

SALES & MARKETING



CEOs are often the last defense against unrestrained discounting that degrades margins and destroys value.

BY JOHN KADOR

The CEO is in a monthly operating review meeting with all of his product managers. One turns to the CEO and says, “I made my numbers this month.” One by one, the rest look the CEO in the eye and say the same thing. The CEO should be delighted, right?

“Why don’t I feel better?” the CEO asks. His answer: “I’m the only one in the damn room who didn’t make his numbers!”

What’s going on here isn’t hard to explain, says Jonathan L.S. Byrnes, a senior lecturer at MIT and president of Jonathan Byrnes & Co. in Lexington, Mass. The numbers most important to the product managers are not necessarily those most important to the CEO. The product managers met their numbers, but the CEO, whose main number is profitability, was disappointed. Let’s look at why:

- One product manager increased sales volume, but did so by discounting the product, thereby sacrificing margins.
- Another managed to grow the top

line—by throwing in free maintenance, further eroding margins.

- Still another acquired new customers, but the additional sales required frequent shipping of small orders. The gross margins did not cover the distribution cost, so the company lost money on every transaction.

Hold That Line

CEOs are often the last line of defense against discounting. Every CEO feels pressure to discount products and services. Yes, customers are more demanding and always seek lower prices, but the most strenuous pressure to discount usually begins inside the organization, where VPs and sales managers clamor to defend market share and meet earnings targets.

So it’s no surprise that, instead of holding the line on pricing, many CEOs defer to product managers or the sales force. This is so, despite the fact that most CEOs know that rampant discounting leads to a death spiral—particularly during times of economic downturn. Even if discount-

ing boosts volume and maintains market share, it usually KO’s profits.

Yet, according to a 2010 study of 5,000 CEOs from all industries and business sizes conducted by Atenga, a Woodland Hills, Calif., price consultancy, 60 percent of the CEOs who responded identified sales volume as their biggest problem and their most important process for improving their profitability. “Focusing a company’s entire resources on increasing sales volume isn’t the only way to pursue profitability,” says Per Sjöfors, Atenga’s founder and managing partner. “It’s highly unlikely that 60 percent of U.S. businesses will be able to increase their sales volume as much or as fast as their CEO wants.” On the other hand, a simple 1 or 2 percent change in prices can produce enormous boosts in profitability.

Optimal, Not Lowest

Of all the levers available to a CEO, price optimization—not sales revenue—makes the greatest contribution to the bottom line. A 1 percent increase in price translates into an 11

percent increase in profits, according to McKinsey. By contrast, a 1 percent sales boost adds 7.8 percent in profits. By far the worst strategy is lowering costs: A 1 percent cost cut added just 3.8 percent in profit. McKinsey concluded that CEOs who establish a pricing strategy and stick to it show profits double those of peer companies, grow twice as fast and have four to five times the market cap.

Optimizing prices doesn't require reducing prices. Regis, headquartered in Minneapolis, owns or franchises more than 12,700 beauty salons and hair restoration centers around the world, ranging from Regis Salons to walk-in Supercuts. Andy Cohen, president of the flagship Regis Salon division, says the economic slowdown has not put undue pressure on prices. "We're trying to be a good value at our price point," Cohen says. "We can't win the price war, so we don't compete in that segment."

In fact, a 2009 pricing optimization study conducted by Atenga suggests there may be room to increase prices at Regis Salons. The study demonstrat-

Allianz: Holding the Line

ESTABLISHING A PRICE IS DIFFICULT ENOUGH when costs are fixed and well known. But what about when costs are unpredictable? "The insurance business is unique in that it takes money from customers today and promises to pay materially more money in the future," notes Gary Bhojwani, CEO of Allianz Life Insurance of North America, a subsidiary of Munich-based Allianz SE. "We can't know for a certainty what the true underlying cost of that promise will be until, say, 10-20 years from now."

The Allianz pricing team meets every Monday morning to consider the impact of market and competitive trends on the profitability of both in-force and new products. Ultimately, however, the buck stops with the CEO. In extreme cases, that can mean actually suspending sales of a product customers are clamoring for. That's what happened in early 2009 when financial markets were melting down. A.M. Best had downgraded 10 of the company's top competitors, resulting in a big sales spike for Allianz. "Normally, I'd kill for an opportunity like that, but we were unsure about the underlying trends," Bhojwani says.

That March, Bhojwani made the difficult decision to suspend sales of the living benefit rider on its variable annuities to recheck product design and pricing. Allianz relaunched its variable annuity business five months later. Did the company take a big hit? On the contrary, in 2009 Allianz Life posted operating profits of \$800 million, the highest in its company's 110-year history.

Bhojwani believes that his decision sent an unmistakable signal, internally and externally, that the company was willing to take a hit to ensure that the products it sold—and the company itself—were sustainable. "To me, there is nothing worse than selling underpriced insurance," he says. "When you do that, the only way to fund that product is to weaken the promises you have already made."

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ed that given the services and value delivered relative to the competition, the company could be even bolder in raising prices. “It’s not a strategy that we have implemented,” Cohen notes, “but we are comforted to know that an upside exists as a hedge against any downward pricing pressure that we may experience.”

Pricing Manager

While most companies have pricing managers, the title is often misleading. They should be dubbed costing

that you can invest in more efficient supply systems that keep your costs down. The problem is the tail: the 5 to 10 percent of customers that cost more to support than they bring in.

A complicating factor is that few accounting systems actually have the ability to isolate costs, much less profitability. Even organizations that go the extra mile to understand profitability often look only at the gross profit line. “Cost accounting may be carried out to the third decimal place—the only problem is that the first digit is

through a deep and potentially long financial crisis. At a minimum, CEOs must determine the true cost of serving a customer. “If you’re losing money on a customer, fire them,” Holden says. “Let the competition serve them. If you really know your true cost for serving a customer and your prices are below those costs, you can’t afford to serve them anymore.”

When a company’s largest customer demands barebones pricing, Holden suggests the CEO give it to them, but first subtract services. Take away the training, free updates, maintenance and all the other features that differentiate the product from the competition. In other words, build a fence around those services and charge for them separately. “If customers complain, that’s a good thing. That’s the only way to understand their true pricing threshold,” he says.

Survival pricing requires informed metrics to decide whether a proposed transaction will make money. It starts at the point of sale, where profit is built one sale at a time. CEOs need to understand the factors that drive the purchase decisions of their customers. CEOs who come out of sales have an advantage here, but even if they know why customers buy, they usually don’t have a clue why customers choose not to buy. The most frequent answer — “because your product is too expensive” — is rarely the whole story.

Pricing discipline requires developing a data model for making rational price decisions. “Companies need to use hard data from objective third-party market research for their price decisions,” Holden says. “They need to understand from this data what price drivers are important for their cus-

Cost accounting may be carried out to the third decimal place—the only problem is that the first digit is often wrong.

managers, because they simply calculate the costs of a product or service and slap on a standard industry acceptable markup. Cost-plus pricing is straightforward, but it’s rarely the best way for companies that sell some products that are commodities and some products that are unique.

Pricing optimization requires segmenting customers, not by profitability, but by uniform characteristics that lead to selling economies. “If you plot all customers as a function of profitability, you get a curve that looks like a whale and invoke the 20/225 rule,” says Reed Holden, co-author of *Pricing with Confidence: Ten Ways to Stop Leaving Money on the Table* and founder of Holden Advisors, a pricing consultancy in Concord, Mass. In other words, the first 20 percent of customers contribute 225 percent of the profitability. The body of the whale is not the real problem, because large customers often bring enough volume

often wrong,” notes Jerold Bernstein, president of Value Pricing Group, a consultancy in Ballwin, Mo.

Yet, even when customers are segmented by profitability, many CEOs have a gut feeling that the process is flawed. The flaw is the assumption that profitability is a function of a customer. That can’t be right. Customers simply have requirements that companies attempt to meet. Profitability is a function of the processes an organization establishes to serve those customers. Seen in this light, customers are not intrinsically profitable based on their characteristics, but rather on how a company manages to serve their needs.

Survival Pricing

“Recessionary times call for CEOs to embrace ‘survival pricing,’” says Holden. Survival pricing focuses on the immediate pricing actions businesses need to take in order to make it

tomers, what is their customer's willingness to pay, and what bundling and different pricing schemes will enable them to capture the maximum of that willingness to pay."

Respect the "Iron Law of Pricing," advises Holden. "Different customers will value your products and services differently. Savvy companies look at their marketplace and identify their most profitable customer segments. They do cost-to-sell and cost-to-serve analyses, and they have processes and a single customer database with data tags that identify their marketplace's purchase and price drivers."

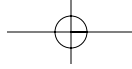
Chief Value Officer

Economic slowdowns create many pressures, but they also create opportunities to take pricing initiatives that are not available when times are fat. CEOs find there's traction to shed marginal products and even customers. It's possible to differentiate pricing to gain positions of advantage with customers who need you as a partner. In fact, slowdowns may be the best time to persuade customers to accept new pricing models.

In the role of chief value officer, the CEO may be the most effective sponsor for establishing a set of pricing initiatives tailored to new economic realities. By whatever name—smart pricing, value pricing, survival pricing—all of these disciplines have one thing in common: the decision to use hard evidence to optimize prices. Notice that the word is optimize, not maximize. What's the difference? Let's put it this way: Optimum body heat for human beings is 98.6 degrees Fahrenheit. Maximum body temperature will kill you every time. ▲

Seven Rules for Effective Pricing

- 1 Establishing a pricing strategy is easier than sticking with it. Observing the following rules will make the task more manageable.
- 2 The Customer Doesn't Establish Pricing. Customers may have the last word on the price they will pay, but pricing remains a management function. There's a difference between price and pricing. Customers have a vote, but pricing executives get to establish a strategy that coherently frames and delivers the value proposition.
- 3 Communicate Product Value. If you think that your products are commodities, you've already lost the battle. It's your job to identify and communicate the value your product delivers for the customer.
- 4 Embrace Variable Pricing. It may be easier to administer a pricing strategy that charges one price for every customer, but an average price across your customer base means that you are leaving money on the table. Why? Because some customers are almost certainly prepared to pay more for the value they are receiving, while others who don't perceive the same value will bolt because they consider your prices too high.
- 5 There's More to Pricing Than Cost. Cost-based pricing does have one virtue: it is easy to explain. But customers don't care about your costs; they care about the value they receive. The goal of a pricing strategy is to link prices with value and benefits.
- 6 Reject Herd Pricing. Some CEOs think there is safety in charging the same prices their competitors do. The fallacy is that someone out there is always willing to cut prices.
- 7 Link Sales Incentives to Profits, Not Volume. There is no better way to undermine pricing than to give salespeople volume quotas. The inevitable result is discounting to meet volume goals. Make it clear that sales incentives are linked to company or department profit.



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