Partner. Policemen report the crimes at sales reviews; Partners coach the managers responsible to take ownership of their pricing results, and help them develop and implement plans to improve performance.

Many organizations lack the process orientation. Some telltale signs of process-focused companies: they have a corporate process improvement methodology; meetings run effectively; teams are organized around processes rather than functions (e.g., the order intake process would include all of the functional areas involved in that process, not just the order processing department); they know that they have high service levels, and why.

We often deal with service companies who find it difficult at first to see themselves fitting into the Five Levels and Four Core Processes.

Our experience with the service industry is that the emphasis might change, but the framework still applies. For example, financial-services companies go through each of the Four Core Processes, and can be benchmarked at one of the Five Levels.

One of our clients is a major bank that has several divisions, one of which provides loans to large multinationals. To create an effective pricing strategy, the division had to segment its customer base and build customized strategies for each segment. Then, when negotiating a deal, it had to set prices. Afterwards, it had to execute those prices, administer them, and finally, manage and measure them in the marketplace.

However, it is important to recognize the differences between services and products. The key distinction is that services are intangible, and therefore, defining the offering and communicating the value can often be a more difficult task. People cannot see or touch the service, so they must experience it before they can judge the value.

Let's now look at the how the Four Core Processes link into the Five Levels. If we use P4—manage performance—as an example, we can see how the overall competency of the company pricing process is determined. Policemen report results at Level 2. Partners, at Level 3, coach front-line managers in sales and marketing to address problems, and use what they learn about customers to improve their understanding of value. Scientists, at Level 4, have the trust of their colleagues to develop sophisticated pricing models that the organization uses to manage pricing more proactively. Masters—Level 5—are recognized for the value they have delivered in their evolution. We chose P4 here to illustrate the relationship of processes and pricing excellence or maturity, but P1 to P3 can be similarly characterized.

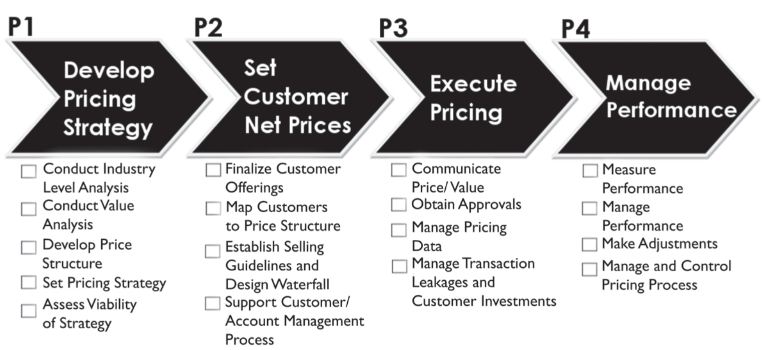
A company that can execute each of these processes at a high level of excellence is essentially operating at Level 5. However, organizations rarely execute all Four Core Processes in such a manner, and instead, have strengths and weaknesses in each of them.

For example, when it comes to setting pricing strategy, some firms have an innate understanding of what their brand means in the marketplace, but fail to consider how recent performance (P4) might impact their future strategy. Take, for instance, high-end fashion retailers in early 2009. Some brands (e.g., Coach) recognized that their consumers would be cutting back and would need to connect with the brand at a lower price point, while others held steadfast to their strategy as volumes plummeted. Effective pricing benchmarks and metrics (P4) can provide an early-warning system to help companies react more swiftly and with much greater precision to changes in the marketplace.

That's why, in order to get a true picture of how you are performing on each of the Four Core Processes, it is important to delve more deeply into the sub-processes. We have identified more than 40 sub-processes. However, some of these will vary across different industries. Below is a list of 17 that are relevant across *all* industries, which you can use as a benchmark to measure your own performance.

Figure 0.3

Four Core Pricing Processes



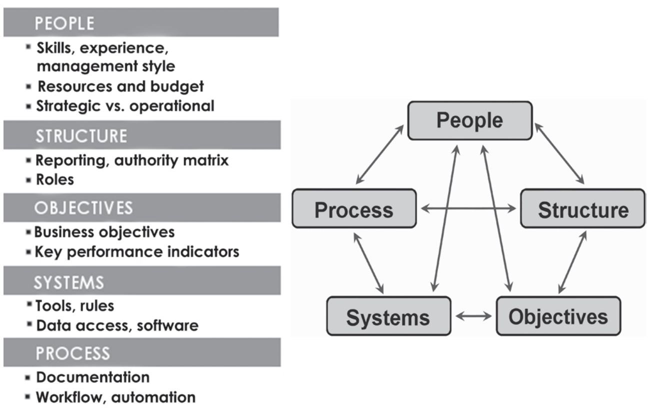
Companies may execute some of the sub-processes well, but others poorly. The key is to know which is which, and then build a plan to move forward.

Pricing Infrastructure

The final piece of the framework is the **Pricing Infrastructure**—the elements of the organization that support the pricing process. It consists of five areas: people, structure, objectives, system, and process.

Figure 0.4

Pricing Infrastructure



Each element of the infrastructure is linked to the others, so a weakness in one part affects the whole.

Here is a brief introduction to the five elements of infrastructure.

People: The human element of pricing. How well do the skills of the pricing team match the skill requirements? Are there enough people to perform the required processing of transactions and analysis of opportunities and results? Do they have the network and credibility internally to advance the process?

Structure: The organizational structure. The reporting relationships that are in place are an important determinant of the pricing organization's ability to execute at different levels. For example, in the early stages of "gaining control" (Level 2), it is typical for pricing to report to Finance, but as the company drives towards value-based pricing (Level 3), it is important for pricing to report into Marketing. In Level 4, companies often have established a vice-president responsible for pricing. We have recently seen v.p. pricing, v.p revenue management, v.p. business analytics, etc. Sometimes, these functions include pricing as well as other operational excellence and strategy areas.

Objectives: Whether the organization has clear goals for pricing and the means for measuring whether they were attained. Most organizations have neither. For example, most companies execute price increases, but have no idea how much money from those increases was actually kept and how much was given back in further discounts or promotions to the customer. We also look at other reward systems. It's hard to imagine, but many organizations compensate the sales team on volume (in units, not even revenue!). Without a sales team that cares about margin, making improvements in pricing will be very difficult.

Systems: The tools, rules, data access, and software that the company has for ongoing pricing management. They can vary from very sophisticated software pricing optimization engines all the way down to simple spreadsheet models and legacy mainframes. Access to data is another matter. Some companies have excellent access, enabling them to make better decisions; for others, it is a highly manual process. It is important to understand the flexibility and limitations of the system before going too far down the path of changing the strategy and execution of pricing.

Process: The documentation of how pricing decisions are made and how pricing is managed. For example, a clearly stated pricing philosophy can help guide individuals, while a written process for pricing new products can ensure consistency and the application of best practices. Having a documented process means that the process can continue to operate effectively even if the pricing manager changes.

As you assess your organization, or plan to improve your pricing process, it is important that there is balance and cohesion across these five elements.

Let’s start with Structure. There is no right or wrong way to organize your business for pricing excellence, but there can be a strong degree of fit or misfit between the elements. One of the most perplexing issues that companies must resolve is whether to centralize or decentralize pricing.

We recently met with the group sales team of a global hotel chain that was highly decentralized; its business was run from a number of corporately owned but highly autonomous hotel properties. The problem was that its pricing structure was contract-based and heavily negotiated, with each sales manager having a number of different levers to pull to win the deal. Furthermore, the corporate strategy was to hold the premium position in the marketplace. The chain offered more overall value than the competition, and wanted to be properly rewarded for the extra effort (and cost) that this model necessitated. Yet, there were no standardized processes for selling the value or delivering the service. Further, the system did not provide regional results much beyond a single P&L statement to each regional office, since the cost structure was not well understood. As a result, the objectives and results management were heavily volume-related. In that case, a salesperson would be foolish to spend time convincing an account of the value proposition when he or she could negotiate a price decrease and move on to the next account with little consequence. Therefore, the company chose to provide value measurement tools and training to the sales team, while aligning performance incentives. These tactics proved very successful.

Another company, faced with a similar challenge, centralized the pricing function, implemented systems improvements so the central team could keep its finger on the pulse of local pricing, and changed the incentive structure for the regional team. This strategy also worked very well.

In summary, there is no one answer for how to organize the pricing team, but changing one element of the **Pricing Infrastructure** must be considered in the context of the others.

Beware Broken Links

Remember that, as badly as you may want to improve the pricing process at your firm, pricing is linked to other core organizational processes. The pricing strategy must link with the overall corporate strategy (we believe it is a core part thereof). Setting Customer Net Prices in P2 must link with the account management process or the CRM process. Executing Pricing in P3 and compiling the information necessary to do so is part of the overall master data management process. Developing a price structure that your system cannot bill accurately and efficiently is of no value to your organization. Pricing KPI reviews are meaningless if they are not done in the context of the sales review process. Being a pricing manager requires that you are able to advance your agenda with the support of other key players in the organization. Building your team to include skilled change managers will serve you very well indeed.

By linking the **Pricing Infrastructure** to the **Four Core Processes**, an organization is taking a holistic look at pricing, and ensuring that improvements are made for the long term.

Summary

In this introductory chapter, we have developed the framework that we will use throughout the book. We have emphasized that pricing is a process just like other enterprise processes, and as such, it can be measured and improved. We have established the framework for the Five Levels of World-Class Pricing Excellence to mark your current position, set objectives, and plot a path forward. That progression involves process improvement, but there is more. The Pricing Infrastructure determines how robust your process is, and its ability to drive change. Ensuring a strong and dynamic fit among the five infrastructure forces will ultimately determine your ability to effect lasting change.

Implementing the changes will take time and patience. Progression from one level to the next typically takes at least 12 to 18 months. Why does it take so long? Pricing touches many different functional areas, and the changes in behavior that are required by each one will take time. There is a strong change-management component to pricing that must be considered. A good rule of thumb is that the people affected by any new process must experience it at least seven times before it is fully adopted and considered part of the ongoing process of the organization. We call this the “7x rule.” If you prepare management to expect that the 7x rule applies to the changes you are implementing, you will have a much better chance of succeeding.