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TIM J. SMITH

PRICING DONE RIGHT

THE PRICING FRAMEWORK PROVEN SUCCESSFUL BY THE WORLD'S MOST PROFITABLE COMPANIES

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The Pricing Framework Proven Successful by the World's Most Profitable Companies

Tim J. Smith

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Preface

Company J versus Company K

Francis, Molly, Sally, and Charles, the good executives at Company J, have a plan and process for managing prices. Unfortunately, they know that it doesn't work as planned. Even though each of these hard-working and thoughtful senior executives has something meaningful and important to contribute to pricing, the outcome never meets expectations. Something has to change, but what?

Francis is the Finance leader at Company J. As a normal part of his financial duties, he pays close attention to meeting shareholder expectations for profits. Profit expectations are translated into target margin expectations for all of the products of Company J.

Although Francis of Finance clearly communicates these target margins, it seems as if they are met haphazardly, if at all. Some products greatly underperform. A few products meet or exceed expectations, but they are a minority of Company J's products.

Francis of Finance has considered divestiture of the underperforming product and business lines, but they represent a significant portion of Company J's revenue, and other senior executives at Company J disagree with this approach.

Molly is the Marketing leader at Company J. As a natural part of her marketing duties, she monitors market share for each product. She is well aware that market demands, competitive actions, and pricing greatly impact market share shifts.

Though Molly of Marketing is aware of the target margins and sets prices and manages products accordingly, she knows they are far too high for the market at times. Competitors routinely match or beat Company J's prices on many of its products. Many, but not all. Market share targets for some products seem to fade into the distant future, while other products are runaway successes.

Molly of Marketing has considered lowering the list prices of underperforming products but knows this would go against Company J's policy, and other senior executives disagree with such an aggressive approach.

Sally is the sales leader at Company J. As a standard part of her sales duties, she focuses on hitting her revenue targets through winning new business and retaining current customers. In keeping with best practices, Sally's sales process includes qualifying leads, communicating the benefits, and negotiating the price. It's the last part, price negotiations, that keeps her awake at night.

From firsthand experiences, Sally of Sales knows that customers never close on the first price offered. Customers expect discounts from the list price, especially in competitive situations. And almost every sale is a competitive sale.

To manage discount decisions, Sally of Sales has set up an escalation policy at which point the size of discretionary discounting authority increases with responsibility. Still, she finds her frontline salespeople routinely asking their regional managers for deeper discounts, and her regional managers asking her for even greater discounts. Too many of her customers have become "strategic customers," that is, customers getting extraordinary discounts. These discount decisions chew up much of Sally's time as well as her sales force's—time she would rather spend selling to customers.

Sally of Sales has considered increasing the discount authority for her managers and vice presidents to reduce the time spent on these decisions, but knows that wouldn't work. Every time someone gets more discounting authority, they seem to use the full extent of it.

Charles is the CEO of Company J. Though the individual targets of his direct reports are commendable, the tidy segregation of responsibilities seems to fall short of the collective goal at Company J when it comes to pricing. Charles likes the target margins from finance, the market share goals from marketing, and the revenue goals from sales, but simultaneously attaining these goals seems impossible.

Francis of Finance claims sales is discounting the margins away, and therefore Company J will underperform in shareholder profit expectations. Molly of Marketing says the prices are too high compared to the competition, and therefore Company J will underperform in market share expectations. Sally of Sales says that without more discounting leeway, Company J will not meet revenue targets, and, in any case, Francis of Finance wouldn't know what a customer looked like if it bit him.

Charles the CEO is tired of missing forecasts. As a good leader, he collects information from his direct reports and listens to their opinions, but he isn't sure of which one he should listen to more. All of them have good points. He knows that following shareholder expectations of margins, share, and revenue isn't what he was put in that office to do. No. His role is bigger than that.

Charles the CEO is a brilliant leader. His job is to set the vision and lead Company J forward. He was made CEO because his vision matched the needs of Company J. But he can't set prices based on his vision and gut instincts alone. He needed facts and informed opinions.

The challenge for Charles the CEO is that each of his reports—Francis of Finance, Molly of Marketing, and Sally of Sales—had solid facts to support his or her individual recommendations, but their viewpoints and recommendations were not aligned. Each of these direct reports is hardworking and trustworthy. They are highly knowledgeable and experienced within their area of expertise. Yet, senior executive agreement on price management was almost impossible to attain. In the end, Charles the CEO found himself adjudicating every significant pricing decision, and yet never felt he had all the right facts to make the decision.

Charles the CEO needed a better process for getting pricing done at Company J, but what would be that process? After all, this is how pricing has been done since medieval times.

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Cindy, the CEO of Company K, has a different plan and process for getting pricing done. Cindy's process includes Fred of Finance, Mark of Marketing, and Salvatore of Sales. Each of these individuals in Company K holds roughly the same responsibilities as their counterparts in Company J. But Cindy's process also includes Paula, a Pricing Executive.

Paula works with Mark of Marketing in setting prices on new products and updating prices on existing products. Paula wouldn't make the final pricing decision. Mark, as the marketing leader, still holds that responsibility. But Paula informs Mark's pricing decisions with market facts and coordinates the gathering of information on how customers would react and from finance on the impact a pricing decision would have on a product line's profitability.

Paula also works with Salvatore of Sales in managing discounts. Paula doesn't always make the final discounting decisions. Salvatore, as the sales leader, still holds that responsibility. But Paula informs Salvatore's decision with customer-specific facts and ensures that the discounts don't adversely impact the anticipated profitability of products nor destroy the planned competitive positioning of products.

Paula even works with Fred of Finance in setting and managing expectations. Paula wouldn't set shareholder expectations, for those responsibilities still belong to Fred as the finance leader. But Paula advises Fred on the reasoning behind different list prices and resulting margins as well as anticipates price variances and their impact on profitability.

Paula brings a different kind of expertise and perspective to the executive table than her peers. She isn't exactly a marketing, finance, or salesperson. She is something different: a pricing executive.

Paula knows many different pricing techniques, for no one technique can address every pricing issue. Moreover, she knows which pricing technique to use to inform which pricing decisions.

Paula also understands that pricing isn't simply a technical decision. Corporate strategy, competitive actions, and customer-specific contingencies could each change the optimal decision over that generated through a single, specific equation or technique.

Moreover, Paula understands the need to create aligned decisions that flow across Company K. Pricing issues arise from the board level all the way through to the point of individual customer transactions, and these decisions have to be coordinated.

Cindy the CEO thinks highly of Paula the pricing professional, but Paula is not the miracle solution in and of herself. No. Paula is smart and skilled, but it wasn't just the addition of Paula that brought about improvements at Company K. It was an organizational change.

The whole process around pricing at Company K is different. In fact, Company K has an entirely different framework for managing price than Company J.

So who is this Paula the Pricing Executive? How does Paula the Pricing Executive fit in relation to Mark of Marketing, Fred of Finance, and Salvatore of Sales? How does CEO Cindy use Paula the Pricing Executive to get pricing done at Company K?

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This is the story of how executives have transformed their business from Company J to Company K. That is, how real companies have moved from a frustrating price setting, reporting, and variance challenge to a predictable and reliable price management process. It has been developed through research into industry-proven best practices, supported by academic literature, and detailed through direct investigations into the practices of leading senior executives.

This is the Value-Based Pricing Framework proven successful by the world's most profitable companies for getting pricing done right.

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Contents

CHAPTER 1

The Value-Based Pricing Framework for Getting Pricing Done Right

Every offering of a firm and every transaction that firm has with every customer has a price. That price may be the result of a lengthy deliberation that includes market research, competitive dynamics, highly researched algorithms, intense customer negotiations, and torrid management discussions, or just a number that popped out of someone's head. Somehow, every transaction gets priced.

That price represents a decision. A decision by the firm that reflects its business and customer engagement strategy, the unique positioning of the product offering within the market, the firm's current needs, the information the managers hold, and the biases and incentives of the current managers. Somehow, pricing decisions get made.

That price impacts many functions within the firm as well as customers and competitive dynamics outside of the firm. As such, sales, marketing, finance, operations, and even legal will want to have a say in pricing decisions. Somehow, people are engaged in the decision-making.

But how should prices be determined? What should inform pricing decisions? Who should be engaged in those pricing decisions?

The job of management is to get the right people doing the right thing at the right time toward the right goal. The managerial challenges mentioned above in pricing are well known. What isn't well known is *how* they should be addressed.

Managing businesses means getting things done through other people. CEOs cannot solve every challenge; they depend on their teams to get things done. CEOs not only lead the organization, they also define how that organization is going to work to get the necessary work of the company done.

While many functional areas of a business are organized based on precedent and cultural norms, pricing is a relatively new function. Not that pricing hasn't been done before—clearly it has—but as a corporate function, it is relatively new.

The challenge executives face is to determine how to organize the pricing function to get pricing done right. They need a framework that will help them shape their organization, routines, staff, information management, and analytical and efficiency tools that will guide the organization toward making better pricing decisions.

Pricing isn't just one thing. It isn't just a decision done before launching a new offering, a number that is estimated in conjunction with a contract or the result of a client negotiation. Nor is pricing a single technique, method of analysis, research effort, or piece of information to gather. Pricing isn't an event. It's a *continual* process.

And pricing can't be done in isolation. The decisions in pricing affect every part of the organization. They are integral to every healthy customer relationship. And, they influence the competitive engagement of the firm with its competitors.

Treating pricing as a process requires *defining* the process. The process must deliver the goal of making pricing decisions repeatedly and reliably that produce the best decisions possible, given the information that can cost-effectively be gathered in the timeframe relevant to the decision-making urgency. It will be a cross-functional activity that leverages the expertise of a pricing professional to provide analytical rigor to the information and insights gathered from sales, marketing, and finance along with other relevant senior executives within the business.

The Value-Based Pricing Framework provides a template for executives to use in managing pricing decisions throughout their organization. It was developed through direct interviews with executives in the field, reviewing academic literature, and implementation in numerous firms. Research was conducted at firms across both business and consumer markets, from small start-ups to large global players, and in locations spanning North America, Europe, Asia-Pacific, the Middle East, Africa, and Latin America. The Value-Based Pricing Framework codifies best practices for managing prices in profit-seeking competitive businesses.

Embedding the Culture of Value-Based Pricing

Value-based pricing itself forms the core culture surrounding the use of the Value-Based Pricing Framework. In value-based pricing, firms seek to set prices according to the value customers place on the offering in comparison to its alternative. Using the nearest competing alternative as a starting point, an offering's differential benefits will either add or subtract value in the minds of customers. In value-based pricing, the prices of offerings are set in relationship to the price of the nearest competing alternatives adjusted for the offering's value differential.

When firms adapt value-based pricing, they often adopt its corollary: value engineering. In value engineering, attributes and features are added and subtracted to offerings according to the willingness-to-pay of customers for the benefits those attributes and features deliver. If an attribute or feature does not deliver benefits to the target customers in excess of the costs, those attributes and features are removed. If they do, they are added. Though simple enough to state, value engineering implies a process where innovation and pricing are inherently connected.

Overarching Pricing Decision Areas

The five key decision areas identified in the Value-Based Pricing Framework are:

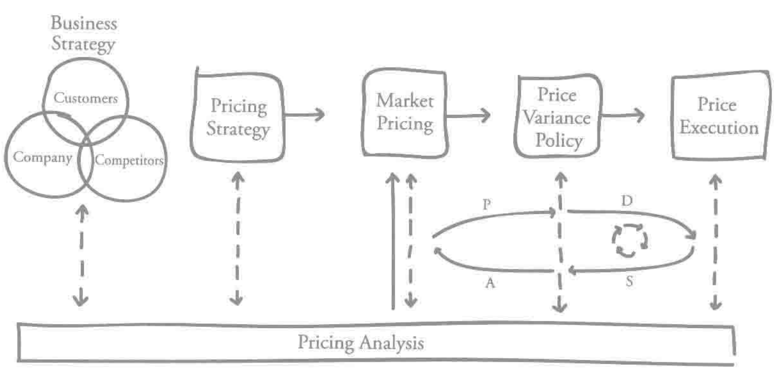
1. Business strategy
2. Pricing strategy

3. Market pricing
4. Price variance policy
5. Price execution

Undergirding these five key decision areas is pricing analysis, an organizational function used to inform, guide, and steward pricing decisions across the organization. Built into the Value-Based Pricing Framework (see Figure 1.1) are specific repeatable processes to inform pricing decision areas or provide an informational feedback loop to improve pricing decisions.

Business strategy, the first decision area within the Value-Based Pricing Framework, comprises the choices the firm makes to differentiate itself from its competitors in a way that results in serving its customers' needs more profitably than competitors. It includes the firm's customer, competitive, and company strategies. The firm's customer strategy identifies the firm's target market and market segmentation schema. This target market selection may result in the firm choosing to target a specific segment of customers, which its competitors are less able to serve as well. A firm's competitive strategy leverages its unique and inimitable resources to deliver a competitive advantage in attracting its chosen target market profitably. Its company strategy refers to the investment choices the firm makes in order to differentiate itself from competitors and to develop future sources of competitive advantage.

FIGURE 1.1 Value-Based Pricing Framework



Pricing strategy, the second decision area within the Value-Based Pricing Framework, refers to the manner in which firms will manage prices. More specifically, a firm's pricing strategy includes its price positioning plan, price segmentation plan, competitive price reaction strategy, and its pricing capability strategy. Each of these areas of a firm's pricing strategy is determined within the context of the firm's business strategy at leading firms.

Price positioning refers to the choice to price an offering at either a penetration, neutral, or skim position. Penetration pricing implies holding prices low in comparison to competing alternatives adjusted for the offering's differential benefits in order to penetrate the market and grab market share. Skim pricing implies holding prices high in comparison to competing alternatives adjusted for the offering's different benefits, and is often used as a new market entry plan. Neutral pricing implies pricing in alignment with the offering's competing alternatives after adjusting for its differential benefits. Of the three, neutral pricing should be taken as the default strategy, for it is most likely to be the most profitable strategy. All three positions can be rationally defended for different firms. The choice of which position an offering should be priced at is largely dependent on the business strategy of the firm.

Price segmentation refers to charging different customers different prices for similar or highly related offerings. Because different customers derive different benefits from the firm's offerings, they will have different willingness to pay. Price segmentation is the means by which firms attempt to price offerings for the individual customer, or at least at the market segment level. Price segmentation may either be accomplished through the price structure choice of unit pricing, two-part tariffs, tying arrangements, tiered offerings, bundled offerings, subscriptions, revenue management, and other price structures, or it can be accomplished tactically through price variance policy.

A firm's competitive price reaction strategy determines how the firm will react to price changes within the market. At times, firms should change their prices when a new competitor enters the market or existing competitors change their prices. At other times, firms should ignore competitive price moves. The optimal competitive price