ATKearney

Price Balance: Set, Get, Go

Business-to-business organizations have long grappled with setting the right prices—and yet, the payoff can be huge. Optimizing pricing can boost profits by 15 percent or more.

The Pitch for Change

The challenge of setting the right prices for business-to-business (B2B) products and services is not a new one. In fact, the unique B2B dynamic has led many companies to believe pricing is too complicated or too sensitive of an area to play with. In turn, pricing often gets pushed down the list on C-suite agendas, falling below other strategic initiatives such as volume growth and cost reduction.

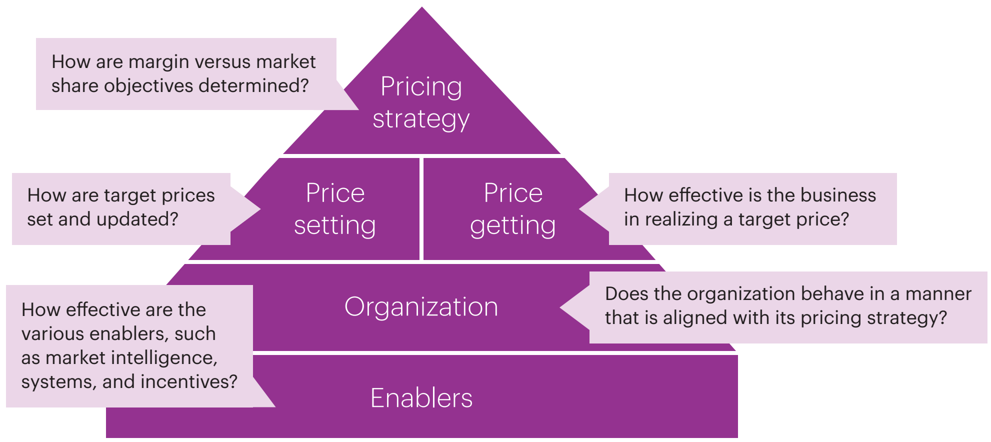
However, few initiatives have the power to impact both the top and bottom lines as much as pricing. Every business knows that, in theory, improving pricing by just 1 percent can increase EBITDA by an average of 7 percent.[1] But what matters more is what happens in real life. An A.T. Kearney study of more than 1,600 companies across five countries shows that better pricing can increase gross profits by an average of 15 percent over three years—and there is always more to gain.[2]

Pricing is at the heart of every organization—a quintessential element of the annual planning process and a vital tool for translating business objectives into action. For instance, to enhance profitability, the strategy is to maximize price realization while restricting the loss of market share. Similarly, a focus on improving market share entails driving market penetration with a less-than-proportionate reduction in price realization. Both these situations reflect an aggressive stance. A third, more defensive objective is to maintain threshold profitability with a less-than-proportionate loss of market share. This objective, again, needs to be executed through an integrated pricing strategy.

Forward-thinking companies keep pricing at the top of their C-suite agendas. To understand how they unleash their full pricing power, we launched the Excellence in Pricing (eXPrice) benchmarking study at the business unit or division level—exactly where pricing decisions are made (see figure 1).[3]

Figure 1
Pricing capabilities can be evaluated along five dimensions

Excellence in pricing framework



Source: A.T. Kearney analysis

[1] Based on analysis of S&P 500 data
[2] For more information, see In Pricing, Success Breeds Success at www.atkearney.com.
[3] For more information, see Excellence in Pricing at www.atkearney.com.

Our eXPrice study uncovers four insights that are common across B2B industries:

- Despite being broadly used, customer segments are not defined in a way that is useful for making pricing decisions.
- In most organizations, the sales force yearns for a credible target price that is tailored to each customer.
- Many approvals for pricing discounts do not translate into better pricing.
- Most organizations would be better off focusing on pricing excellence in the absence of "perfect data."

In this paper, we discuss a powerful pricing tool to address these challenges: A.T. Kearney's Price Balance.

> The sources of value are not limited to the product. A range of factors across the seller–market–buyer ecosystem can extract better pricing.

Debunking the Pricing Myths

One of the first steps in creating value through pricing is to question the entrenched beliefs. Three misperceptions are common:

Myth #1: Beyond a limited premium for product quality, the market determines the price. B2B organizations deal with a more rational set of buyers than in business-to-consumer (B2C) transactions, which tend to be more emotional. B2B buyers tend to be tough bargainers, driving prices down to levels quoted by other companies. Amid aggressive competition, the only realistic price premium is for a better-quality product, and when it comes to commoditized products, the market completely controls the price.

Reality. The rational nature of B2B buyers is a blessing in disguise. Pricing can be improved by communicating with customers about incremental value. More importantly, the sources of value are not limited to the product alone. A range of factors across the seller–market–buyer ecosystem can extract better pricing. In fact, this is what creates a "price band" in the market, which the leaders exploit, even for commoditized products.

Myth #2: Because every B2B transaction is unique, it is impossible to define a standardized approach to pricing. Most B2B organizations have fewer transactions with higher value than a B2C organization of a similar size. Every situation and every customer order is unique. The buying process is more complex, with an array of stakeholders from decision makers and influencers to end users. It also involves a varied set of time-consuming processes, such as requests for proposals that have defined evaluation steps and criteria. Any attempt to structure pricing for B2B transactions will therefore be impractical or too complicated.

Reality. Our work with leading B2B companies shows that despite the perceived uniqueness of individual transactions, it is practical and rewarding to adopt a standard pricing structure that captures the complexity. The complexity can be broken down into variations in the factors (price drivers) across the seller–market–buyer ecosystem, making it possible to create a standard approach that is relatively easy to understand and execute. The intricate analysis can thus be bundled into a simple solution.

Myth #3: A standard pricing system is a guaranteed recipe for lost volume. The core strength of a B2B sales organization is having a sales force that can extract the best price by capitalizing on their experience in the field. A standard pricing system takes away their flexibility to tailor pricing to a specific situation, which in turn can prolong the negotiation and closure cycle, eventually leading to lost orders.

Reality. A well-designed pricing structure hits the sweet spot—providing customized target prices for salespeople to play with. The system ensures that decisions are driven by information and logic while also limiting self-serving behavior, such as pricing too low to close an order. Flexibility is retained in the form of "informed flexibility", with management maintaining adequate pricing control. Of course, for this to work seamlessly, the escalation process and the supporting organization must be designed with the right balance of agility and control.

Tear It Apart, and Stitch It Back Together

A Price Balance technique revisits an age-old rule: divide and conquer. The complexity of B2B transactions can be broken down into 10 factors across the seller–market–buyer ecosystem:

Seller. Some factors are largely internal to the seller. Examples include input costs (raw material type, composition, and quality) inclusive of inbound freight, conversion costs (variable, fixed, and variable by location, technology, and application), product characteristics (product type and production volume) and outbound freight, including costs and fulfillment mode (direct from plant or from depot).

Market. Some factors are market-driven, including the intensity of regional competition and the availability of substitutes.

Buyer. Some factors are dependent on the buyer. Examples include the strategic relationship with the buyer, any product customization requirements (standard or non-standard), product application and utility, order characteristics such as volume, urgency, and delivery requirements, and credit and financing terms.

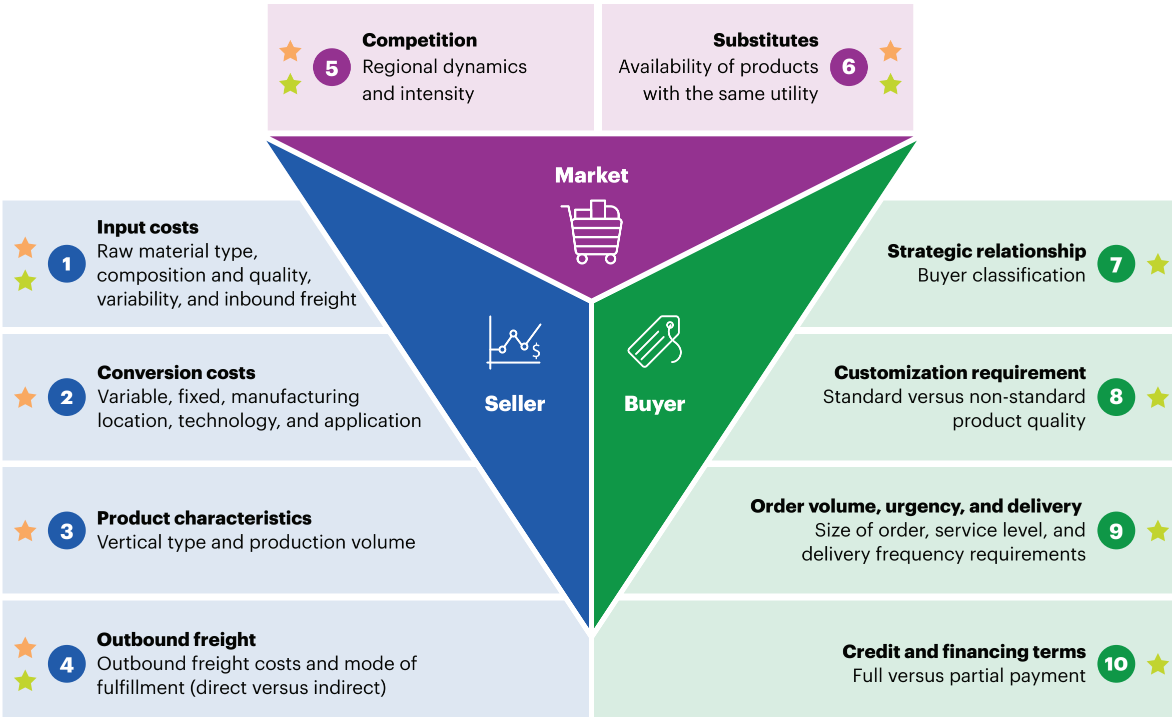
Pricing can be used to balance variations in these factors across the seller–market–buyer ecosystem. In other words, incorporating these factors into the pricing structure will extract the most value. For instance, order volume can vary across orders from the same customer or from different customers. As volumes get smaller, there are implications for costs in production, freight, sales, and other areas. These variations can be balanced by raising prices for smaller volumes.

A comprehensive pricing structure incorporates variations in these factors on two levels (see figure 2 on page 4):

Price setting. For any given product, management or the central pricing function sets a determinative price: the list price. Typically, this price is constant for one to three years and is changed to account for structural changes in the product vertical or the nature of business.

Figure 2

Ideal pricing focuses on both setting and getting the right price



★ **Setting the central price.** Constant over a longer period of time (one to three years) and changed mostly to account for structural changes; implemented through list prices

★ **Getting the best price**. Flexible for the quantity of discounts and premiums; guidelines adjusted to account for short-term fluctuations; implemented through discount structures

Source: A.T. Kearney analysis

Price getting. The price realized from the customer is the list price less a discount or plus a premium. The sales force can make decisions about the size of the discount or premium, usually based on guidelines (and an upper cap on the discount) set by management or the central pricing function. Typically, these guidelines are adjusted to account for short-term fluctuations in the product vertical or business.

In summary, management or the central pricing function sets the prices, and the on-the-ground sales force gets the price within the guidelines. An optimal mapping of factors in the seller–market–buyer ecosystem to the levels above (list price and discount or premium structures) can equip the organization to extract better pricing. The specific mapping of factors to the levels in the pricing structure will depend on the nature of the business and strategic business objectives. In addition, a robust escalation process and a well-designed supporting organization will enable tight management control on pricing while giving the on-the-ground sales force the right information and support to get the best price.

For instance, on the seller side, list prices can be modified to account for structural differences in raw material type, composition and quality, depot deliveries, conversion costs, variations in inventory costs across product vertical types, and SKU demand. Discount structures can be changed to account for short-term fluctuations in input costs. Outbound freight can be charged on an actuals basis. Market factors such as competitive intensity and the presence of substitutes can be incorporated both at the list price level and within discount structures.

On the buyers' end, the Price Balance approach incorporates strategic importance, product utility, order characteristics such as volume and urgency, and other customized requirements on an actuals basis or within discount structures.

Thus, the factors in the seller–market–buyer ecosystem can be packaged into a price setting–getting structure that the sales force can easily understand. With a limited range of inputs from the salesperson (such as customer name and requirements, product code, or order volume), the recommended price—or target price—can be worked out in the system. This target price also shows the salesperson what his or her colleagues achieved in similar situations. After all, salespeople tend to trust other salespeople. Having a transaction-specific target price enables management or the central pricing function to indirectly control both price getting and price setting. And with the right set of enablers, the structure can be seamlessly implemented and managed.

Full Steam Ahead

Three elements can enable successful implementation and control of a pricing program:

Process and organizational support. One success factor of this pricing approach is a clearly defined escalation process. Beyond the maximum recommended discount allowed to the sales team, the pricing call needs to be escalated to a higher authority who has a defined additional delta discount at their disposal. Beyond this additional delta, the call needs to be escalated again, and this continues until it reaches the highest authority in the pricing decision. Typically, a guideline for the overall maximum delta is also defined so that a threshold level of profitability is maintained.

Monitoring, reporting, and reviewing. The Price Balance approach moves towards tracking every transaction. In addition, the implementation performance should be tracked on a periodic basis. Typically, only the output metrics (price achievement relative to the transaction-specific target price) are monitored and acted upon. Equally important are the input metrics, which are indicative of the performance of the pricing approach itself. The exact nature of the input metrics depends on the pricing system and what management wants to drive through it. A sustainable process requires regular monitoring and reporting.

Tools, including IT. As mentioned, the recommended price (or the maximum recommended discount or premium) can be worked out using a limited range of inputs about the product and the customer's requirements. This calculation can be enabled using IT, for example, by salespeople using a handheld device to gather input for a recommend price in real time. More importantly, the platform can provide vital information about the customer's purchasing history to augment negotiations.

Create a Positive Feedback Loop

The Price Balance approach has led to a substantial increase in price realization for an array of companies with no impact on volumes—0.5 percent for hard-core commodities companies and 2 to 7 percent for others. And it creates a positive feedback loop—driving behavioral changes in the sales organization, which in turn lead to operational improvements that affect factors in the seller–market–buyer ecosystem.

For instance, customers tend to limit their orders of higher-priced slow-moving products instead opting for fast-moving alternatives or ordering higher volumes that are above a defined minimum order quantity. Similarly, volume-based price structures encourage customers to place higher-volume orders instead of multiple small orders spread out over time to get higher discounts. At the same time, they also drive advance payments and shorter credit periods to compensate for higher discounts.

Over time, Price Balance makes the sales team cognizant of less strategic customers and the fact that they have a higher cost to serve. Hence, salespeople aim to close those orders over the phone or by email with minimum negotiations. These behavioral changes lead to overall operations changes and reinforce a positive feedback loop.

In summary, the Price Balance approach can deliver a significant impact on the price realization for B2B companies to drive organizational value and translate business objectives into action. Bursting the pricing bubbles will help reinstate pricing as a strategic area of executive focus. The approach needs to be comprehensive, accounting for all relevant factors in the seller–market–buyer ecosystem in both the price-setting and the price-getting levels. It also needs to be adequately enabled through process and organizational support as well as regular monitoring, reporting, and reviewing, thus creating a positive feedback loop that leads to operational improvements across organizations.

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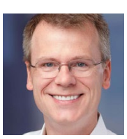

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