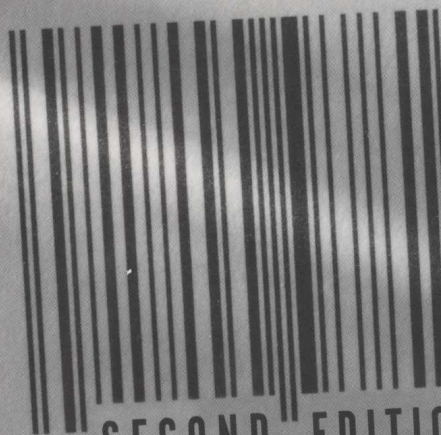


WILEY FINANCE

THE PRICE ADVANTAGE

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SECOND EDITION

The Price Advantage

Second Edition

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WILEY

John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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ISBN 978-0-470-48177-6

Printed in the United States of America

10 9 8 7 6 5 4 3 2

Preface

As we approached the task of writing this second edition of *The Price Advantage*, we revisited a few basic questions—questions that our readers might have as well. Why a book on pricing? Why a book by McKinsey & Company? And finally, why a second edition now? Let us begin by addressing these basic questions.

WHY A BOOK ON PRICING?

Pricing, although one of the most critical management functions, remains one of the most misunderstood and undermanaged functions at many companies that are otherwise high performers. Pricing is far and away the most sensitive profit lever that managers can influence. Small changes in average price translate into huge changes in operating profit.

Although more companies have made gains in pricing in recent years, too few businesses have successfully tapped into the full potential that improved pricing holds. Even thoughtful general managers often feel helpless to make real progress on the pricing front. Many managers do not know where to begin to get a handle on identifying the exciting performance upside that pricing so often holds. And those who identify this upside struggle to really capture and sustain it.

This book is not designed to be an exhaustive review of the considerable body of pricing theory that has accumulated over the years. To the contrary, it has been written as a practical pricing guide for that thoughtful general manager who has been tempted by the unrealized promise of improved pricing and, perhaps, frustrated by attempts to translate pricing theory into bottom-line impact for his or her business. It is intended to provide a logical and structured approach for identifying where the most precious sources of untapped pricing opportunity reside in a business, along with practical, case-illustrated guidance on how to capture and sustain that opportunity.

WHY A BOOK BY MCKINSEY ON PRICING?

Over the past 20 years, pricing has become one of the most frequent areas in which we have helped businesses across every continent (except Antarctica!) to improve their performance. These companies represent a rich and diverse range of industries, including industrial goods, consumer packaged goods, consumer durables, banking, telecommunications, chemicals, retailing, high-tech products, basic materials, insurance, pharmaceuticals, and transportation. To support our service to clients, McKinsey has invested more than \$25 million in developing practical knowledge in pricing over the past five years alone. We are credited with having developed and advanced a majority of the most useful contemporary pricing frameworks—the pocket price waterfall and the value map are just two examples.

WHY A SECOND EDITION NOW?

Since the first edition of *The Price Advantage* was published five years ago, much has changed. First, our knowledge has advanced significantly in a number of areas—areas of growing currency and relevance that were not included in the original edition. A new chapter is devoted to the topic of managing price wisely over the course of a product's lifecycle. In an ever-growing number of product categories, for example, high-tech products, consumer durables, and medical devices, product lifecycles are compressing, which makes this a topic of broad application and significance.

Included in this edition is an entirely new part titled “Advanced Topics,” which were not covered in depth in the first edition. This includes Chapter 12, “Complexity Management,” which addresses issues that complicate the pricing challenge, including the complexity of pricing custom-configured products, pricing when the number of individual products sold is extremely high, and pricing through a large and distributed sales force. Chapter 13, “Tailored Value,” explores issues around tailoring value to specific customers and markets, including segmenting price, pricing product line tiers, dealing with “razor/razor blades” offerings, and pricing new products and integrated solutions. Chapters 12 and 13 contain sections of information that do not apply to each and every business; but when they do apply, we have found that they are often central to a company's realization of *the price advantage*. Chapter 14 “Software and Information Products,” is also new and discusses how to tackle the unique challenges of pricing software and information-based products.

Second, the legal landscape has also continued to evolve since we wrote the first edition. The United States' pricing rules have evolved and enforcement has been generally more aggressive. EU pricing law and enforcement has moved closer to and, in some cases, surpassed that of the United States in severity. Likewise, pricing and antitrust law in many Asia-Pacific countries is gradually becoming more strictly defined and aggressively enforced. Chapter 9, "Legal Degrees of Freedom," has been updated to reflect the changing degrees of legal freedom that companies must operate within today. Furthermore, we have updated language throughout this second edition to avoid pricing wording and phrasing that might be more likely to raise legal red flags in the current legal environment.

Finally, we have heard from businesses around the world asking for more details on how to build a sustainable capability in pricing; that is, what does a high-performing pricing infrastructure look like today and how do you best move an organization in that direction. Our overarching framework, "The Three Levels of Price Management" from the first edition, has been extended to include a cross-cutting pricing infrastructure level; Chapter 6, "Pricing Infrastructure," is completely new and dedicated to issues of pricing infrastructure—where we have synthesized our experience in helping companies build high-performing organizations, processes, and tools. So, as we mentioned above, much has changed since we published the first edition back in 2004—so much that we deemed the writing of the second edition of *The Price Advantage* timely and warranted.

STRUCTURE OF THE BOOK

This book is organized into six main sections. Part One describes *the price advantage* and explains why it is worthwhile for businesses to pursue that rare but valuable advantage. It then lays out our overarching framework for identifying and ultimately capturing pricing opportunity. This framework, the three levels of price management plus pricing infrastructure, provides the integrating thread that weaves through the book and is applicable to most business situations.

Part Two explores each of these three levels plus pricing infrastructure in considerable detail. Part Three addresses unique pricing events that almost any company might have to face on an occasional basis. Part Four explores some of the boundaries of *the price advantage*—boundaries that may affect a company's degrees of pricing freedom and boundaries that companies can expand to find opportunities beyond the fundamentals covered in Parts One and Two. Part Five covers a variety of advanced topics,

as mentioned earlier. Part Six is devoted to the practical enablers and constraints to making enduring and positive pricing change happen, including a detailed case study and some final thoughts. In addition, the Appendixes are designed to provide some useful examples of the application of core frameworks discussed in the book, an overview of key points in pricing law, a list of acronyms and abbreviations, and instructions for accessing a functional demo of *Periscope*, a web-based pricing tool that has been loaded with realistic transaction data for a hypothetical company. This book contains a number of disguised cases to illustrate pricing concepts, frameworks, and insights. These cases are rooted in McKinsey's extensive client work in pricing, and client identities are heavily disguised to assure protection of confidential client information and strategies. The location and nature of opportunities identified are consistent with the underlying cases, and the magnitude of improvements shown by these examples is real.

Unless otherwise noted, when we talk about a company's "product," we are referring to that company's comprehensive product, service, and support offering to customers. This convention allows for more economical word usage throughout the book.

Acknowledgments

As we embark on this journey for a second time, we do so with a full understanding and appreciation of the level of support it takes to write a book. As with the first edition, our colleagues, our clients, our firm, and our families continue to support us in extraordinary ways. To them we extend a hearty thank you in the hope it captures our true appreciation for what they have contributed.

We start our acknowledgments with the “godfathers” of pricing. Those that saw the power of pricing before the rest and persisted in sharing the story—Kent B. Monroe, Tom Nagle, Dan Nimer, and Arleigh Walker. And to the leaders at McKinsey & Company who supported and invested in the development of our pricing knowledge—David Court, Tom French, Marc Singer, Robert Garda, Philip Hawk, Ralf Leszinski, Andrew Parsons, Hajo Riesenbeck, and Rob Rosiello—thank you for believing in us and the impact we could have for our clients. We also want to recognize the tremendous support of Eric Roegner, an author on the first edition. Eric’s ideas and contributions remain at the foundation of this edition.

There are some special people who accompanied us on this journey and we would like to take the time to recognize them. Cheri Eyink served as our undaunted project manager. Beyond driving the process of creating this second edition with resolve and enthusiasm, she acted as an irreplaceable thought partner to the authors—adding content, insight, and clarity at every turn. Sarah Smith was our trusted editor—pushing us to express in written word the knowledge we had gathered over many years of serving clients. She gracefully and persistently challenged us to share our best with our readers in a clear and concise manner. To them both, we are grateful.

A number of past and current McKinsey colleagues contributed their deep content expertise to this book, including John Abele (postmerger pricing), Scott Andre and Robert Musslewhite (market strategy), Daniel G. Doster (solutions pricing), Dieter Kiewell (pricing tools and implementation), Andy Kincheloe (lifecycle pricing), Stephen Moss (pricing infrastructure), Adolfo Villagomez (market strategy), and John Voyzey (price wars). Special thanks to Gene Zelek, partner and chair of the Antitrust and Trade Regulation Practice Group at Freeborn & Peters LLP

in Chicago (legal issues). In addition, we would like to thank current and past McKinsey colleagues who made significant contributions to the knowledge we shared here: Kevin Bright, Hugh Courtney, Gareth Davis, Tom Dohrmann, David Dvorin, Jonathan Ford, Amit Jhawar, Kristine Kelly, Michal Kisilevitz, Eric Kutcher, Eric Lin, Glenn Mercer, Jamie Moffitt, Derick Prella, David Rosenberg, David Sackin, Mike Sherman, Philippe Stubbe, and Florian Wunderlich. Thanks also to George Gordon, partner and co-chair of the Antitrust/Competition Group at Dechert LLP in Philadelphia and Lynda Martin Alegi, of Counsel in Baker & McKenzie LLP's EC Competition and Trade Unit based in London.

We would also like to take this opportunity to thank the editing and publishing experts at the *McKinsey Quarterly*, past and present, including Don Bergh, Stuart Flack, Allan Gold, Rik Kirkland, and Allen Webb, as well as those at John Wiley & Sons, including Bill Falloon and his team.

Mary Turchon spent countless hours taking care of all of the details required to publish a book. Creating exhibits, scheduling meetings, formatting text; the list could fill pages. Her excellent skills and willingness to help out in a crunch are deeply valued. We would also like to recognize the research assistance provided by Danica Reed and the graphics support of Janet Clifford and Mary Ann Brej.

We close with recognition and appreciation for the hundreds of McKinsey & Company consultants that have worked alongside us over the past 30 years, expanding our knowledge and bringing the power of pricing to thousands of companies. And to our clients, who opened the door to their businesses and allowed us to be a part of their transformations.

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Pricing Fundamentals

Part One describes what *the price advantage* is and explains why this is such a worthwhile and profitable advantage to pursue. This part also introduces an overarching framework for identifying the magnitude and location of pricing opportunities—and for sustainably capturing those opportunities.

Introduction

What's your advantage? What capabilities distinguish your company most from its peers, allow your business to perform better than your competitors, provide the foundation for superior returns to your shareholders? Is it a cost advantage—do you purchase better and manufacture more efficiently than your competition? Is it a distribution advantage—are your products sold through the best wholesalers, retailers, and locations in your markets? Is it a technology advantage or an innovation advantage? Or is yours a brand advantage or a capital structure advantage or a service advantage?

For all of the advantages that businesses pursue, there is one powerful advantage that is accessible to virtually every business, but actually pursued by too few—and ultimately achieved by even fewer. That advantage is *the price advantage*.

Setting prices for goods and services is one of the most fundamental management disciplines. It is, in truth, unavoidable. Every product and service sold since the beginning of time has had a price assigned to it. Setting that price is among the most crucial, most profit-sensitive decisions that companies make. Ironically, very few companies price well. For a host of reasons, few ever develop anything resembling a superior, business-wide, core capability in pricing. In other words, few companies build pricing into the distinctive business advantage that it can be.

In this book, we discuss the details of creating and sustaining *the price advantage*, where pricing excellence generates superior returns to shareholders and enables a company to invest in sustaining its advantages in other areas. But first, let us look at why getting pricing right is so important, and why so few companies realize this advantage.

THE POWER OF 1 PERCENT

Why is it so vital to get pricing right? Because pricing right is the fastest and most effective way to grow profits. The right price will boost profits faster