PRICING FOR PROFIT

A PRAGMATIC APPROACH TO IMPROVING B2B PRICING

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COMPANIES TEND TO SET THEIR PRICES TOO LOW IN THE BUSINESS-TO-BUSINESS MARKET.

REGARDLESS OF PRICING POLICY, SOME CUSTOMERS END UP PAYING A PRICE THAT IS NOT JUSTIFIED BY THE AMOUNT THEY BUY OR THE COSTS THAT THEY INCUR. AND THAT IS PERHAPS PUTTING IT MILDLY.

AS A RESULT, YOU GET LOWER MARGINS, YEAR AFTER YEAR.

Often nobody realises that customers are paying too little and, if a company does pick up on it, it usually fails to tackle the problem decisively. So how can you make sure that you're not setting prices that harm your business? Most importantly, if closer examination reveals that prices are too low, how can you correct this situation without alienating customers or demotivating sales staff?

In the course of our work with clients over the last few years, we've developed a successful method for tackling precisely this problem. Because correcting low prices has a direct impact on profits, you can often achieve a considerable improvement, in our experience from one to three per cent of turnover.

PRICES ARE SUSCEPTIBLE TO NATURAL EROSION

Figure 1 shows an example of substantial differences in prices charged to customers – even where purchase volumes are comparable. Such price differences can arise even in the best-run companies with the strictest controls. In our analyses we constantly come across abnormally large differences in the net prices ultimately paid, whether it's a firm of mechanical engineers, a supplier of construction materials or a business services company. These sorts of differences are not due to negligence. They are the result of a natural process of erosion, reinforced by the many criteria which determine prices.

COMPLEXITY IS AT THE ROOT OF THE PROBLEM

In the business market there are often large numbers of

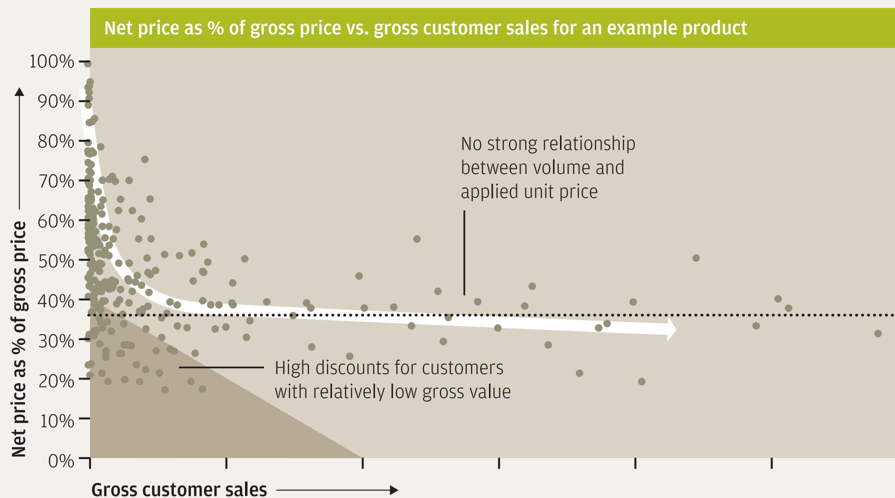

Figure 1 – Prices charged to customers vary considerably – even when purchase volumes are comparable

customers, products and services. This complicates the management of customer relations, particularly because every customer relationship is unique, many parties are involved and the flow of information increases year by year. If financial directors only look at averages, they will not detect this complexity and thus be unaware of the existence of the problem.

Each customer relationship is unique

Even where there's an extremely detailed breakdown of the market, it's possible for a sales representative to stray from the prices that have been established for a specific customer segment and offer customers a price that is too low, while being fully convinced that this is in the interests of the company. This might be done to win a new business, to reward a customer for loyalty or simply because the sales rep is afraid of losing an order or is in a hurry to round off negotiations so that he can move on to the next customer.

Various parties influence pricing

Pricing is the result of a series of decisions by all those involved. The marketing and sales departments have different approaches for different types of customers, promotional programmes and loyalty schemes. Representatives are given strict criteria for setting discounts and net prices, but they are fairly flexible in applying them in practice. Sometimes other departments grant additional discounts for things the customer may or may not have done, for example, the finance department (payment conditions, financing schemes) or logistics (for a minimum purchase volume, number of drop-off points), and so on. Linking all of these decisions reinforces the effect of each minor individual deviation. This means that the original gross price has to be adjusted for all sorts of factors to get to the net-net price for each order (see Figure 2). This process is called 'transactional pricing', as opposed to 'strategic pricing', which is based on the environmental factors that affect each product or customer segment, the most important being buying factors, competitive strength and developments in the prices of raw materials.

The complexity of these common pricing schemes, in combination with the ever increasing flow of information, often creates customer conditions which are hard to manage, with the risk of persistent patterns being established.

> **THE PRICES A COMPANY CHARGES FOR A GIVEN PRODUCT IN THE SAME CUSTOMER CATEGORY CAN VARY BY AS MUCH AS A FACTOR OF THREE**

Organisations are often obsessed with averages

It is not surprising that prices vary somewhat; this is perfectly normal. But how can it be that organisations that are so strongly focused on company results lose track of these variations? The reason, we believe, is a fixation on averages. Take for instance a distributor who wants to know how consistent the net prices are that the various sales teams charge. Management asks the teams for information, is sent totals for each customer category and compares these with the volume-related target prices. What is the upshot? The

average price that is reported declines in line with a 'more or less normal pattern' as the customer purchases greater volumes. There are a few deviations from the target price, but nothing to get excited about or deal with urgently. In many cases such a quick check is all that is done.

Figure 3 shows what can happen if you evaluate current pricing conditions in each customer category, based on a clear and unambiguous breakdown of the customer base. This shows that the prices a company charges for a given product in the same customer category can vary by as much as a factor of three. No higher maths is needed to gain such an insight but it still appears to be a difficult thing for many companies to achieve. Conventional information systems are not geared up for it and the managers who are responsible will have to push their sales staff to deliver such information. Apart from such a detailed view, it's also essential to have clear insight into the real costs involved in delivering a single order. Think of the costs associated with administering orders, order picking, transport, and invoicing. A good, comprehensive evaluation of these costs frequently reveals a substantial 'cost to serve'.

TOWARDS A 'LEAST BAD' PRICING POLICY: FIRST TACKLE EXCESSIVELY LOW PRICES AND UNACCEPTABLE ORDERING BEHAVIOUR

Once it has become clear how much prices vary in practice and what the 'cost to serve' is, some urgent issues need to be addressed. 'Do we have to throw out the whole pricing policy?', 'Do we have to raise prices across the board?', and 'What incentives do we want to give customers so that they change their ordering behaviour?' The answer is no, the pricing policy does not need to be completely revised – that would be far too laborious. Instead of a complete reorganisation, it's sometimes better to adjust policy in a targeted fashion, concentrating on the lowest prices and those

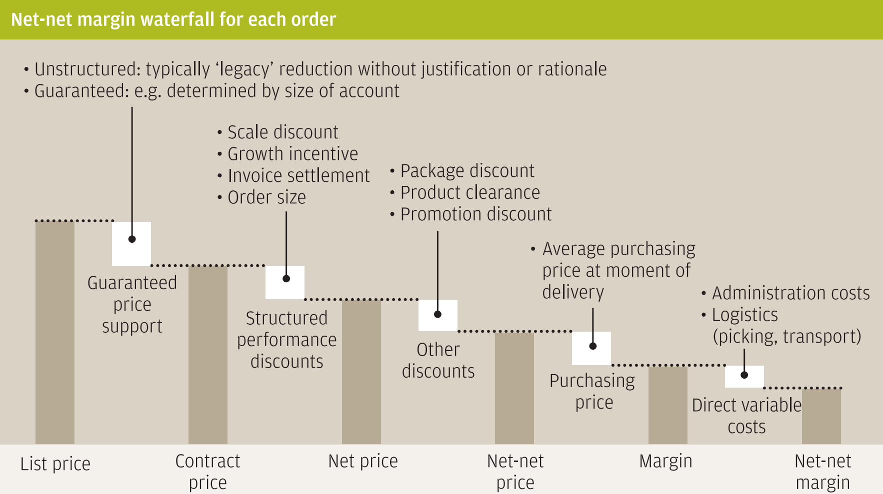

Figure 2 – The original gross price has to be adjusted for all kinds of factors before we arrive at the net-net price for each customer order

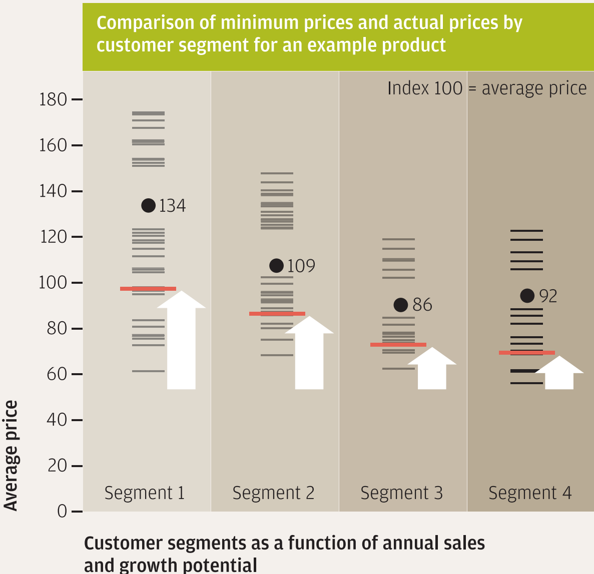

Figure 3 – Prices that are charged for a given product in the same customer category can vary by as much as a factor of three

specific customer orders where the company makes no profit, and then taking specific action.

This can include:
Setting minimum and target price levels, depending on the specific customer segment, to avoid abnormal low pricing and to align pricing with customer value (see Figure 3).
Passing on costs for an excessively small order or rapid delivery time. Because the scale of these costs is often significant – certainly given rising fuel costs – a detailed analysis is essential to give customers the right incentives.

This approach has three advantages: it's discreet because it involves 'surgical' measures; it's direct, as it immediately gives a boost to net profit; and it's a stimulus, because it's part of a continuous process of improvement. For instance, by structurally raising the lowest price point, new, more realistic prices can be set. For this reason the sales department is generally positive towards such moves.

The secret of an initiative to tackle excessively low prices and orders that are too small is not to believe that you can do away with them completely. The key thing is to set an acceptable

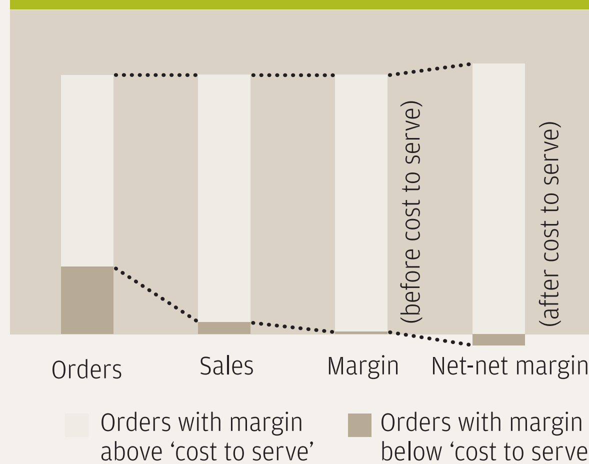

Figure 4 – It's essential to have a clear picture of net-net margins per order and build the right kind of incentives for customers on that basis

lower limit, so that the price or order size is not allowed to go below that limit. It's a case of arriving at the 'least bad' pricing policy, so to speak.

You then concentrate on those prices that are currently under the lower limit and that need to be ratcheted up at least to the 'floor' you have set. These measures are realistic and they generate additional profits.

CRITERIA FOR SUCCESS

By identifying the prices that need to be tackled, it becomes possible to calculate how much is at stake. In our experience substantial improvements in margins can usually be achieved. Three golden rules have proven their worth over time:

Respect the culture of price agreements

Every company has its own methods of setting prices and monitoring them. These methods have their roots in the corporate culture, the nature of the customer relationship that has generally been built up, and the data available in the information systems. It is crucial to take this into account as it makes it all the easier to improve the existing situation. This approach was chosen by one of our clients, who had a fairly complicated system of calculating net prices, based on estimated volume.

Investigate net prices thoroughly, taking account of the costs incurred – by customer, by product and by order

It is never easy for a manager to instruct sales staff to carry out a thorough evaluation: 8 x 8 sales reps per team x 150 customers per sales rep x 10 lines of unreasonably low prices per customer ... just do the calculation – that's an awful lot of cases to go through! However, experience shows that such an exercise is not as difficult as it appears at first sight. Sales reps are pleased with the information that they reveal and are willing to go through with the necessary adjustments, as long as they are given well-designed tools for the purpose (such as overviews of customers who are outside prescribed norms for maximum discounts and minimum order sizes, for example).

Give the sales staff the last word

Do not finish the exercise without an action plan and make sure that the sales staff are 100% behind it, in order to ensure it is executed as intended. After all, sales reps know all the ins and outs of the customer relationship. This means that they are the best people to make decisions about any corrections that need to be made. They are also the only ones who can explain such measures directly to customers and who can justify them. So it's important to leave the final decision to them.

> **IT'S A CASE OF ARRIVING AT THE 'LEAST BAD' PRICING POLICY**

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OC&C is a leading international consultancy firm. We assist our clients' top management in solving complex strategic issues that are of crucial importance to their business success. We do this by developing radical and creative, but at the same time practical, cost-effective and action-oriented strategies.

Founded in 1987, OC&C operates globally from 12 offices (2011). We help clients develop winning strategies in a broad host of industries, in over 45 countries. In sectors such as transport, consumer goods, retail and media we are acknowledged as leading contributors to the international debate. In addition, we are a leading adviser to private equity firms in evaluating the strategic prospects of potential investments.

OC&C's mission is to have a positive, enduring impact on the performance of our clients' business. We believe that superior and profitable growth – not just cost cutting or downsizing – is the best route to long-term shareholder value creation. To achieve this, our clients need creative and insightful strategies that give them a lead over competitors. OC&C is one of few specialist firms who provide advice on how to win this competitive battle.

Discovering new routes to business success requires creativity, intuition and – to a degree – visionary thinking. However, they are not sufficient. Our recommendations are therefore fact-based, arrived at through rigorous quantitative analyses and built on sound business logic. Still, even smart solutions for important problems are in themselves no guarantee for success. OC&C translates choices made into concrete measures and visible improvements.

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