How to Price Smarter in Uncertain

Timidity is not an effective response by pricers facing challenging market conditions. Instead, a willingness to read changing consumer signals and the confidence to make smart, strategic price decisions will ensure that companies flourish even in a difficult economic environment. The authors discuss five key strategies that should be applied. All are applicable to consumer-facing businesses; some have relevance for B2B companies as well. This article was contributed by: senior executives John G. Hanson and George L. Coleman and consultant Raymond C. Florio, all with the Pricing and Profit Optimization group of Accenture, the global management consulting, technology services and outsourcing company. The authors can be reached at: john.g.hanson@accenture.com, george.l.coleman@accenture.com, and raymond.c.florio@accenture.com, respectively. This article originally appeared in the September 2008 issue of *Outlook*, an Accenture publication. For more information about the Accenture Pricing & Profit Optimization practice, please visit: www.accenture.com/Global/Consulting/Strategy/Pricing_and_Profit_Optimization/default.htm.

Pricing power does not weaken along with the economy. With more sound improvements in pricing efficiency, a recession can actually spur future profitability and market share growth.

When demand starts to slacken and becomes difficult to predict, managers lose confidence. The discomfort can be especially acute for those responsible for pricing. Understandably, they become jumpy. They assume that the falloff in demand will affect all products immediately. Their sense is that if they don't take the initiative and cut prices—and cut them promptly and deeply—their rivals will do so.

To be sure, this sort of reactive price cutting can make everyone feel better for a little while. It will almost certainly please consumers. And, in the short term, it will probably help mask underlying demand weakness.

But demand does not weaken at the same rate, at the same time, across all customers. Consumer needs and behaviors do indeed change quickly when the economy softens, but customers are not always looking just for price cuts. Vendors that do not understand the pace or scope of the changes in buyer preferences will be all the more tempted to pull the pricing lever.

The last thing a company should do is give away its pricing power preemptively. Impetuous price cuts across the board are almost always the wrong move. They can quickly erode brand equity and sink earnings—a reminder that pricing should be very much on the minds of senior executives, and never more so than during economic slumps.

By cutting prices prematurely or in a reactive fashion, companies encourage customers to regard the depressed price as typical, which makes it very difficult to raise prices back to normal levels when the economy rebounds. The result is an almost permanent loss of profit margin, perhaps not just for the company but for the entire industry.

Case in point: During the last recession, many leading airlines, in an attempt to maintain market share, followed one another in a downward pricing spiral. Those cuts may have permanently compromised the pricing power of the airlines.

Beyond that, the company that cuts prices reactively may compromise its hard-won reputation, trading a high-end image for something more down-market—without thinking through the implications for the integrity of the brand and the long-term impact on customers and other stakeholders.

And pricing isn't the only problem. When managers overuse or misuse sales promotions, profitability suffers. For example, when household appliances are heavily promoted—during the winter holidays, for instance—unit sales spike. But those short-term volume increases do not offset the much lower selling price per unit, which depresses revenues and margins. (See "Disconnect" chart.)

And promotions encourage customers to cherry-pick. While marketers may view promotions as "one-time" or "seasonal" adjustments to "real" prices, to buyers a price is a price. They can pretty much bet that if they wait, marketers will drop their prices—especially in downturns.

Relative Value

The key to pricing effectively in uncertain times is to remember that pricing power does not weaken along with the economy. While it may be much diminished in nonessential categories, it

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can be very robust in others. In the B2B world, for instance, even in times of uncertainty, most businesses have no choice but to pay for the essential products and services that make their companies operate—like voice and data communications, lighting and spare parts for machinery.

Armed with that knowledge, business leaders can be confident about defending the relative value of their offerings.

High-value product and service providers must base their pricing decisions on the changing needs of their customers, not on the pricing moves made by their lowest-cost competitors. In weak economies, smart pricers outperform their nervous rivals by confidently honing their strategic focus and deeply understanding changes in customer demand.

There are five key solutions that pricing decision makers can apply to keep profits growing during economic downturns. All are applicable to consumer-facing businesses; some have relevance for B2B companies as well.

In any period of economic uncertainty, the factors that matter most to your customers will change. What had been true about the way customers related to your product or service most likely will no longer apply during tougher times.

These solutions are not intended to comprise a comprehensive pricing strategy, much less a set of pricing execution steps. Rather, we offer them as evidence of the bold—but not brash—mindsets that best-practice players demonstrate when the overall demand picture starts to dim.

1. Understand the Changing Nature of Demand

In any period of economic uncertainty, the factors that matter most to your customers will change. What had been true about the way customers related to your product or service most likely will no longer apply during tougher times. Customers will value other elements of your offering—showing less enthusiasm for product selection, for instance, and more for tight delivery windows. They will also make big shifts in what they will continue to pay for and what they won't.

The key questions to ask are: Where in my product portfolio do I have a differentiated advantage? Which products will remain essential to customers throughout the downturn? Which ones will most easily lead to sales of other products? Companies that "manage for recession" will focus on these products and the opportunities they provide, and they will seek to minimize the costs associated with that emphasis. Specifically, they will strategically price around these products. They know that those products are crucial not only to their customers but to their own profitability during and after a recession.

In cases where there is a clear advantage, matching competitors' price cuts is likely to be unnecessary, especially for premium brands. The pricing exemplars learn how different customers buy and how different products perform during and after the downturn, and then they build up their inventory of those products as the next recession looms.

But what about actually *increasing* prices during a downturn?

Some would argue that any increase is a mistake. However, there are three related reasons why this should be considered—all rooted in strong levels of confidence in the organization. First is the issue of rising commodity costs. To maintain minimum margins, it may be necessary to increase prices for goods and services whose input costs—energy, for example—have risen significantly.

Second, if you fail to increase prices during the downturn, when your brand is robust, you can diminish the brand's value. A leading maker of fire and rescue vehicles demonstrated its mastery of pricing in tough times. It recently raised prices on its popular emergency vehicles, citing rising steel costs. In effect, the company seized an opportunity to "reset the base" on prices—an especially smart tactic at a time when customers are conditioned to expect some inflation.

A third point is especially relevant to the B2B sector. Customers may be suffering in one market, but in today's multi-polar world, few companies have only that one market, and there will surely be business areas in which they are doing better.

For instance, an agricultural equipment manufacturer, already staggering under increased costs for steel, might have little or no overall revenue growth in its home market. Its Brazilian operations, however, may be increasing production because of the growing demand for biofuel crops. So in that market, the company might be able to increase its prices even as it holds them steady or reduces them at home.

Price hikes during downturns highlight the issue of confidence like no other. In many situations, business leaders listen to salespeople who insist that the sky is falling, so they must have pricing relief. But savvy managers push back with queries about where, exactly, the sky is falling and where it isn't, and they continue probing until they learn where, in which markets, and with which customers and which product lines there is cause to be confident.

2. Fine-tune the Product Mix

Customers' wants and demands change with the size of their wallets, and there are a couple of ways to adjust product mixes to suit. For retailers, a downturn can be an opportunity to introduce consumers to their private-label products. Another tactic is to shift the balance of products toward lower-priced alternatives—a risky approach for premium retailers but a fairly low risk for big-box retailers and discounters. (See "Leverage beyond Pricing" chart.)

When the economy slows, some customer segments will be more profitable than others. Those segments are where both B2C and B2B companies must focus their efforts rather than pursuing market share across all markets.

During the 2001 economic dip, a popular grocery chain responded to tighter customer spending by improving the selection and promotion of its private-label products. These offerings—snack foods such as cookies and chips—cost the retailer less and sold on the shelf at a lower price. Customers took advantage of the private-label snacks or even switched from shopping at other stores, allowing the chain to maintain its profitability. Meanwhile, several of the chain's competitors were eager to take the same approach, but because they had long-established agreements with national snack-food brands that prohibited or restricted them from selling private-label products themselves, they were not able to do so.

Retailers, in particular, need to revisit their product assortment and category strategies. Indeed, customers may be better served with different products than during buoyant economic periods. The trick is to offer substitutes that better fit the customer's new requirements and that will generate higher margins—without hurting the vendor's brand perception.

In B2B industries, marketers often find that during periods of economic softness, many of their customers are less interested in "nice-to-have" product attributes than in the basic attributes that help them manufacture products more efficiently, or improve their own sales responsiveness. So some B2B sales efforts can be moved from promoting the discretionary features to emphasizing the fundamentals on products whose prices can likely be maintained.

Between 2001 and 2002, many new technology companies, such as application service providers and server farm hosting companies, found themselves unable to maintain their sales in the face of shrinking IT budgets. Their offers were just not as essential as stand-alones. On the other hand, a number of big, well-known incumbents in communications, high tech and software were able to adapt and survive. Their product mix included a variety of basic items that attracted recession-burdened customers.

3. Narrow the Customer Focus

When the economy slows, some customer segments will be more profitable than others. Those segments are where both B2C and B2B companies must focus their efforts rather than pursuing market share across all markets. It is vital to understand the revenue and true cost to serve each customer segment, and to allocate resources and time accordingly.

Pricing exemplars excel at focusing on the high-value customers that will sustain their profitability during the dark days, and then help them make gains in market share after the economy recovers. Leading makers of chemicals and other bulk commodity products, for example, shift their distribution channels during uncertain times to lower their costs to serve certain customer segments. For the most part, such shifts will incorporate a move to an indirect channel and the use of distributors rather than the company's sales force to reach out-of-the-way, lower-volume customers.

In consumer electronics, a leading retailer, responding to the 2001 economic trough, decided to concentrate its resources so it could improve service for its high-end shoppers—the entertainment-center enthusiasts, computer gamers and high-tech early adopters who regularly spend large sums on their hobbies.

Not only did these customers generate much more revenue for the investment, but also (as a group) they did not change their buying habits during the recession—a prized customer attribute. The retailer designed areas of its stores specifically for those buyers—showcases for some of the most expensive, feature-rich products, with sales staff trained to address their unique interests.

The move—completely antithetical to conventional price-cutting instincts—not only allowed the company to sustain solid profitability through the weak period, but also positioned it to capture greater market share in a previously untapped customer segment. The key to its savvy segmentation: The retailer had used advanced pricing strategies and supporting technologies to identify the scope and scale of the new market segment and to test its pricing tolerance.

However, these leading companies don't discard their lower-value customers; they simply ease up on the service they offer to match the share of revenue they get from them, knowing that they can woo those customers again when the time is right.

4. Invest in Value beyond Price

The pricing masters know that they must become invaluable to their best customers. To avoid being considered commodities, they ensure, as much as they can, that price is not the be-all and end-all when customers are making their decisions.

This is particularly applicable in the B2B arena, where leading vendors focus far more of their selling efforts on helping their customers through their economic troubles. Most large business customers have long institutional memories that extend well beyond the last price they paid, and they will think more fondly of a vendor that was more of a partner than a salesman during the tough times.

Businesses can make themselves more attractive by offering an array of extras that do not cause a surge in fixed costs—for instance, convenient, contract-specific pricing on their websites, electronic data interchange relationships, free industry advice and shared industry research. The more value they can offer, the more flexibility they have with price—and the more painful it is for their customers to switch to the competition.

Leading vendors also take advantage of downturns to improve their financing and contract terms. Customers typically take longer to pay bills when the economy is soft. So vendors that extend payment plans and provide more lenient financing terms can make their products appear more economically viable, even if they actually cost more.

That's what home furnishings retailer Restoration Hardware has been doing recently with its "no interest, no payments" programs. B2B companies will often pull similar levers, extending warranties or payment terms for their best customers so they can hold their prices on product and service orders.

Some companies have even found success by completely changing their pricing structures during a downturn. Software companies have switched from offering an entire productivity suite to offering individual modules à la carte, while some mail-order companies have offered a wider range of delivery options—each with its own cost—to suit customers' pocketbooks.

One technology provider that was concerned about losing market share to extremely low-cost, low-priced competitors from Asia first tried to narrow its focus to just its most valuable customer segments. Next it determined what aspects of its offering those customers really valued when buying this type of product.

It turned out that while price matters, other elements of the value proposition, such as extended service warranties and guaranteed on-time delivery, were far more important—and the Asian companies could not compete on those attributes.

By providing those "soft" offer elements to their most valuable customers, the technology provider was able to maintain price and still grow profitably—leaving the most price-sensitive commodity business to the other players.

5. Maintain Pricing Discipline and Confidence

Salespeople commonly accept deals during downturns that they would walk away from when times are better. That lack of discipline may work for their sales figures, but it can greatly harm their companies, even after the economy recovers, as shareholders again clamor for earnings growth as well as market share gains.

Loose pricing practices are particularly prevalent in the consumer market, especially in retail, even though most companies in this sector have well-defined pricing rules and policies.

When times are good, these rules are adhered to. However, as shoppers become more discriminating with their purchases, merchandisers, store managers and even those in the executive suite become more willing to bend the rules. For example, while appearing to adhere to price-matching policies, they will stretch their definitions of "competitor" to include rival retailers that are not on the approved lists.

Worse, some retailers will bow to the car dealership practice of bargaining off the list price. Others will make the mistake of matching the deep discounts offered in desperation by the retailers most imperiled by the slump.

Leading vendors are all too aware of the concept of the customer's reference price—the price that is probably the lowest they have paid recently and against which they now gauge subsequent deals. To avoid this "slippery slope" scenario, and the prospect of unprofitable sales, it is critical that the company keep control of the deals it makes. (See "The Discount Trap" chart.)

For instance, the discounts the sales force may offer must be tightly controlled. While there are rare occasions when it is acceptable to bend over backward to retain a very valuable customer during a recession, that behavior must never become the norm, and it is essential to signal how generally unacceptable it is. True deal discipline means a salesperson can't go below a certain price range or change service features without special approval.

Deal discipline also calls for a detailed understanding of all the costs related to the product, both before and after the sale. Waterfall pricing diagrams—which depict price levels that coincide with various circumstances—help determine acceptable price ranges and point to the service options that will allow the sale to remain profitable. The diagrams will also show where price leaks are occurring.

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The price exemplars also modify sales force compensation to match industry conditions. If revenue is hard to come by, and the company wants to remain profitable, it will ensure that its salespeople receive the appropriate incentives to help achieve that goal. The firm's managers must understand that if they don't change the metrics of the deal, then they will have exactly the same salespeople selling the same things in the same ways regardless of the prevailing economic conditions.

The management team at one enterprise applications software vendor is facing those challenges now—and is working hard to overcome them. Customers have learned from experience that the company's sales-people are willing to discount very aggressively at the end of a quarter in order to make their numbers. Naturally enough, the buyers wait until the end of the quarter to buy.

The vendor's managers are concerned that while seasonal over-discounting has been bad enough in the past, it could be truly devastating in a year when CIOs' budgets are so tight. Facing the prospect of depressed margins, management is poring over past transaction data to understand where they may have been able to discount less heavily—by customer type, by application, by geography, even by sales manager—and to come up with fact-based guidelines their sales teams can use to negotiate deals profitably in the year ahead.

When the economy is ticking along nicely, pricing with precision is important though rarely critical. But when demand slackens or is uncertain, the flaws in pricing performance become unbearable—and the penalties for those flaws are magnified enormously.

Yet economic uncertainty does not have to lead to a strategically barren series of price wars and round after round of random, desperate price cutting. Contrary to many managers' expectations, not all pricing power is lost. If a company avoids the knee-jerk reactions that so many give in to when the economy slows, and replace rampant price cuts with more sound improvements in pricing efficiency, a recession can actually spur future profitability and market share growth.

That's reason enough for the executive team to care about getting pricing right.