

How Pricing Can Be Effectively Used to Improve Channel Management

The use of different distribution channels can easily result in channel conflicts within companies. Pricing should be well balanced between channels in these mixed distribution models. Otherwise, channel conflicts may contribute to value destruction, as ineffective pricing can favor specific channels leading to changes in the channel mix.

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Hybrid distribution models are common in most companies, but the use of different distribution channels can easily result in channel conflicts. Pricing should be well balanced between channels in these mixed distribution models. If this is not the case, the consequent channel conflicts may contribute to value destruction, as ineffective pricing can favor specific channels leading to changes in the channel mix.

If managed effectively, pricing can be a powerful tool in channel management. Equivalent channel pricing (ECP), is a good way to manage channels to our advantage, allowing us to capture the full value potential of our channel strategy. Let's see how we can implement ECP.

A good balance between channels is often difficult to achieve as many factors affect it. Dealer consolidations and new emerging distribution alternatives are examples. These new alternatives may be seen by management as a good way to increase revenue and at the same time reduce costs to serve, but often things can be very different.

Channel Price Clouds

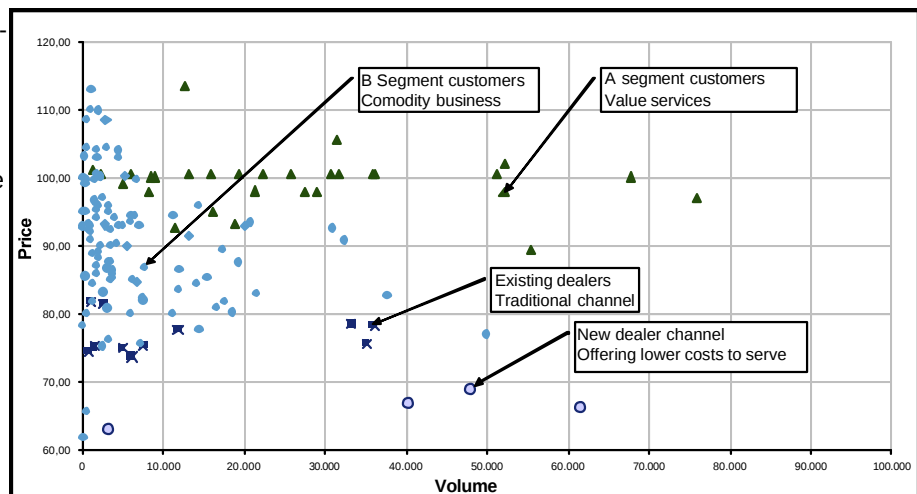
Typical price clouds, normally used to identify price differences between customers and its relation with volume, can help to identify these changes. Let's see this in a practical example (below).

In a typical price cloud, as we often see in many companies, prices are scattered around the graph with little relation to volume. It is a common assumption that a lower price will automatically create higher volumes and vice versa. But volume is not only a function of price. A channel and segment look to this price cloud

shows that there are more elements in the price/volume equation.

With the segments and channels clearly visible through different colors, we can identify certain clusters.

Let's first look at the difference between customers in segment A and B. The first ones (triangle dots), despite having on average higher prices than segment B, realize much higher volumes. The reason is that the value proposition in segment A works very effectively as those customers are willing to pay a higher price for the product. To the contrary, customers in segment B (round dots) perceive the products as a commodity and prices are on average lower than in segment A. Note that only a few customers, with low volumes, pay a higher price than customers in segment A. Customers in every segment have different requirements and may value products in a different way.



Segment A is more complex to serve, requiring a much closer contact with the manufacturer. Segment B was easier to serve, with significant competition between dealers, reducing the market price. This had an effect also on their direct customers. As competition between channels increases, more customers are approached by the different dealers and prices are gradually reduced. A different channel strategy with less competition between dealers and direct sales for the B segment would have allowed the supplier to achieve higher prices without loss of volume.

On the other hand, as seen in the bottom of the graph, there are significant price differences between the traditional dealers and the new dealer channel. See the differences between the round and square dots.

Consolidation in the distribution channel initiated this change. The new consolidated dealers gained critical mass and this was an opportunity for the supplier to reduce the cost to serve by refocusing on this channel. From this business switch to these dealers, costs to serve can be reduced, but the average selling price will decline also.

To What Extent Has This Strategy Created Value?

To answer this question we need to evaluate other elements. Since cost to serve is one of the arguments for the change in distribution, we should look at the balance between it and price. Considering both will give us an indication of the profitability per channel. This is what we mean by ECP. **Equivalent Channel Pricing should avoid the destruction of value, maintaining a fair balance between the different alternatives in our distribution strategy.**

To do so, we need a comprehensive understanding of our costs to serve per channel and the real competitive advantages that every channel offers. This can be done by analyzing the sales process in detail and evaluating the costs per channel of the different business processes.

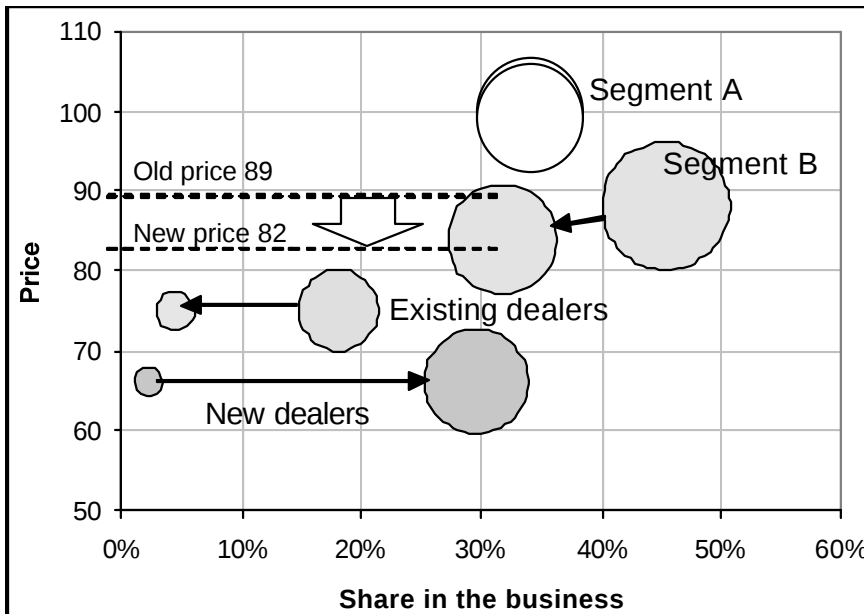
In the table below, the different segments and channels are described in detail and the costs to serve (for the supplier) are calculated as percentage of turnover. These costs to serve are calculated based on the activity per segment as defined by specific process KPIs. We chose the number of visits per rep to define the cus-

tomers acquisition costs, number of calls received in the call center for the ordering process, the number of deliveries for the shipping costs, the time spent by the application engineers for the product support cost and number of invoices for the invoicing and credit collection costs. The average cost per unit of measurement gave us an indication of the overall cost per process in the different segments (or channels) as a percentage of sales.

Customers in segment A were more demanding in terms of product support, which gave the supplier a differential advantage. However, overall costs to serve are similar in both segments. The higher product support costs in Segment A are compensated by lower acquisition and delivery costs, as average turnover per customer is higher.

But let's see what happens with the dealers. The new dealer channel, which was created through consolidation, did offer the supplier the possibility to reduce costs to serve. These new dealers, with increased critical mass, were able to streamline their activities and improve operations. Introduction of EDI ordering could help the supplier to reduce call

Costs to Serve as % or turnover	1 Direct sales to Segment A		2 Direct sales to Segment B		3 Existing dealer channel		4 New dealer channel	
Acquisition	Direct	5.0%	Direct	6.0%	Direct	2.0%	Dealer	1.5%
Ordering	Call center	0.8%	Call center	1.0%	Call center	0.6%	EDI	0.3%
Warehousing	Direct	2.0%	Direct	2.5%	Dealer	1.5%	3 rd Party	0.5%
Delivery	Direct	2.0%	Direct	3.0%	Dealer	1.5%	3 rd Party	0.5%
Product support	Direct	3.0%	Direct	1.0%	Supplier	0.4%	Supplier	0.2%
Invoicing/Credit	Direct	1.2%	Direct	1.5%	Direct	0.6%	Dealer	0.4%
Total cost to serve	Direct	14.0%	Direct	15.0%	Direct	6.6%	Direct	3.4%



center requirements. More effective warehousing and delivery by outsourcing logistics was also attractive as the supplier could also reduce the costs to deliver them. It is legitimate whenever new dealers try to exploit the added values of their new business model. The problem was that the price advantage the supplier gave them was too high, giving the new channel an additional price advantage.

The Impact on the Channel Mix

Channels share the same customers. If one of the channels is favored by our pricing it may grow against a profitable channel, thereby reducing our overall margin. Although you may reduce your costs to serve, this reduction may not compensate for the price reductions and the decline of business in the traditional channel. A clear and well-balanced price policy per channel is therefore essential.

You can see this in the graph above. The new channel could use its price advantage to attract the business from the traditional dealer channel and even in our direct sales in the B

segment. Consequently, a substantial part of our profitable business in the traditional dealers and segment B did move to the new dealer channel, delivering substantially lower margins. At the same time this increased the price competition in the market, influencing reactions from other competitors.

The business in segment A, more difficult to serve, is the only one that has remained stable over time. In Segment B the existing dealers have gone down, which has contributed to an overall price reduction from an average of 89 to 82.

The price reduction was not compensated by equivalent reductions on the costs to serve, resulting in a net margin reduction.

When changes in the distribution mix start to take place, we need to do a detailed analysis of its potential impact on our business. New emerging channels may offer us growth and cost reduction opportunities, but at what price cost.

To anticipate these changes and avoid value destruction, before prices are effectively reduced you need to compare price margins with costs to serve. This is what we mean by ECP.

In the graph below you can compare the costs to serve in the different segments and channels and the price per channel. The costs to serve in percent of sales as defined before and the price per channel are used to calculate the channel margin.

You can clearly see the imbalance between the existing and the new channel. Costs to serve are lower, but not enough to compensate the price difference between 75 and 66. A price of 72.0 € to the new channel would have secured the same margin in both channels. Even when the new dealers overachieve with their new value proposition, and achieve significant growth, our margins will not be affected.

The implementation of ECP will not stop changes in distribution. New distribution models with innovative ideas should be welcome, but allowing them to compete in equal terms will strengthen our distribution model. □

Costs to Serve as % or turnover	1	2	3	4
	Direct sales to Segment A	Direct sales to Segment B	Existing dealer channel	New dealer channel
Total cost to serve	Direct 14.0%	Direct 15.0%	Direct 6.6%	Direct 3.4%
Price per channel	100.0 €	88.0 €	75.0 €	66.0 €
Cost to serve	14.0 €	13.2 €	4.95 €	2.24 €
Product cost	50.0 €	50.0 €	50.0 €	50.0 €
Channel margin	36.0 €	24.8 €	20.0 €	13.8 €