POWER PRICING

How Managing Price Transforms the Bottom Line

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and
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To

KATHLEEN and CECILIA,

with thanks for encouraging the partnership

that got this to market.

Preface

Pricing seldom is an area that business managers talk about with great enthusiasm. Price is often the centerpiece of strained relations with a good customer; the weapon competitors are using to steal market share; and the source of conflicts within the company as those with the spreadsheets, pro forma income statements, and knowledge of costs have different pricing ideas from the customer contact people.

In our discussions with executives in general management and across the various functional areas in the firm, we continually hear that pricing is a big headache—and one that is getting worse by the day as markets globalize. Many firms have given up—"we determine our costs and take our industry's traditional margins" or "the market sets the price and we have to figure out how to cope with it." Others have a different attitude, proactively using price as a key tool to achieve their business and financial aims. These "power pricers" have discovered the highly leveraged effect of price and built the capacity to practice pricing in a way which transforms the bottom line.

Power pricers think and act differently from everyday pricers. In our various capacities as case study developer, consultant, researcher, and teacher we have had the opportunity to work with power pricers around the world in industries ranging from pharmaceuticals to industrial machinery to automobiles to snack foods. We understand what makes them stand out: their attitudes, thought processes, and actions. And we have observed their successes—not small improvements but major transformations of the bottom line. This is a book about how to become a "power pricer."

We joined together as an international team on this book to be sure we could capture the practices of the worldwide leaders. We consistently rely on these firms to develop our underlying ideas and exemplify practices worthy of emulation. Our approach though is not simply to describe interesting pricing strategies but rather, aided by our understanding of the underlying economics, to weave these best practice examples together into a framework for advancing your own pricing program.

At the outset, we note that becoming a power pricer is not without certain costs. Investments must be made in mechanisms to assemble the necessary fact base and to rethink what it means to manage price. We set out these processes. Our objective is to provide proven, implementable pricing practice prescriptions.

Our research showed us that various aspects of pricing responsibility are typically diffused across the organization. Consequently, our intent is to present a set of pricing ideas useful to general managers, finance and accounting, and marketing and sales executives alike.

There have been many contributors to our thinking. We both spend lots of time "in the field" working with and learning from managers in companies. We owe these managers a great debt for sharing their problems, attempted solutions, and judgments of success or failure. While not "in the field" we each sit in an exciting intellectual environment: Dolan at Harvard Business School and Simon at Simon, Kucher & Partners. Our colleagues there have been subjected to the initial formation of lots of the ideas in this book—and also some ideas that are not in the book because they exposed us to the frailty of the ideas. We thank them both for sorting the ideas worth cultivating and those that were not, and for helping us to grow and articulate the ones in the former set.

The logistics of writing a book with authors working in two quite different environments have been eased by modern communication technology; but, still, our assistants combined an uncommon amount of talent and good cheer during this project. As authors, we created many issues but they were always resolved with competence and style by Sheila Linehan at Harvard Business School and Ingrun Rodewald at

Simon, Kucher. Thanks also to Robert Wallace at The Free Press for his enthusiasm for this book when it was nothing more than an idea and also to Bob, Dewey Brinkley, and the rest of The Free Press team for all the help along the way.

We dedicate this book to our wives, Kathleen Splaine-Dolan and Cecilia Simon, who both regularly insisted "one book by the two of you together will be better—plus it will be more fun to write it that way." They were right. This joint effort led to many ideas that would not have developed if each of us had gone off on a solo adventure. So, we thank them for their insight and encouragement throughout this collaboration.

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Boston, Massachusetts

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Cambridge, Massachusetts

Contents

PART I

Foundations

1
Introduction

INTRODUCTION

"We have to get our prices up." This is a common refrain in businesses around the world today as competitive pressures have sliced margins. Often, however, the exhortation which follows is an unrealistic one—for example, "Boost prices, sales volume, and profitability each by ten percent in the next year!" Opportunities to do this are rare; but opportunities to improve profit dramatically by better pricing are the norm.

Consider the CEO of a $10-billion company meeting with the marketing managers of his various divisions. "Get me a nickel, get me a dime—every day. Find a way to convince the customer that we are worth it. Pick up these nickels and dimes all around the world—every day—they drop right to our bottom line—and pretty soon we are talking big improvements to our net income." What about this dime? Does it really mean "big improvements to our net income"? Suppose your average price is $10 per unit. Now add a dime to it, to make the price $10.10, a 1% improvement in average price realization. Not necessarily by getting the price on every single order to improve by 1%—but some 2%, some 5%—just average out to 1% and hold your sales volume.

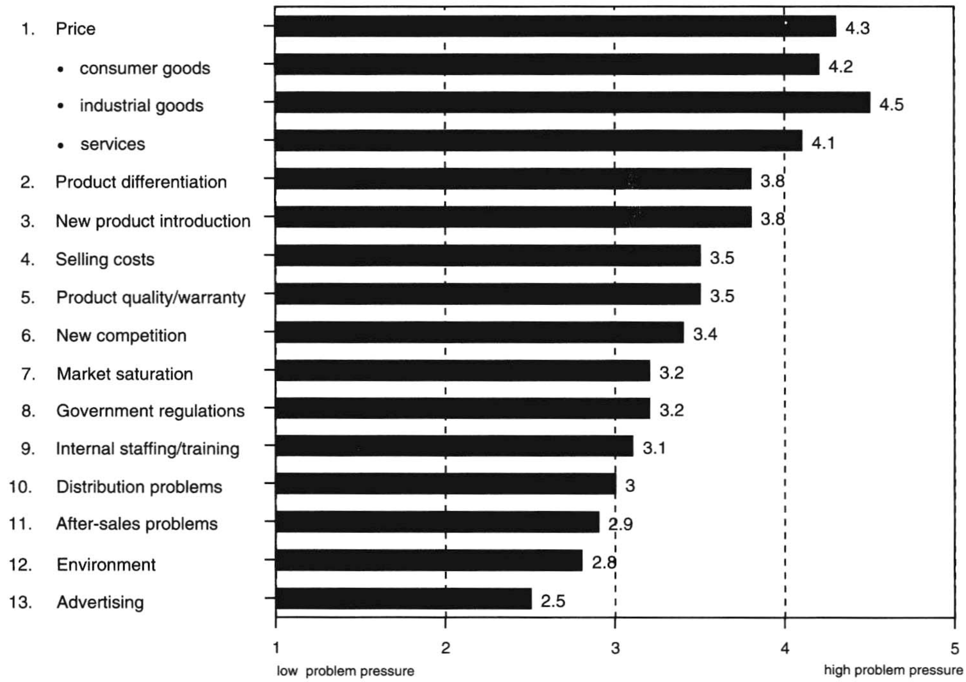
What would that be worth to you? How much leverage is there in that? How much would it improve your net income?

If you worked at Coca-Cola, the 1% price realization improvement would boost net income by 6.4%; at Fuji Photo, 16.7%; at Nestle, 17.5%; at Ford, 26%; at Philips, 28.7%. In some companies, it would be the difference between a profit and a significant loss. Given a cost structure typical of large corporations, a 1% boost in price realization yields a net income gain of 12%.[1] In short, it's worth some effort to figure out how to do it. In fact, it's worth a lot of effort in data collection, analysis, creative thinking, and willingness to experiment. Yet most firms just don't. A 1994 survey found only 12% of firms doing "any serious pricing research" and one-third of these had no strategy for using the research results.[2] Our general experience squares with these survey findings. Many firms abrogate pricing responsibility—"the market sets the price" or "we have to match our competitor"; others use an inappropriate rule of thumb such as taking a standard mark-up on cost. These firms leave "nickels and dimes" and in some case thousands of Deutschmarks, Swiss francs, yen, dollars, and other currencies with customers around the world because they do not understand and capture the value they create for individual customers.

The cost of such lack of sophistication in pricing is growing day by day. Customers and competitors operating globally in a generally more complex marketing environment are making mundane thinking about pricing a serious threat to the firm's financial well-being. Managers are feeling this pricing pressure. Figure 1-1 presents the results of a recent (1995) survey in which we asked 186 managers (57 from the United States and 129 from Europe) representing a broad range of industries to rank 13 marketing issues on a scale ranging from 1 = low problem pressure to 5 = high problem pressure. Pricing tops the list at a 4.3 rating overall. This is indicative of the importance for company financial performance of "pricing right" and the difficulty of getting it right. The reasons for the increasing difficulty of doing a good job on pricing can be summarized in two words: interdependence and information.

Interdependence comes in two forms: products and markets. The days of Coca-Cola being an "anytime, anywhere" drink (as Coke ads proclaimed) and for anybody (ads showed everyone from little children to Mom and Dad to grandparents drinking Coke) are gone. Now, it's Classic Coke, Coke, Diet Coke, Cherry Coke, Caffeine Free Coke, etc., etc. The single product has evolved into a varied product line for differ-

FIGURE 1-1
Managers' Rating of Marketing Issues



ing tastes. This represents one form of product proliferation—"horizontal" in the sense that all Coke products are on the same inherent quality level; i.e., whether Coke is better than Diet Coke is determined by the individual consumer's tastes.

"Vertical" product proliferation in the form of "good, better, best" strategies are common as well. AlliedSignal's Autolite spark plugs come in three grades: carbon, platinum, and double platinum. Kodak markets three grades of consumer film: Funtime Film "for casual picture-taking," its mainstay Gold Film, and a high-performance Royal Gold Film that they advertise as "extra clear and extra sharp for extra special moments." Similarly, firms offer complementary products. Intuit markets not only its Quicken home-finance software but also the checks to put in the system, a Quicken credit card, and electronic bill-paying services. The razor and blades, cameras and film, hardware and software, products and technical support scenario of tied, complementary products is commonplace.

This trend to offering interdependent products complicates pricing—because the price of the individual elements cannot be set independently. A product's role in the portfolio must be established and pricing considered at the product line rather than at the individual product level.

Market interdependence also is impacting pricing. Pricing is relatively simple when markets can be separated and a price individually determined for each. Historically, pricing has tended to be a highly decentralized decision with individual country managers setting prices in pursuit of their own objectives. However, today, as products are standardized across the world and global brands become the norm, treating markets individually risks shrinking worldwide profitability, because gray markets are emerging as third parties buy, sell, and ship around the world to take advantage of differences in prices. Second, individual customers have moved to worldwide procurement, further narrowing the flexibility of pricing managers as they try to set prices across markets.

The second related cause of complexity is information: better information creating smarter, more powerful customers. Buying services emerge as intermediaries for end users in industries such as automobiles because of their ability to access and process data. Information technology allows for international tracking and transmittal of pricing information, creating the need for harmonized world pricing. Buying groups have formed in a wide variety of situations from independent funeral home operators sharing information and pooling casket purchases to major corporations joining with one another to negotiate ticket prices with airline companies. For many companies, purchasing has become a strategic function. The acrimonious situation starting in the mid-1990s and continuing for years involving General Motors in the United States and Volkswagen in Germany was not about the "defection" of a great car designer or marketer, but rather about Volkswagen's spiriting away of GM's Vice President of Worldwide purchasing manager, Ignacio Lopez, and GM's allegation that Lopez took supplier pricing information with him.

The forces of interrelatedness and information have created more complex price schedules. No longer able to charge customers different prices just because of their geographic separation, firms attain price customization by applying the *same pricing schedule* to all customers, fully aware that because of the specific terms and conditions of sale different prices are received in the end.

Finally, all of this occurs in an environment of increasing competitive diversity. Coke now faces not only Pepsi, but also President's Choice, a "brand" of Loblaw's, the Canadian supermarket chain. Kodak film competes not only against Fuji and Agfa, but also against viable quality products manufactured by 3M and sold under private labels. Industry leaders in high technology continue to battle one another on technological innovation grounds; but they now also face firms with "rapid imitation" rather than innovation strategies. Eight hundred different car models vie for the consumer's attention in Germany, where traditional suppliers from throughout Europe, the United States, and Japan have been joined by cars from Korea, Malaysia, and Mexico.

The net result of this is that being simply "good" in your pricing thinking has become very costly. Customary rules of thumb are inadequate in dealing with this environment. Becoming astute in pricing analysis and judgment can pay big dividends. The goal of this book is to help your firm attain maximum financial performance by improving its pricing thinking and to show how that improved thinking can translate into improved net price realization. We do not describe good pricing practice. Rather, we specify the practices of those who have moved pricing to a higher level, the "power pricers" who have transformed their bottom line by pricing. This chapter begins by looking at some power pricers and then sets out the book's plan to help you attain this level of pricing sophistication and resulting profit improvement.

BECOMING A POWER PRICER

Four dimensions help to define the power pricer:

1. viewpoint on pricing
2. fact files to support pricing
3. tools and scope of analysis
4. determination and implementation

Viewpoint on Pricing

The three profit drivers are sales volume, price, and costs. Specifically:

Profit = sales volume × price – costs

Sales volume inevitably gets everyone's attention. What actions are we going to undertake to move product? What investments are required in sales force, advertising, and production capacity? Sales volume is seen as a controllable outcome of company actions. Recently, the "costs" part of the equation has received the spotlight in many companies as companies like AT&T are "rightsized" and processes are "reengineered" in an attempt to "get the costs out." The attitude is that sales volume and costs can and should be managed vigorously. Pricing, however, is often the third front in the battle for profitability, as the scarce resources of management time, energy, and imagination are siphoned off to the first two fronts of sales volume and costs. The power pricer does not treat price like a third front; rather, he brings it to the fore. The power pricer believes price can be managed as effectively as other profit drivers and recognizes the extraordinary leverage that price offers.

The power pricer does not let "the market" or "the competition" set his price. His viewpoint is that given a customer's wants, his offering and its presentation, along with competitive products and prices, create a value for his product. He coordinates this "value creation" with pricing, his "value extraction" activity, and understands the system relationship among his profit drivers. Price is a key element of his profit system and he does not give up control of it to someone or something else; nor does he see it as less manageable than the other profit drivers.

Fact Files

A power pricer has data that are more *accurate, timely, relevant,* and *disaggregated* than everyday pricers. There is precision in what he does. He understands what is happening now—not just what happened two months ago; he knows a product's value to the customer—not just its cost, and he understands what's happening at the individual account or key market segment level—not just at a broad market aggregate.

Figure 1-2 shows the central role of perceived customer value in pricing. Starting at the top of the diagram, the firm's initial analysis has two components—*competitive analysis* (left) to identify differentiation opportunities, and *consumer analysis* (right) to identify consumer wants and important segmentation of the market. Based on this, decisions are made that create the perceived value of the firm's offering in the marketplace: first the target market is selected, and then the value-creating elements of the marketing mix assembled, i.e., the product itself, communication efforts to support its marketing and distribution to create convenient availability, and other support.

These efforts in concert with the offerings of competitors determine the *value* that a customer perceives in the firm's product. This perceived value is the maximum price the customer will pay. Knowing these values for members of his target market shows the power pricer the trade-off between price and sales volume. These values vary by customer. The power pricer understands this variation and the source of it. This requires data on customers' viewpoints and competitors' performance and pricing.

The dotted line at the bottom of Figure 1-2 shows that the firm's price may impact competitive offerings—either their prices or their value creation activities. The power pricer understands his competitor's cost structure, capabilities, and business model and systematically tracks competitors' actions and reactions. He takes advantage of his experience in the marketplace, carefully observing and generalizing from market activities to develop a deep understanding of how the market works.

FIGURE 1-2

Schematic of Value and Pricing Process