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Creating a Pricing Function to Adopt Value Based Pricing, Stop Margin Leakage

In this article, the author outlines four key steps for creating an internal pricing function that can successfully implement a value based pricing strategy: creating and assuring senior executive buy-in, hiring a lean staff to analyze win/loss data to understand market based pricing, driving discipline to quote within the guidance provided, and working on pricing waterfalls to target specific incidents of margin leaks. Author Patrick J Taylor is a business and process improvement expert with 22 years of experience. He is Managing Director of Strategy Process and Analysis LLC, an independent consulting firm and can be reached at pjtaylor@spna-llc.com.

Many case studies are surfacing showing dramatic profit and revenue gains by companies who have done successful pricing improvement projects. But, if you ask around, there are also cases of companies who did not succeed in this domain.

The fact remains though, pricing is the hottest area for intense management scrutiny today. So what steps do you take to create a new pricing function with the goals of implementing value based pricing and stopping margin leakage? What resources are required? And where do you focus first?

Imagine, your executive just read an article that said she can expect at least a 1% improvement in her bottom line profit if she introduces a pricing initiative. Now, she wants to know what steps you will follow to create a new pricing function with the goals of implementing value based pricing and stopping margin leakage. What resources do you need to be successful and where do you focus first?

Organizational alignment/implications: The most effective team will have a direct relationship to the CEO and dotted lines to the chief sales and marketing officers. The reality is, this team has to have the clout to drive organizational alignment to market strategies and the ability to drive pricing discipline across the business. Without an executive sponsor and backing, you are going to be struggling to drive change.

As for staffing there is a need to be realistic about what your organization can and should afford for this effort. You may not spend more than the expected ROI of the next best investment your business can make. So if your company needs a 10:1 payback to put this initiative on top of the list, your mandate is a 1% improvement in profit, and your company's revenue is $1 Billion per year; then you may not spend more than $1 Million for everything (software, headcount and benefits, change management, travel, third-party consultants, research studies, etceteras). So as a response to your CEO, you need to make sure she sees an organizational plan, budget, and an expected ROI that makes sense.

You also have to realize that while the $1 million in my example sounds like a lot of ammunition to get a job done, most executives want to see things happening on a 30, 60, 90 day progression. So you will need to have strong tactical plan for ramping up a team. This means you need to focus on the "low hanging fruit" while working on the longer-term business problems; e.g. extracting your fair value from the market and identifying which customers are costing you the most to support.

Pricing and Market Intelligence Processes: Different companies use different tools and processes for creating their solutions, marketing them, delivering to the customer, billing, and reporting what happened. As such, there is no prescription for the exact right process, system or tools. But, as there are so many companies without a pricing process and/or a way to understand what market prices are on a consistent and regular basis, the right one is any process that gets the company doing it without creating chaos in the existing processes.

Someone in your company is currently doing bids and price quotes. As a pricing team with short-term objectives, you have to focus here. You do not have the staff or the time to own this unless it is dumped on you in the process of gaining the business' investment dollars. Either way, have someone immediately start trapping all prices quoted to the market, determining what market segments are in play, understanding if there is seasonality to the business and analyzing the pricing to look for anomalies, and start creating pricing curves.

You need to know what pricing your sales team quoted that is working. Even if competitor pricing is completely unknown and there is no ethical way of finding it out, this single effort is the bare minimum of what every business needs to be doing.

Also, knowing which price points are losing is important too. **What price sold your product or service and what price did not tells you a lot about what your customer's believe is fair market value. There are always other factors; perception of quality, mapping to needs, relationships. But, if your price is too high, the sale will not occur.** Additionally, seeing the prices that did not work on a

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scatter plot with pricing that does work, is a powerful way of hunting for "willingness to pay" patterns for segmentation.

Once you know what the right prices are to win business, you have to force your quotation teams to be disciplined. Give them a low, medium, and high price point to quote or use discount ranges. If you can have the sales' team compensation tied to the net price ranges, you will be amazed at the user adoption rate. Also, have signature authority levels with executive compensation tied to the approval of special pricing which has rates quoted below guidance. When it is strategic, special pricing will get done. The rest of the time reps will start looking for ways to sell without using price as a weapon of choice.

"Value Based Pricing": Ideally every company would be able to sell their products and services at the price which maps to the exact value their customer's get from the use of their solutions. Unfortunately, there is the sinister problem of competition. And like it or not, every offer has a competitor. Sometimes doing nothing or creating a workaround is the competitor. If this is cheaper and your offer is not perceived to be that much better, the prospect will not buy from you.

It is a good strategy to set **List Pricing** reflective to the customer's ROI as a benchmark and to fully expect to see the impact of competition (e.g. there will be a discount between **List and Net Price**). Understanding this discount gap will give you a strong barometer of how your products and services are viewed in the market relative to the competition, and watching the trend of this discount gap over time will make you aware of any issues in your pricing strategy, such as a need to work on marketing communication of value and competitive preeminence, improve sales skills, and/or improve product and service quality. Alone it will not tell you which problem it is. But, it is an important part of your product management dashboard.

When new products are introduced to the market, having a value based list price and the research that explains that value articulated for the sales team will dramatically help them articulate value when they engage customers. If you identify that your marketing or product management organization is having trouble quantifying value, this could be a signal the business strategy is not translated into a market strategy, which is not translating into creation of solutions the market places value upon. Many great companies have failed due to a "build it and they will come" mentality. **If you are not clear on what problem you are solving for the customer, no matter how good you are, you cannot determine the value the customer will get.**

Targeting Margin Leakage: A highly effective tool for identifying margin leakage is the pricing waterfall. Pricing waterfalls provide a graphical view of all the elements that play between what is set as the List Price and what is kept in pocket. Comparing waterfalls for a product versus its market segment or a customer versus a peer group provides astonishing insight about where the product's value is lost or where a customer relationship can be specifically targeted for improvement. Without a powerful pricing system or a dedicated team of analysts though, this work is time consuming.

Working with pricing waterfalls can be seen as a three phased approach.

Phase 1: Create waterfalls for all key customers, major market segments, groups of smaller but strategically important segments, for the top 10 to 20 products, and for each of your major product categories (assuming the 80/20 rule).

Phase 2: Compare customers to segments and products to categories.

Phase 3: Work with account teams and product management to drive action plans to stop the margin leakages where elements are outside of the norm. Once done, return to Phase 1 and grab the next biggest set of products and customers.

Note: If you have done a detailed pricing segmentation study you most likely do not need this coaching. The results of determining statistically valid groups based on pricing behavior will generate an amazing view of your customer's willingness to pay. If you have not done one, do your best to use basic business sense, such as considering geography, total annual revenue, purchasing frequency, method of payment, or any other metric that is natural to your industry, and get started.

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In sum, what steps are recommended?

1. Create/assure senior executive buy-in.

2. Hire a lean staff to focus on analyzing your win/loss data in order to understand market based pricing.

3. Drive discipline to quote within the guidance provided.

4. Get someone working on pricing waterfalls to target specific incidents of margin leakage.

So, what are you waiting for? Your executive wanted an answer yesterday.