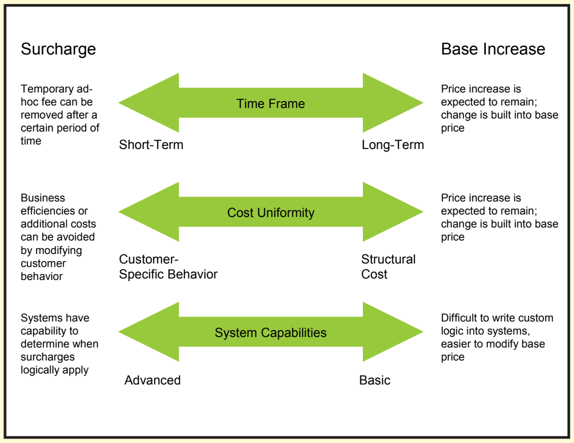
Changing Prices in a Volatile Economic



In the past year sellers have had to deal with erratic economic conditions and their effect on pricing. Authors Ranjit Singh and Steven Tom of Deloitte Consulting LLP's Strategy and Operations services area examine how companies tend to react to these conditions. They suggest firms often respond fearfully, if they cannot use pricing to reduce margin erosion; or impulsively, which can lead to misguided decisions to cut prices in hopes of increasing sales to equally-stressed buyers. The writers maintain that firms should, instead, pursue targeted pricing strategies, focusing on select customers. These should then be implemented carefully with well-devised communications plans. For more information you can reach the authors at: ransingh@deloitte.com or stom@deloitte.com, respectively.

In 2008 pricing organizations fought to hold their ground against waves of decreasing consumer confidence and rapid changes in raw material costs. These organizations were seemingly trapped in a vice, which squeezed profits as costs moved higher. Many were tempted to reduce prices in a hasty effort to somehow meet financial expectations. In circumstances like this, a sales force will claim it needs price reductions to meet quotas; marketers will point to reduced pricing power in the marketplace due to weakening conditions; and customers will generally reflect the same pressures in their businesses. Competitors, too, will likely face the same challenges, but a race-to-the-bottom price war can substantially erode profits for all involved long after the economic turbulence has subsided.

These responses are counterproductive and need not happen. Instead, pricing organizations should seize the opportunity to make a carefully orchestrated effort to maintain prices and preserve margin. To achieve this, companies must pursue sharp, targeted price actions at the most granular product level; and prepare and guide consumers through these economic times with carefully planned communications.

How to Implement Price Changes

Some companies choose to impose across-the-board increases or decreases in an attempt to secure sales or retain customers. A blunt-edge, uniform approach may be simple to implement, but it will prove difficult to forecast the results or the reactions of customers. Analyzing your prices product-by-product and making changes at the same granular level can lead your business to more optimal and predictable results. How does a company execute at such a level?

- Know exactly how your costs have changed on an individual level
- Reassess what your customers value and their current macroeconomic challenges
- Determine what kind of price signaling (in the form of base price adjustments or surcharges) is appropriate
- Increase your visibility into pricing performance and discounting activities, as too often increases are offset by concessions elsewhere

Know Your Own Inflation Impact

Many organizations fail to determine a particular product's true cost and profitability. While using assumptions to allocate costs can be helpful, a targeted pricing movement requires greater accuracy. Start with the price waterfall at a transaction-by-transaction level and account for your costs down to net margin. How has inflation impacted, for example, the raw materials costs? Or where are these costs falling for you and your competitors? Next, do a sensitivity analysis to determine what kinds of cost changes will impact the bottom line most. Businesses should also undertake a "fix or flush" exercise, looking at the entire portfolio and asking if each product or service meets certain financial performance standards or is even worth offering anymore. This process will build an understanding of which products or services are experiencing the most cost pressure, and what the degree of impact is to the business. While this can help in prioritizing candidates for price increases, it should be coupled with a refreshed knowledge of customers' needs and preferences.

Understand What Consumers Value in the Downturn

Marketers always pay close attention to customer needs and purchase drivers. Executing a price increase in an insecure economic environment may prompt an organization to reexamine its knowledge of its customers. Consumer perceptions are likely to be different from even a few months earlier. To speed the process, step into the buyers' shoes and consider the macroeconomic environment that currently challenges them. Ask a few key purchasers and yourself the questions in Figure 1:

Figure 1

What pressures are top of mind for customers in the current state?	For example, a small components manufacturer selling to larger firms may find that its product or service is viewed as either a minor or (conversely) a critical offering by a particular market segment. Both scenarios offer the seller the opportunity to raise prices with less protest.
How much do consumers value each feature in the offering, and what tradeoffs do they make in the purchasing decision?	Consider if the buyer's industry has weathered the economic turmoil well, and if the firm itself is performing better than the rest of your customer base. Also, consider whether your purchasers can find alternatives for your products and how easy it is for them to switch.
How does a price increase for one product impact bundles, both formal and informal?	Changing the price of one element in the bundle may change the value proposition of the overall bundle.

knowledge of your own costs to determine exactly which product prices can be raised—and to what extent. Now, your organization can begin planning how to make the increases a reality.

Choose the Right Signal

Be tactical about how the price changes are structured. Typically, they take one of two forms, a base price adjustment or an additional surcharge. For example, the overnight package delivery business employs both kinds of price increases. Using a base price adjustment, a next day early morning guaranteed package may now cost 5% more. A fuel surcharge may also apply in certain situations; for example, where the delivery location is particularly remote. In deciding which tactical signal to use, consider the points laid out in Figure 2 on page 12.

Competition is another dimension that may impact the decision of which signal to use. If rivals have already implemented price increases or decreases, then survey customers to see how they have reacted to the changes. A pricing organization may choose to implement a surcharge to outflank a competitor who has opted for a base price adjustment or vice versa. If it makes sense to choose the same movement, then use your knowledge of what consumers value during a downturn, and avoid letting your rival's prices be the main factor in how you set your price.

With new prices and tactics in hand, the organization is ready to execute. Now it needs to be able to monitor and track results.

How to Measure Performance

Even the best-intentioned, thoroughly-crafted price changes can underperform. Often, the cause is internal. Delivering an "increase" message to customers is difficult, especially if an organization utilizes a sales force which negotiates directly with buyers. A customer will ask the salesperson for a concession or special arrangement to help offset the increase, which negates its effect. These activities can continue unchecked until it is too late to save the quarterly numbers. Organizations must be able to see the effects of pricing performance and discounts at every stage to manage this behavior effectively.

Companies should measure exactly what discounts are given (and where) and establish approval procedures for single, or combinations of, discounts that exceed minimum customer profitability levels. Use a strategic accounts list based on strict guidelines to ensure particular buyers deserve the special discounts they receive. Then, set annual goals for the customer to determine whether

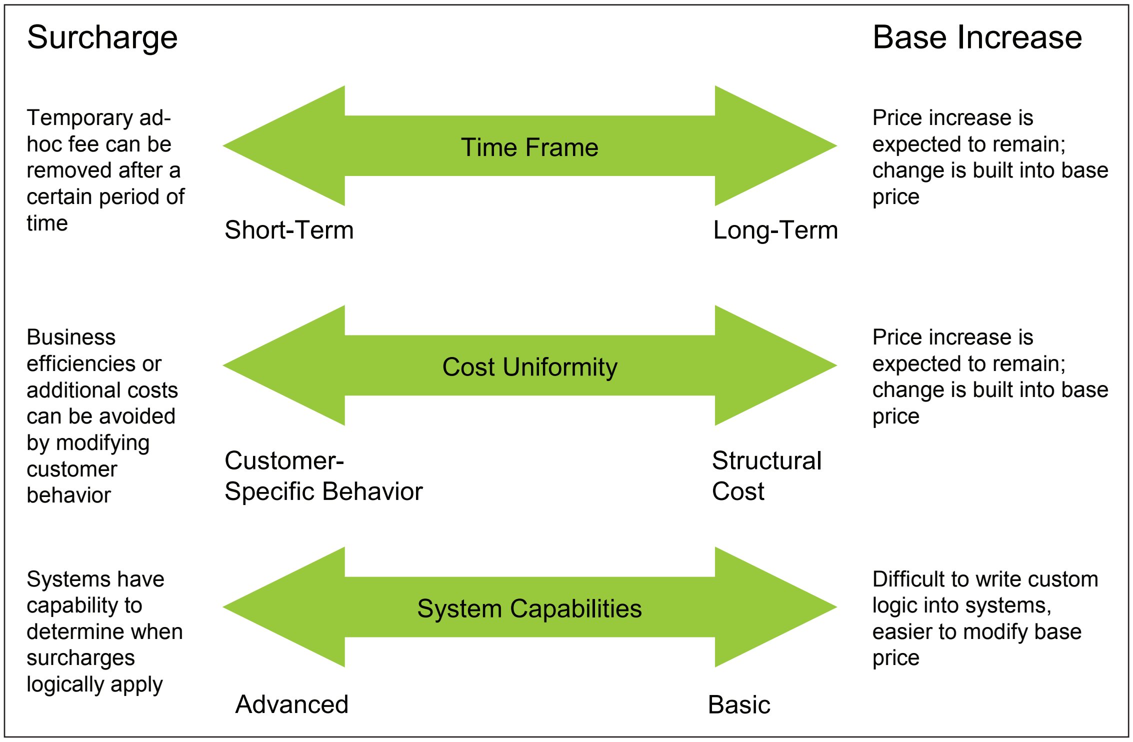
Case Study

The Situation: In 2008, a part supplier was facing a staggering array of cost changes to its sourced materials. At the same time, the sales force was reporting a drop in revenues as consumer confidence fell in response to the overall economic environment.

The Challenge: Internal debate raged at the executive level. Should they raise prices to cover cost increases or lower prices to respond to customer demands, as sales suggested? Finance argued that lowering prices would not result in enough incremental volume to justify the drop in margins.

The Result: The business took a detailed analysis of the competitive intensity of each of their product markets and implemented a combination of pricing increases and decreases in parallel. The decreases were aggressively communicated to show responsiveness to those competitive markets, while the increases covered the gap in margins. The result was a net gain in revenue and margins, and credit from certain customer segments for being responsive to requests for lower prices.

Figure 2



that discount should continue. Provide salespeople with a small concessions budget, allowing them to manage their own customer portfolio amidst a price increase. Finally, organizations should audit pricing and discount performance results on a regular basis.

Devise Your Message Carefully

Organizations should be deliberate in how they communicate price increases. Poor planning can lead to inconsistent messages or ones which fail to account adequately for the customers' loss risk from the price hikes. Obviously, this can damage a firm's credibility and result in its permanently losing certain customers. While no process or amount of planning will entirely eliminate customer gripes about price increases, companies can employ three mitigation strategies:

- Develop a detailed communications plan that exudes transparency and candid reasoning
- Understand which buyers are affected and to what degree
- Involve Marketing and Sales to emphasize selling and messaging based on value

Price communications are sensitive, both internally (to the people who have to execute the increase) and externally (to customers). Thus, companies need to determine exactly what channels, tone, and timing should be used to deliver these messages. These should not simply be guidelines, but rather reflect a carefully orchestrated effort. Hold joint Sales and Marketing sessions to coordinate the customer messages and to maintain the brand tone. The first communication should emphasize transparency by explaining the causes for the current increase, particularly the rising economic pressures your firm is confronting as it strives to maintain the same level of service and quality.

Although this initial message will be broad and generic, the resulting pricing execution should be targeted and specific. Utilize your sales force to help deliver the price-specific information. Prepare the team to handle objections with FAQs and data to build the case for why an increase is necessary. If prices in your industry are tied to an index, or the index is going to be the basis of a surcharge, provide the quantitative evidence to quell doubting customers. Prepare your communications so that buyers have advance notice and the opportunity to react. Then, provide your salespeople with the impact intelligence they need to understand how to approach each customer.

Forecast the Impact by Individual Buyer

Many businesses do a holistic analysis of how inflation is impacting their profitability, and what results a price increase will have on their financial statements. However, minimizing the customer fallout and achieving anticipated financial results requires understanding how each buyer will be impacted. Build a customer impact and risk assessment matrix based on three dimensions: inflation pass-through ability, change in annual spend and customer annual profit.

More resistance will be met from customers who play in highly competitive markets, and who face a larger increase in overall spend due to your price change. So, classify them by levels of risk. Use the size of the bubble or the customer annual spend to prioritize which buyers are most important in each risk area. Then, provide the sales force with the intelligence needed for them to focus on retaining customers in a

Figure 3

Inflation Pass-Through Ability	**Understand the buyer's ability to pass those costs further along the value chain or to its own customers**
Change in Overall Spend	Use historical purchase data or a customer's annual contractual commitment and apply the price change to that data to anticipate how the buyer's overall spend will change
Customer Annual Profit	**Use this information to identify high-profit customers who should be given greater priority in addressing inflationary price increase concerns**

prioritized order. Review the list of strategic accounts, or those accounts that receive better discounts than they deserve. Actively question whether the customers on the list are still the targeted accounts, and whether the criteria classifying them need to be adjusted. As customers are identified and prioritized, Marketing and Sales also need to determine simultaneously how to adjust their current approach to address buyers' economic woes.

Emphasize Value

Much has been written about maintaining core value propositions and price integrity in times of economic recession; the ease of sacrificing positions is significantly outweighed by the long-term challenge of repairing them when conditions improve. However, there are always opportunities to tweak messaging and to use customer interactions to stress value. Think about value as representing not merely better price, but also the usefulness or utility of the product or service. Formulate messages and key themes which will remind customers of the full value of the product—even if that value may be perceived differentiation. Establish joint planning meetings between Marketing and Sales to share knowledge of what is going on in the market and decide together how to communicate and sell to customers. Determine what channels should carry the message and to what extent typical buyer segments purchase through them. Finally, make sure that salespeople have the training to execute more value-based selling techniques with customers.

Make It Stick

Price changes may not produce the instantaneous results that executives wish for, especially when economic turbulence continues to upset financial targets and goals that were set before trouble signs emerged. Pricing managers should communicate to the executives the need for patience and perseverance to see through the changes. Share the detailed analyses and specific price movements to build the case. Then walk through the communications plan, customer impact and risk assessment, and renewed emphasis on messaging value. Agree with executives to measure periodically the customer volume and retention against the predictions of the impact and risk assessment.

By ensuring everyone in-house agrees on the goals and the communications plan, pricing managers can create the best conditions for implementing successful increases.

Figure 4