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CONTENTS

Pricing Transformation: Decision Making Required, Software Optional

Pricing transformations are a big topic in the business world, but many companies do not understand how to bring such a transformation into fruition. In this article, the author explores the key cultural and organizational changes required to implement meaningful pricing change. Tim J. Smith, PhD is the founder and CEO of Wiglaf Pricing, adjunct professor at DePaul University, and Academic Advisor for the Certified Pricing Professional designation. His most recent book is Pricing Done Right: The Pricing Framework Proven Successful by the World's Most Profitable Companies *(Bloomberg Financial, 2016). He can be reached at tsmith@wiglafpricing.com.*

by Tim J. Smith Ph.D.

Pricing transformations are a hot topic. People have been preaching to CEOs, CFOs, CMOs, and CCOs for years that a 1% improvement in price can lead to 8 to 13% improvement in profits. Even better, experience has shown that 1% improvement is a low-estimate of the expected outcome of a pricing transformation. Pricing transformation efforts routinely deliver two additional margin points, and have been observed to deliver an additional 9% to margins. But where is the origin of these improvements, and how do companies get this improvement?

Pricing Transformation is a Transformation in Decision Making

At its core, pricing transformation is about transforming how organizations make decisions regarding pricing. It is a transformation of the processes used in pricing, the people engaged in pricing decisions, the information applied to pricing decisions, and the goals of those pricing decisions. It is an organizational structural change to align with the corporate strategy and goals.

A wide variety of coordinated profit-focused decisions are required to drive a strong pricing transformation. These profit-oriented decisions will coordinate list prices, target prices, commercial policy, tactical price management, and sales-incentives towards more accurate pricing.

It isn't a single decision nor single process that delivers the improvement, but rather the coordinated effort across many decision points, processes, and routines to ensure pricing

➤ CONTINUED on 3 ➤

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works as one system to deliver better pricing at the point of sale. In most cases, it transforms pricing from piecemeal efforts and departmental hand-offs into a coordinated effort that encompasses the whole.

A good pricing transformation is a cultural change – a change in the corporate cultural practices around pricing.

What is not stated is "pricing transformation is a software implementation." Pricing transformations do not require software. Changing routines, the way people work, and the goals of their effort may benefit from software and software may support the cultural change, but new software is not fundamentally required.

Pricing Transformation Value Drivers

Let's look at the value drivers of a pricing transformation.

The major concrete outputs of a pricing transformation are improved pricing accuracy and aligned decision incentives. Accurate pricing means that the right price is extended to the right customer, at the right time. Aligned decision incentives imply that the key criteria to define the meaning of an accurate price is aligned with the company's strategic goals and particularly its profit goals.

Accurate pricing reveals itself in many ways. Most people initially focus on the issue of higher prices. This is clearly within the scope of pricing transformations, but "accurate" and "higher" are not the same word. Yes, pricing transformations are likely to deliver some price increases, but it is also likely to include some price decreases. When a lower price is likely to yield higher profits by improving sell-through, pricing accuracy will call for that price to be appropriately lowered.

And definitely, accurate pricing does not mean an across the board price increase. It implies targeted price adjustments: targeted at the offering, market segment, and even customer level.

Accurate pricing coupled with aligned decision incentives can also reveal itself by improving the offering mix. Engaging customers with a better mix of high-margin and low-margin offerings enables the business unit to both sell more and improve the margin of the overall offering mix sold.

Thus, the major value drivers of a pricing transformation are improved price capture, improved sell-through, and improved offering mix. These value drivers are delivered through improvements in pricing accuracy and decision alignment. And, these improvements themselves are created from a variety of many other issues that can best be encapsulated as a cultural change.

But none of these improvements require a new software system (see Figure 1.)

The Role of Pricing Software

If the main value of a pricing transformation is in changing how the organization makes decisions about pricing, then what is the value of pricing software? Every seasoned executive has experienced a software implementation that has yielded tools that go unused. When buying pricing software, shouldn't executives know how it will be used, what it is good for, and what isn't it good for?

In general, experience has taught us that enterprise software does not, in and of itself, transform an organization. Its main value is in automating and coordinating some of the organizational tasks. It is a productivity enhancement measure.

As a productivity enhancement tool, pricing software is excellent at automating the routine. It can execute a commercial policy, route workflow, and communicate incentives. It can even conduct standard forms of analysis, analytical outputs which

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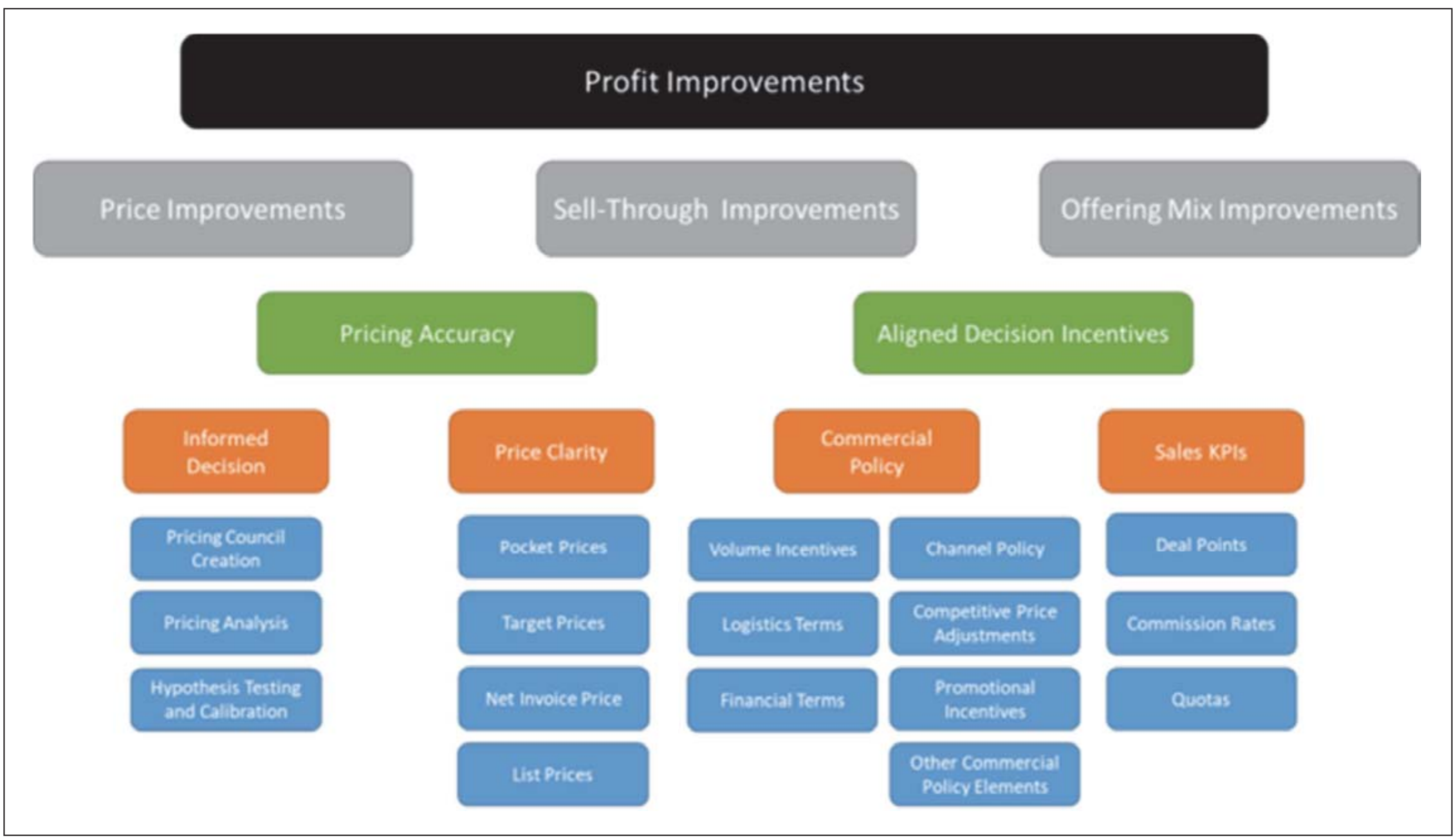
Figure 1



still must be reviewed by humans to inform decisions. That is, pricing software can reduce the labor required to administrate an existing pricing policy or inform a pricing decision. This reduction in labor requirements may appear in the form of ease of use, error reduction, reporting, and tracking and control.

Reducing labor costs and improving productivity is important, but it is not the main driver to undertaking a pricing transformation. At most, 10% of the value of a pricing transformation can be attributed to labor savings. Much of these labor savings will be reflected in shifting area of responsibility, not actual headcount reductions.

Within larger organizations, the value of automating the routine can be significant. For mid-size to small organizations, the accounting cost savings will be greatly reduced.

Valuing Pricing Transformations

An evaluation of the value of a pricing transformation should quantify the major value drivers. We have identified the four major issues as price capture improvements, sell through improvements, product mix improvements, and labor-saving software.

Figure 2

Overall Impact ...			
$100,000,000		Revenue	
$2,000,000	2%	Overall Improvement	
Of this Impact, it can be attributed to ...			
$1,000,000	50%	Price Capture Improvement	Consulting
$600,000	30%	Sell Through Improvement	Consulting
$200,000	10%	Product Mix Improvement	Consulting
$200,000	10%	Labor Savings	Software

For a representative pricing transformation outcome, we estimate that 50% of the value of a pricing transformation will derive from price capture improvements, 30% for sell-through improvements, 10% from product mix improvements, and 10% from labor savings. This is calculated in terms of profit impact for a representative $100 million business unit, as seen in Figure 2.

As this representative model clarifies, the impact of a pricing transformation, and the value of undertaking one, is in driving a quantum and lasting improvement in the structure, routines and culture of pricing decision making. These improvements are usually delivered through the consulting part of an engagement. Software, by itself, does not deliver the bulk of the value of a pricing transformation, and in the end, it's optional.

Note: *Pricing transformations can be categorized into two major areas: price architecture changes and pricing organizational changes. Here, I focus on the organizational side of pricing transformations, as this is the more common usage of the term today.* ❖

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Editor: ....Rebekah Wortman, PPS Marketing Publications Editor

Publisher:.............. Kevin Mitchell, PPS President

For all other inquiries, including subscription and PPS membership information, please contact:

Professional Pricing Society
3535 Roswell Road, Suite 59
Marietta, GA 30062 USA
Tel: +1.770.509.9933
Web site: PricingSociety.com
E-Mail: contactus@pricingsociety.com