Professional Pricing Society

The PRICING ADVISOR

The Pricing Advisor™ is published monthly by the Professional Pricing Society
3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
**www.pricingsociety.com**
Kevin Mitchell, Publisher


A Professional Pricing Society Publication

March 2013

*In this article, the author presents an all too common situation in which a company finds its profits and margins at risk due to lack of pricing research and strategy. The author then outlines the ten first steps every company should take in order to establish a vibrant and effective internal pricing organization. Eric R. Robles is the Pricing Manager of one of the largest e commerce online retail organizations in South-East Asia and the author of The Price Workshop blog (http://www.priceworkshop.wordpress.com). He can be reached at eric_robles@live.com.*

# Establishing the Pricing Organization

**Situation:** The General Manager of a mid-sized company just got informed that despite the high volume (units) the company produced this year, sales units and revenues are dropping compared to previous years.

Last year, external forecasts predicted business challenges for the following year due to the economy's volatility. During a general meeting the marketing department reported that market share has dropped significantly in all four quarters for the first time in five years. Historically the company has enjoyed double-digit growth year-on-year since it was established in the region. And, as expected, existing competitors and new entrants are gaining ground due to their lower prices and growing presence in the market.

Meanwhile the finance department also furnished their report, and the same undesirable performance reaches the General Manager. That profit margins are leaking away particularly with the top products being sold by the company. After reviewing the financial data it was found out that discounts and rebates were not properly administered due to hesitations of losing further volume. Customers have now become more hesitant when responding to the company's prices. And to complicate the situation, the sales organization was not only short of its sales targets but also the quality of profit margins gained on a per unit sold was not healthy – and on frequent occasions even losing.

The General Manager has now decided that it is high-time to stop the bleeding, shift-gears and make a move to change how prices are managed. But how will he start the change?

## In This Issue:



*Have a pricing article, case study or story to share? Send articles to editor@pricingsociety.com.*

## PPS Happenings

Serving the Pricing Community Since 1984

### Upcoming Events

- **PPS Inaugural Asia-Pacific Pricing Workshops & Conference** – Fairmont Singapore & Swissôtel The Stamford - Singapore / 18-19 April 2013

- **24th Annual North American Spring Workshops & Conference** – The Palace Hotel – San Francisco / April 30-May 3, 2013

For the most up-to-date information about PPS events and programs, please visit our website at www.pricingsociety.com frequently.

The PRICING ADVISOR
A Professional Pricing Society Publication
3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

**The following are ten essential elements required to establish an effective 'pricing organization' and achieve pricing excellence:**

1. **Pricing Road Map.** Begin to diagnose and map the organization's current pricing policies and practices. Evaluate existing challenges and opportunities – identify what is relevant and what is not. What needs to be challenged, what needs to be changed, and what needs to remain. Assess the current pricing operations, processes, systems, tools, capabilities and alignments within the organization. Identify the key departments, business units and 'champions' that will contribute significantly with nurturing and realizing both short-term and long-term pricing goals. Establish a common purpose and road map for pricing.

2. **Pricing Body (Leadership).** An effective pricing organization should not be built in isolation (silo) but rather as a collaborative function; therefore it is paramount to have a high level of coordination with departments or business units that will have the most impact to overall pricing strategy. For instance Finance, Marketing, Sales, and Demand Planning departments are some of the organizations whose individual performances have a direct impact to pricing. However, this will depend to the organization's structure and nature of business. The bottom line: buy-in is critical when making pricing decisions, thus the presence of a pricing body or committee is a must when establishing the pricing organization. Organize a body or leadership committee composed of representatives from functional level management and top management to champion the pricing organization.

3. **Pricing Champion.** The person in this role will champion the discipline of pricing in the organization and will bring-in leadership, best practices, innovation and strategic ideas to help establish the pricing road map. Another significant role will be to effectively reconcile data and information from other departments and conclude with actionable analysis and recommendations. One critical role is to act as an 'ambassador' who can effectively communicate from different business perspectives and successfully align commitments from stakeholders. Resistance from within the organization (in the initial stages of the implementation) is expected, thus it takes effective communications and good interpersonal and negotiation skills to bridge different business perspectives and align it to pricing decisions. The pricing champion shall perceive pricing as both a science and an art – hence, deep commercial awareness, knowledge of the market, the ability to crunch numbers, creativity, innovation, and good business acumen are ideal requirements. However it is important to note the role and responsibilities of the pricing champion may still differ according to the purpose, objectives set and organization.

4. **Change Management.** Employ a change management program to prepare the organization for the transition and to realize the desired change. This will lay the foundation for the pricing road map. Friction and resistance from employees is expected especially with regards to those old processes and routines that will be re-organized and re-established. Partnership with the Human Resource department is ideal to reinforce the transition and change.

Resistance from within the organization (in the initial stages of the implementation) is expected, thus it takes effective communications and good interpersonal and negotiation skills to bridge different business perspectives and align it to pricing decisions.

3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

Other support endeavors like leveraging branding and marketing principles to communicate the pricing strategy will not only strengthen 'change management' but it will also institutionalize a strong 'pricing culture' within the organization.

5. **Key Performance Indicators.** Develop and employ well-defined performance metrics / KPIs aligning departmental objectives to support short-term and long-term pricing goals. The objective is to align and enforce commitments and resources. One effective way is to seek buy-in from stakeholders and co-develop performance metrics. It is imperative that each organization within the company clearly understands how their individual performance will impact prices and eventually revenue.

6. **Pricing Policy and Guidance.** It is substantial that a pricing policy and guidance be put in place both in the (a) regional level in order to align and reinforce local level pricing and discounting policies, and (b) country level to give the organization flexibility to meet market demand requirements, respond to competitive moves and to make the most out of short-term business opportunities. A good policy and guidance will clearly communicate the company's pricing objectives and set guidance on how prices and discounts will be set and implemented.

7. **Price Exemptions and Discounting.** A comprehensive and well-defined price exemption and discounting policy and process should be implemented in order to properly administer and police discounting and rebates. Discounting and rebates should be designed and planned in a way that will drive both sales units and profits, and as well protect the product's brand position.

8. **Sales Incentives.** This is also a good way to align sales KPIs to short and long-term business objectives. Create control mechanisms and integrate them with the sales rewards and incentive program. For instance, (a) sales rewards and incentive KPIs should be anchored to the extent of discounts the sales man will give to customers. Another way, (b) sales rewards and incentive KPIs should be tied to the quality of revenue a sales man will bring in to the company – e.g. "...is the large percentage of the revenue driven by high profit products, or is it driven by low profit products?" It is most important to understand that the sales organization is the last element in the 'price value chain' responsible for implementing the prices and realizing the strategy. Any inefficiencies in this level will increase the chances of a failed price strategy.

9. **Reporting.** Providing the right information to stakeholders through regular weekly, monthly or quarterly reports are crucial to keep track of outcomes of pricing decisions made. This is not only good practice to achieve transparency but it also strengthens accountability of each department. Numbers are measurable and are the best indicators for tracking strategy realization.

10. **Milestones.** Celebrate and communicate pricing milestones to the organization. Communication is of great significance in sustaining the pricing strategy in the long run. Economic benefits gained during a business period such as increased sales units, market share, profit margins, and revenue are good examples of milestones. Milestones are clear indicators of the organization's achievement, performance and progression in the pricing road map.

Given that these fundamental elements are vital to the transition and change, the design of the pricing organization may still change or vary in accordance to the organization's structure, business objectives, competitive landscape and long term directions. **Whether it is a start-up, medium size or large scale enterprise – a good pricing endeavor begins with pursuing and establishing a well-defined pricing organization.**

There are two approaches to this, one is top-down approach of establishing the pricing organization – that is the initiative, push and sponsorship will come from the very top of the company's leadership – in most cases it is the call of the Chief Executive Officer. Therefore strong support and commitment is expected to be extended from all levels of the leadership and equally from all business organizations operating within the company. This approach is characterized by a more formal, progressive and sustained approach to implementing the pricing organization.

The bottom-up approach would be more challenging and difficult since it usually starts as a breakthrough business case or best practice. The challenge in this second approach to implementing the pricing organization is that there is a need to sell the benefits (first), get buy-in from the leadership and business divisions where pricing have influence with their output and performance.

## Key Takeaway

**Introducing changes to the way pricing is done in the organization is not a short term commitment of time, redirection of resources and realignment of commitments – rather it is a long term endeavor that is both progressive and sustained.** And changes implemented to the organization are paramount in order to attain pricing excellence.

The PRICING ADVISOR
A Professional Pricing Society Publication
3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

# Pricing for Cultural Differences

*The growth of emerging markets in recent years has increased the opportunity to sell products internationally. However, pricers should do their homework while setting prices in new markets. Setting prices requires more consideration than just margin, market share and sales targets in varying cultural regions. Understanding customers and their cultures goes a long way to getting the price right, as the author explains. Paul Hunt is the president of Pricing Solutions and a frequent PPS contributor, instructor and presenter. He can be reached at phunt@pricingsolutions.com. He also writes a pricing column that appears monthly in the Financial Post (www.financialpost.com), where this article originally appeared.*

The opportunity for brands and products to grow globally has never been greater. Asia, Latin America, the Middle East and Russia are emerging markets for any product you can think of. So what does global growth mean for Pricing Managers? Setting prices requires more consideration than just margin, market share and sales targets in each region. **Understanding customers and their cultures goes a long way to getting the price right.** Here are three key considerations when pricing for cultural differences.

## Perceived value

Understanding what your customers value and cultural influences on product attributes are the keys to a good global pricing strategy. **Consider these examples:**

▪ A toy manufacturer planned to reduce pack size while maintaining price. This toy is typically purchased as a gift and it was important for the manufacturer to understand how a smaller pack would impact sales during the critical holiday period. In Italy and Spain, consumers equate a good gift with a large package. Customers perceived the smaller pack as less valuable which would result in lower sales. Understanding the importance of pack size in the gift purchase decision allowed the manufacturer to decide between accepting the loss in sales and reducing the price in Italy and Spain to realign the perceived value of the product.

▪ In North America goods that are locally manufactured are increasingly popular and usually priced at a premium because of the value placed on the local label. In China, the opposite holds true. A recent study in the infant nutrition category found that customers in China value international brands manufactured in North America. A premium price was set for the imported products over the domestic competitors.

▪ A new prescription pharmaceutical launched in Latin America, advertised the benefits of natural ingredients and was priced at a premium. Interestingly, customers in Mexico valued the natural ingredients and were willing to pay the premium price. However, in Brazil, customers placed less importance on the natural ingredients and the premium price resulted in lower sales. The lesson here is regional pricing isn't always feasible but understanding cultural differences can help you accurately forecast sales.

## Discounting

Figuring out the optimal depth, frequency and timing for discounts is a challenge for most pricing managers. Considering cultural differences only adds to the challenge.

▪ For example, a premium brand in women's fashion is sold in Canada and Germany with very different discounting strategies. In Canada the brand competes in a discount-driven environment. Customers don't just hope for a sale, they expect one. A 20% discount is just an alert to wait a few weeks for the price to drop to 50% off. However, in Germany, a hi-low promotion strategy is uncommon. The brand maintains a consistent everyday pricing strategy that reflects their premium offering. The Canadian business would like to replicate the German strategy, but realizes that this is unrealistic and that they are better off implementing a balanced strategy — lower everyday prices but use fewer discounts to maintain brand image and effectively use discounts only for end of season clearance to meet Canadian customers' expectations.

## Pricing Psychology

Pricing for cultural differences goes beyond pricing strategy. You also need a good understanding of cultural traditions and behaviors.

▪ Consider the importance attached to certain numbers in the Chinese culture. The number 8 is a number that signifies good luck and good fortune whereas the number 4 signifies bad luck. A pricing manager could use this insight to make sure price endings are set not just to achieve the highest margin but also to prevent negative perception of the product because of its price.

▪ Buying behavior is another consideration. Some cultures consider a price tag to be the starting point for negotiation and some consider it set in stone. In cultures where negotiations are expected it is important to know the lowest price you are willing to accept and the size of the discount the customer requires to feel like he got a good deal. These two pieces of information will allow you to set a price with room for negotiation to make the customer happy while maintaining your profit margin.

Businesses looking to price smart should account for cultural differences or risk being disappointed by sales results.

The PRICING ADVISOR
A Professional Pricing Society Publication
3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

# Do You Have a Pricing Problem?

*Many companies are recognizing that their pricing strategies are ineffective and non-existent and are trying to take steps to improve internal pricing processes. However, for many companies pricing problems are indicative of greater internal and strategic problems which need to be addressed in tandem to pricing improvements, as the author explains. Stephan Liozu, CPP (www.stephanliozu.com) is a member of the PPS Board of Advisors, the Founder of Value Innoruption Advisors and specializes in disruptive approaches in innovation, pricing and value management. He earned his PhD in Management from Case Western Reserve University and can be reached at sliozu@case.edu.*

Many companies hire pricing consultants to address their price erosion problems or to reduce complexity in their pricing process. These companies clearly state that the time has come to address their "pricing problems" and stop the bad discounting behaviors. That provides leaders with a sense of relief that they are now serious about working on pricing and that the situation will improve in the short to medium term. The reality of their situation was that they did have a pricing problem. Because pricing excellence is a journey and not a destination, every organization might be faced with pricing problems of different nature and different intensity.

But the reality also is that, for these companies, the pricing problems are symptoms of greater internal and strategic problems. Trying to resolve their pricing problems might yield some positive short term developments and potentially provide short term relief. But if the issues are really strategic ones related to business model or corporate strategy, these gains will be short lived. Since the root causes of the pricing problems are not properly addressed, the pricing problems are not fully being resolved. That is why structural issues need to be first addressed and fixed prior to investing a large amount of resources and attention into resolving pricing problems.

They are many potential structural business problems that may lead to serious pricing issues. Six of these problems are presented below:

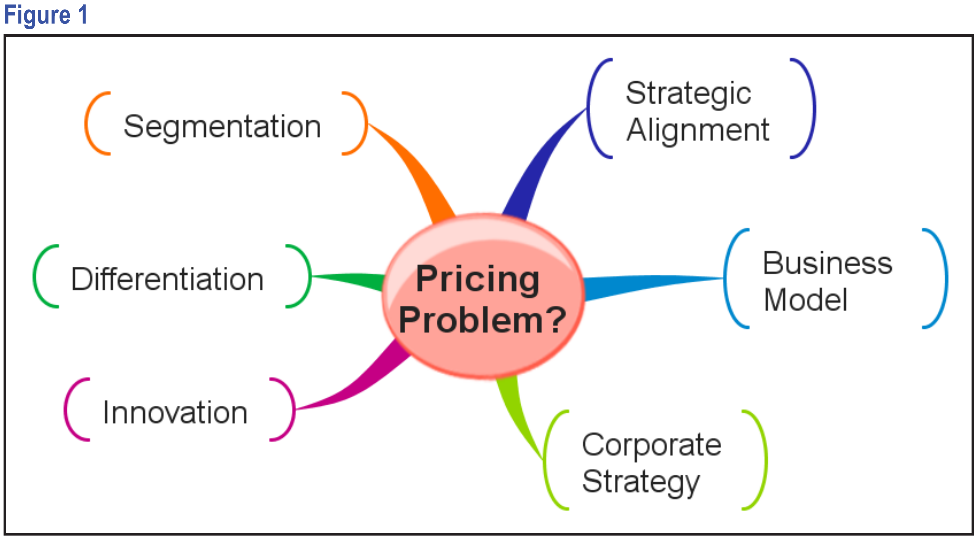
1. **Segmentation:** Perhaps the most common marketing problem is a total lack of segmentation based on user needs. Without segmentation, firms cannot separate various types of buyers and they try to be everything for everyone. The end result of this problem is customers' confusion with pricing, severe pricing overlap across segments, and profit leakages when customers get things they do not value and are not willing to pay for. **Segmentation is one of first steps of the value-based pricing methodology.** It is also the fundamental step for the development of a sound marketing strategy.

2. **Business model:** Another significant structural problem leading to pricing erosion is the lack of a sound and differentiated business model. In times of increased competition, business models are challenged and experience diluted versus competition. **The bottom line is that if the business model is broken, there is a high chance that the pricing models are also broken.** Therefore before working on their pricing models, business leaders should figure out what their business model is, how strong it is and what is needed to reinforce it.

3. **Innovation:** Business models can be modified and reinforced by injecting formal innovation. Business model innovation has gained significant interest lately but lags behind traditional product and service innovation. Firms rarely have a formal and structured process to study. They might adopt a more reactive approach to business model management once they face uncertainty and competitive pressure.

4. **Differentiation:** Business model in-

Figure 1



3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

novation is conducted to generate superior differentiation and competitive advantage in the market place. This is one area where I have seen most firms with "pricing problems" experience real difficulties. Differentiation is similar to the concept of value. It is vague, subjective and relative to something else. Understanding the real business differentiators and measuring their strengths is a really complex initiative. So instead of conducting this analysis, many firms claim differentiation without measuring it while trying to capture it with pricing. When differentiation erodes and gets diluted versus competition, it is difficult to evaluate the level of erosion and the impact on pricing power.

5. **Corporate Strategy:** The same could be said about a corporate strategy that has become obsolete, that is too internally focused and that is not delivering superior value to customers. There is no pricing program or action that will solve this situation. Sometimes industries and markets experience severe disruptive changes that require deep strategic redirection. That takes courage and attention from top leaders and should be the number one priority to redirect corporate resources and refocus strategic capabilities.

6. **Strategic Alignment:** This structural problem occurs when teams work in silos with different goal systems, different compensation structures and different perceptions of what the business model is. This lack of alignment generally leads to internal dysfunctionalities. The sales force for example will not deploy the marketing programs while cost accountants will focus on producing reports that no one reads. Strategic alignment starts at the top. If pricing and value are priorities at the top levels, everything cascades down the organization.

In order for pricing programs and strategies to be successful, they have to be aligned with a sound business model and a strong corporate strategy which aim at creating and delivering customer value. Then pricing can become an effective weapon to capture that value.

**In order for pricing programs and strategies to be successful, they have to be aligned with a sound business model and a strong corporate strategy which aim at creating and delivering customer value.** Then pricing can become an effective weapon to capture that value. When the business model and the corporate strategy are broken, pricing cannot do miracles and be considered a silver bullet to save the day.

Any customer consulting engagements related to pricing should start with business model and strategic discussions with top executives. Generally, these sessions lead to excellent exchanges on business model innovation, on value proposition and on the relationship between business strategies and pricing strategies.

The PRICING ADVISOR
A Professional Pricing Society Publication
3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

# Thinking Strategically About Price Wars

*In the current economic climate avoiding "price wars" is a top priority for every company, and understandably so as the climate price wars generate prove detrimental to profits, both short-term and long-term, and may threaten the long-term survival of the firms involved. Modelling pricing tactics in a simple game theoretical space sheds light on the nature of price wars. In this article, the author uses recent discussions involving pricing and game theory applications to offer new viewpoints on using these types of models with regards to price wars. Nickolas Cherrier is a consultant at Simon-Kucher & Partners. He can be reached at nickolas.cherrier@simon-kucher.com.*

In the current economic climate few words echo more fear in a boardroom than "price war," and understandably so as the climate it generates proves detrimental to industry profits in the long-term and may jeopardize the very survival of firms involved in it. Modelling pricing tactics in a simple game theoretical space sheds light on the nature of price wars.

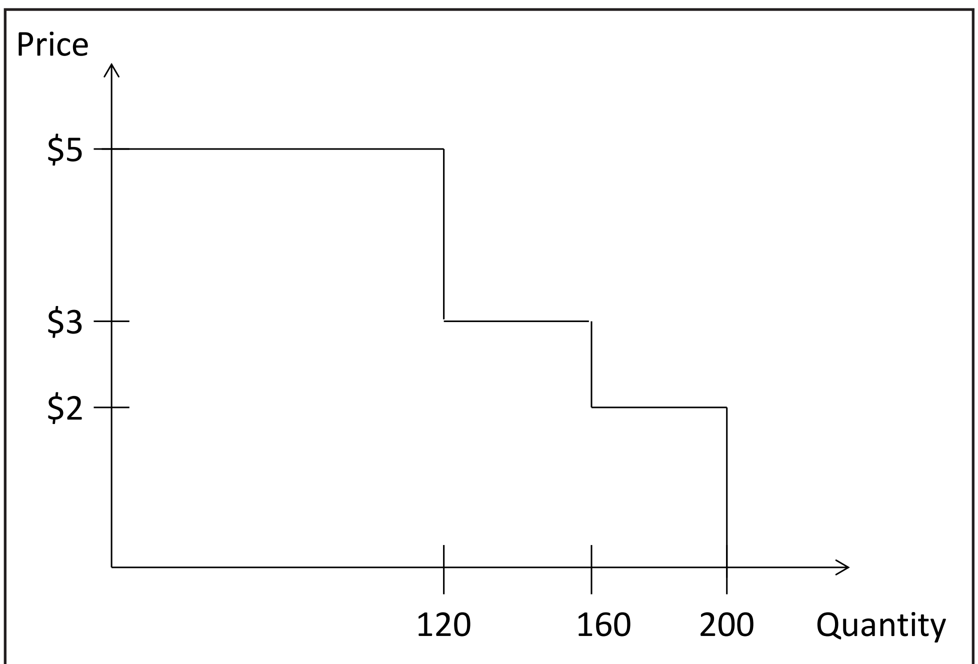
An article entitled "Avoiding Price Wars" was featured in the The Journal of Professional Pricing (Fourth Quarter 2012). Its author attempted to represent pricing tactics in a simple two-by-two prisoner dilemma in order to illustrate the importance of non-price factors such as customer loyalty. His demonstration contrasts with the Bertrand duopoly model in its acceptance of two markets, one elastic and one inelastic. Customers he argues, even in a commoditized market, are not all driven solely by price. The outcome of his model is that the Nash Equilibrium is found when one firm cuts price and the other maintains price.

The above conclusion while significant is overshadowed by flawed assumption. Indeed, while the author introduces an expanding demand as prices decrease, the portion of the market which is inelastic behaves irrationally in the model. When firm A has a lower price than firm B, it attracts 45% of the market segment. When firm A has a higher price than firm B, it attracts 80% of the same market segment. The assumption is therefore that the inelastic market segment has a negative cross-price elasticity. All else being equal, a pure price increase from a firm rarely, if ever, draws-in new customers.

The following representation offers a different approach. Our assumptions are built on two firms competing in a commoditized market. The legal framework insures the game is non-cooperative in nature. Price is the only available variable to achieve the objective: profit maximization. Other non-price constants such as market forces and brand loyalty constitute a black box which directly impacts the market demand. As market prices increase, market demand decreases. Each firm has three price points it may choose from for its good: \$5, \$3 and \$2. Each customer contributes a marginal payoff equal to the chosen price point. 200 customers are willing-to-pay up to \$2, 160 customers are willing-to-pay up to \$3 and 120 customers are willing-to-pay up to \$5 (Figure 1).

Customers have the choice to purchase goods from either of the two firms and, while price plays an important role, it is not the only factor. By assuming that other factors come into play, demand is treated as not fully elastic which results in a softer allocation of customer preferences. If both firms choose a similar price point, the market will be split equally. For the sake of simplicity, the outcomes are mirrored which results in three other potential scenario: (\$3,\$2),

**Figure 1: Willingness-to-pay assumption**



3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

($5,$3) and ($5,$2). For these, the market allocates the market demand in the following ratios respectively: 7:13, 5:11 and 1:4. Payoffs are calculated by multiplying the price point chosen by the demand allocated to each firm (Figure 2).

The outcome of this three-by-thee model is noteworthy when considering there are two Nash Equilibriums in ($3,$2) and its mirror strategy ($2,$3). Given the nature of the Nash Equilibrium, no one firm would be better off with a unilateral change in strategy. Note that the ($2,$2) strategy yields the worst result: 'price war'.

**The implications are threefold:**

1. The co-existence of two different dominant strategies hint to a real-life equivalent of no one-size-fits-all. In this particular model, one firm opts for a volume based strategy while the second opts for a more value based approach. The volume strategy in this outcome is the one which yields the highest payoffs and is therefore the more attractive of the two. This does not mean that a volume strategy is preferable to a value strategy in all cases, just in this particular game. Ultimately price elasticity of demand and cross-price elasticity determine the optimal strategy.

2. This model was set out as a single iteration non-cooperative game. In the business world, pricing does not happen in a vacuum. Firms use their competitive intelligence to predict and react to their competitors. If this game was sequential (but still a single iteration play), thinking strategically the first player would choose $2, forcing the second to choose $3. The existence of a first mover advantage can therefore not be ignored. Firms' actions trigger competitive reactions. Managers should therefore make sure they factor the sequential nature of business into their pricing strategy.

3. Pricing decisions should always be taken with a long term vision. If this game is not played once but repeated over a long period of time, industry payoffs ought to be considered (Figure 3). The industry as a whole would benefit from a ($5,$5) strategy, and indeed both firms would be better off. Unless the market demand is extremely price elastic, or the product is very easily substitutable, industry-wide price increases are always beneficial for all firms in the market.

The last point brings about an interesting question. **If we understand business to be a reiterative sequential non-cooperative game, how can we explain the existence of price wars?** Rejecting the irrationality argument, below are four common reasons:

1. **Market entrants may undercut competitors to establish themselves as price leaders.** This price war scenario assumes a price response from established competitors as they attempt to retain market share.

2. **Hurt yourself but hurt the other more.** Traditionally seen as a Goliath strategy for established market leaders, the aggressor believes it will run its opponents out of business or teach them an expensive lesson.

3. **Short term vision and miscalculations are causes for disaster.** When management are short sighted, the game shifts to a small number of iterations and decisions are made to maximize profits in the short term. Also, markets are not always transparent and customer responses not easily predictable. Miscalculations of payoffs may result in a volume strategy appearing more appealing that it actually is. Undercutting competitors could therefore seem appropriate and may unfortunately trigger a tit-for-tat response.

4. **Profit maximization is not always the objective.** Indeed, as a manager you may be playing an entirely different game from your competitors. In some countries and/or industries market share is held sacrosanct. Firms may be willing to sacrifice profit for share.

In all cases, consequences of price wars are long lasting and detrimental to industry profits. Managers should think strategically about pricing in order to avoid embarking on an unpleasant journey.

**Figure 2: Payoff matrix**

| A,B | $5 | $3 | $2 |
|---|---|---|---|
| $5 | 300,300 | 250,330 | 200,320 |
| $3 | 330,250 | 240,240 | 210,260 |
| $2 | 320,200 | 260,210 | 200,200 |

**Figure 3: Industry payoff**

| A,B | $5 | $3 | $2 |
|---|---|---|---|
| $5 | 600 | 580 | 520 |
| $3 | 580 | 480 | 470 |
| $2 | 520 | 470 | 400 |