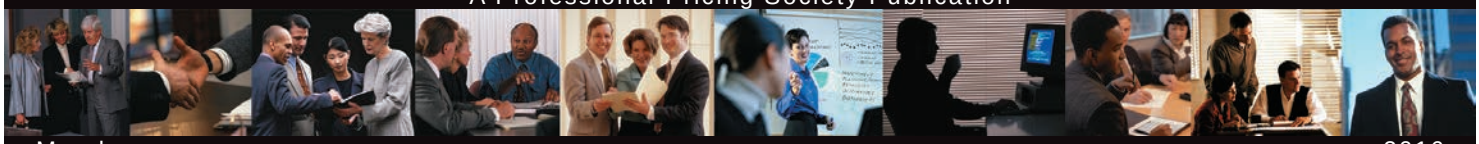
PROFESSIONAL PRICING SOCIETY

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
All Rights Reserved © 2016

A Professional Pricing Society Publication



March 2016

# Pricing Like Grandmasters: 5 Steps to Optimize Cost-to-Serve

*This paper discusses the five steps B2B suppliers should implement to optimize their cost-to-serve. Sudipto Banerjee is a Principal in the Munich office of The Boston Consulting Group. He is a core member of BCG's Marketing, Sales, and Pricing Practice and one of the founding leaders of the Pricing Enablement Center (PEC) initiated in Atlanta. He is currently helping launch the PEC in Europe. He can be reached at Banerjee.sudipto@bcg.com. Steven Greene is a Project Leader in the BCG Chicago office. He has done extensive work with BCG's Pricing Enablement Center (PEC), is part of BCG's Big Data and Analytics Experts Cadre, and built digital pricing solutions in collaboration with software developers. He can be reached at greene.steven@bcg.com.*

Mature pricing professionals conduct a range of analyses to understand customer profitability. In doing so, they attempt to understand the Total Cost-to-Serve (TCS), or the cost of serving their customers, and thereby optimize their spend depending upon the strategic importance and their objective for customers. Conversely, mature procurement professionals also conduct analyses to understand their cost of owning a product or service. The term procurement professionals use to define these analyses in the strategic sourcing approach is Total Cost of Ownership (TCO). This approach may be used to bring all suppliers monetarily at par in order to make the best supplier selection and retention decisions.

Often these analyses are conducted disparately with little shared insight between the supplier and customer during negotiations. Both parties may obscure this information to avoid giving up any "bargaining power" that they assume to have. The result is a less optimal negotiation that discourages value protection. Furthermore, in many cases, these negotiations are held for extended periods of time, thus prolonging the value leakage for both parties.

This paper discusses the strategies that companies should adopt to minimize this value leakage and maximize the win-win outcome. The perspective used in this paper is primarily from the eyes of a business-to-business (B2B) supplier such that they may succeed in their goal to maximize customer profitability.

## Understanding Total Cost-to-Serve (TCS)

**TCS is an analytical approach that uses activity-based costing techniques to identify and understand the costs of producing, marketing, selling, fulfilling, and providing after-sales support to customers.** TCS provides the facts required to work collaboratively with customers to improve profitability and strengthen relations.

CONTINUED ON NEXT PAGE ➔

## 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

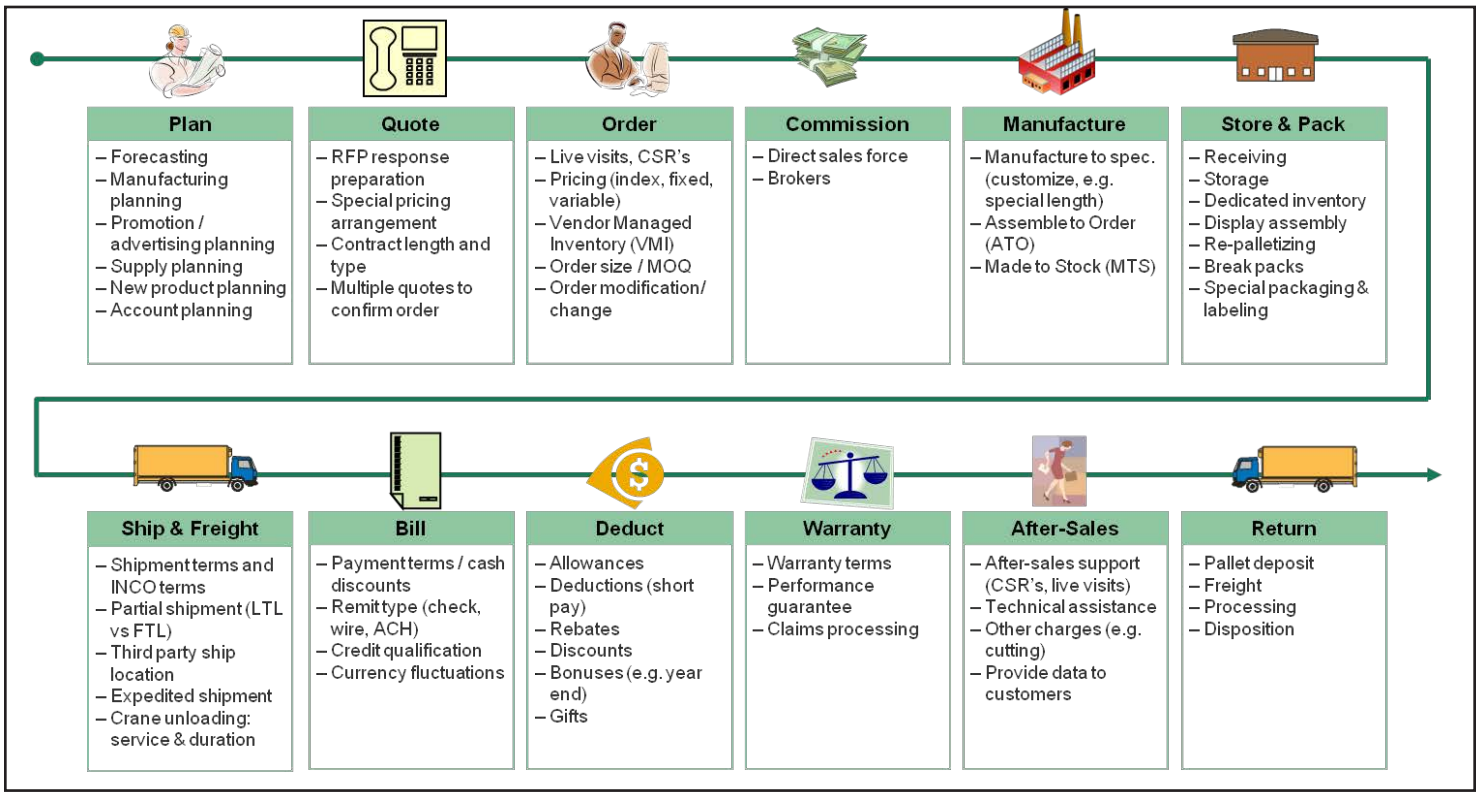
### Upcoming Events

27th Annual Spring Pricing Workshops & Conference – Loews Chicago O'Hare Hotel – Chicago, IL / May 3-6, 2016

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

Figure 1: Plan-to-Return cycle used to understand TCS (Illustrative)




TCS can be typically understood across the various elements of the Plan-to-Return cycle (P2R) for an organization. The 12 major process steps across the P2R cycle provide a comprehensive understanding of TCS. These include planning, quotation and order generation, commissions, manufacturing, storage and packaging, shipping and freight, billing and deductions, warranty and after-sales services, and returns. While the applicability of the service elements across the P2R cycle changes from one industry to the other, in general, many of them remain pertinent.

## Understanding Total Cost of Ownership (TCO)

**The Total Cost of Ownership (TCO) captures the total cost of acquiring, implementing, using, and maintaining the product or solution.** A new kind of procurement professional is emerging – one who seeks to understand the "value received" from the product or service.

This is often understood from the following equation:

**Value received = Benefits – TCO**

Procurement professionals are seeking to increase the value received by minimizing their TCO and maximizing the benefits received. Oftentimes, in their pursuit to decrease TCO, buyers overlook imperative business requirements. For example, a buyer may decide on a monthly shipment to decrease TCO while the business requirement might require a weekly shipment. By opting for the monthly shipment, the buyer may jeopardize production schedules, which could eventually impact customer satisfaction.

## Five steps for B2B suppliers to optimize cost-to-serve

**1. Comprehensively identify and prioritize TCS**: Organizations should rapidly develop the applicability, understanding, quantification, and variability of service elements across their customer segments and the Plan-to-Return cycle and eventually be able to distinguish the profitable ones from the unprofitable (Figure 1). An effective first step in TCS analysis, especially where data is limited, is to lay out the P2R elements to understand which of these services the supplier provides and what they charge their customers for. Start with identifying which TCS elements the supplier is offering to its customers.

In one diversified industrial company, a rapid analysis revealed that while two customers were at par in sales, they had very different cost-to-serve patterns. One of the customers was served more orders, had more out of sphere shipments, had a higher weight per order, and larger cash discount. All of these, consequently, contributed to lower realized margin for that customer, something that managers were not aware of.

**2. Gain cost transparency:** Ideally, before moving into a customer strategy or price-setting exercise for the TCS elements, suppliers will benefit from gaining an accurate, customer-level picture of costs of each of the TCS elements. This provides an accurate view of customer level profitability to fuel annual commercial strategy and account planning pro-

CONTINUED ON NEXT PAGE →

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

cesses as well as a reference point in the price setting process.

Suppliers often use simple allocation schemes for logistics costs and selling costs. As an example, a power cable producer with multi-country operations in Europe allocated its logistics costs based on sales, but would give the same weight to Buyer A with 1 warehouse and "x" logistics costs and another Buyer B with 300 branches and "2x" logistics costs, so long as they have equivalent sales. This simple allocation is not only misleading but dangerous. If, for instance, Buyer A has a marginally worse mix, it may show as worse from a profitability standpoint than Buyer B, despite a 2x logistics cost difference, and could steer volume in the wrong direction during the annual sales processes.

To gain better cost transparency, heavy lifting analytics or client surveys are usually required. At a Medtech company producing laboratory products, logistics costs were allocated to product groups with 90% accuracy using geo-spatial data, INCO terms for the client's buyers to determine who paid shipping, and standard shipping rates, weights, and volume. The SG&A costs within a country were allocated with a workshop-based approach: the sales force broke down time spent across all customer and product groups and applied the appropriate percentages to the total SG&A costs.

**3. Fine tune analysis with consensus workshops:** A common issue facing suppliers is low data transparency pertaining to services provided to buyers. Often it is unclear whether the services provided are charged or not. At the same power cable company, no markets consistently invoiced services other than basic freight to the customer, meaning that few TCS elements appeared in the client's SAP data and therefore could not be traced. The implication was that the commercial leadership could only anecdotally determine if certain services were charged to the customer, e.g. cutting or expedited freight. For this supplier, 4-hour workshops were held in 5 markets with the Sales Directors, Pricing Managers, and Local Finance representation to lay out which services were provided to customers, which were charged, and where there was willingness to pay from the market (Figure 2). TCS elements to charge through to the customer, or leakages to shore up, were prioritized based on where services were provided but not charged, and where there was customer willingness to pay. Immediate opportunities on several technical services provided at the point of delivery were identified as quick win opportunities and were "live" in the market within 1-2 months.

**4. Set customer strategy and prices of service elements**: Fundamentally, there are two tactics for setting prices for these services – leakages and surcharges. When addressing leakages, evaluate for which customers to reduce or eliminate leakages and by how much. This could be established by considering several customer dimensions such as overall deal economics, historical customer profitability, growth potential of the customer, customer share of wallet, or customer lifetime value. For example, a large Technology company reduced the returns quota from 2% to 1% for their smaller, less strategic customers leading to an immediate margin uplift of 50 basis points at these accounts – a big number considering the low margins in their Industry!

When evaluating surcharges, a cost-plus strategy (if the cost of the service element is known) is a good first step, but more value can be extracted by using a value-

CONTINUED ON NEXT PAGE →

Figure 2: Fine tuning analysis with consensus workshop (Illustrative)

| Sales process step | Cost to serve element | Segment A | | Segment B | | Improvement area? |
|---|---|---|---|---|---|---|
| | | Provided by Supplier | Charged by Supplier | Provided by Supplier | Charged by Supplier | |
| Pre-sales | Product samples / test products | ✓ | ✗ | ✓ | ✓ | |
| Manufacture | Made-to-order | ✓ | ✗ | ✓ | ✗ | ✓ Segment x |
| Storing | Required stocking (max lead time) | ✓ | ✗ | ✓ | ✗ | |
| | VMI (Vendor-managed Inventory) | ✓ | ✗ | ✗ | | |
| | Consignment stock | ✗ | | ✗ | | |
| Freight | Orders < minimum order quantity | ✓ | ✓ | ✓ | ✓ | |
| | Less than full truck load (LTL) | ✓ | ✗ | ✓ | ✗ | ✓ Segment x |
| | Expedited shipping/freight | ✓ | ✗ | ✗ | | |
| | Freight to central warehouse | ✓ | ✗ | ✓ | ✗ | |
| | Freight to customer branches/sites | ✓ | ✓ | ✓ | ✓ | |
| Billing | Paper invoices | ✓ | ✗ | ✗ | | |
| | Early payment discount (sconto) | ✓ | ✓ | ✗ | | |
| | Supply Chain financing | ✓ | ✓ | ✗ | ✓ | |
| After-sales | Cutting | ✓ | ✗ | ✓ | ✓ | ✓ |
| | Technical assistance / engineering | ✓ | ✓ | ✓ | ✗ | |
| | Drums | ✓ | ✗ | ✓ | ✗ | ✓ Market x/y |
| Warranty | Warranty | ✓ | ✗ | ✓ | ✗ | |
| | Performance guarantee | ✓ | ✗ | ✓ | ✗ | |

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

based pricing strategy. As an example, the customer service center, sales force, or dedicated technical staff will respond to inquiries from buyers related to their purchasing patterns. Some big customers require as much as 1 day per week from an employee in the finance department to monitor purchased volumes, sales, forecasts, and product offering. These costs are often considered as part of the offering by the buyer, but a better approach for the supplier is to standardize the data, technical support, and customer service support offering then add surcharges for any buyer requirements above and beyond the standard.

**5. Embed TCS in the sales process:** Several projects in consumer and industrial goods industries have revealed that many TCS elements often surface as hidden pockets of value. During price negotiations with buyers, these elements can frequently be a lever to build into the offer, or even into standard terms and conditions of frame contracts, to shore up gaps in target product prices. In negotiations, leverage these as a trade-off or balancing tool: "If you really want us to give you a discount, you have to pay extra for expedited shipment since last year 20% of your shipments were expedited and it cost us $15,000." Very importantly, communicate with confidence: don't apologize! Many times, the discomfort arising from putting strain on old sales relationships between buyer and supplier gets in the way of taking tough, but valuable, discussions on TCS and TCO. Also, build a robust tool that embeds the standardized treatment of TCS into the quoting engine. This would provide the transparency required for your sales force to know, communicate, and negotiate in real time. Train your sales force around the logic behind the tool and the tool itself. Prepare them to win in these negotiations by coaching them through robust use cases (both real and hypothetical) to hone their capabilities. Finally, roll it out with pilot markets or customer subsets and expand from there. To test and learn, a good practice is to start with the long-tail of customers and work your way up from there.

> When evaluating surcharges, a cost-plus strategy (if the cost of the service element is known) is a good first step, but more value can be extracted by using a value-based pricing strategy.

## Closing and summary

There is a compelling reason to establish an end to end view of TCS. Doing so affords suppliers two clear benefits:

1. Developing an accurate picture of customer profitability, which feeds into annual commercial strategy setting and account planning processes, and
2. Equipping the sales force and customer service center with a seemingly endless menu of service elements to use in price negotiations

Experience has shown that companies that can articulate the TCS elements for their business work more collaboratively with customers, have a sales force that more aggressively negotiates on price, and are better at continually finding improvement levers in the sales process. By producing the end to end view of TCS, laying out the largest elements from a cost perspective, identifying gaps on what can be measured with today's data and capability, fine tuning the analysis with a cross-functional team, and developing a TCS systematic solution along with robust sales training, tomorrow's pricing professionals can systematically incorporate TCS elements, one by one, into their negotiation tactics. Doing so leads to an incremental **50 – 100 basis points** of margin enhancement within 12 months, and more in the long term.

Knowledge of true profitability empowers managers to make the right decision for their customers. By controlling their investment on service elements, customer-centric companies can take their profit destiny into their own hands.

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

# Increase Topline Growth in the Off-Highway Vehicle Industry by Optimizing Spare Parts Prices

*In this article, the authors present pricing strategies that pricers in the off-highway vehicle industry can employ to increase profits and cut costs in the fluctuating global economy. This industry-specific analysis provides pricing strategies and advice that can be applied by pricers in multiple industries.* *Antoine Weill is a Partner Elect in the Global Heavy Equipment Practice at the Simon-Kucher & Partners Frankfurt office. He can be reached at antoine.weill@simon-kucher.com. Jan Yang is Managing Director at the SKP Bejing office. He can be reached at jan.yang@simon-kucher.com.*

The global off-highway vehicle industry has been facing severe headwinds in the last few years. China, the global growth engine in the last decade, has considerably lost steam. Sales of construction equipment, for example, is expected to dip year-on-year into the next five years. Other major markets such as Europe and North America are recovering only slowly. The near future of the industry is uncertain and fraught with challenges, especially in terms of topline growth. Overcapacities in production inherited from periods of fast growth, coupled with sluggish global demand, are causing original equipment manufacturers (OEMs) of off-highway-vehicles serious problems.

To navigate the difficult time ahead, many OEMs are taking measures to streamline production processes and slash costs. Unfortunately, they have not paid sufficient attention to the revenue side – the actual core of the issue. **One source of topline growth that is largely overlooked is the aftermarket, which will play an increasingly important role in maintaining topline and profit growth for the entire industry for the years to come.**

Spare parts, and specifically spare parts pricing, is one of the largest levers to drive aftersales performance, and the potential in many OEMs remains largely untapped. It is no easy job and takes a lot to manage the pricing of spare parts effectively. Just imagine there are a hundred thousand stock keeping units, multiple price levels and thousands of customers to be checked and maintained each year.

Leading OEMs in the industry manage to achieve >65 percent gross margin on spare parts while keeping their distribution network financially healthy. They master spare parts pricing by focusing on the following four essential elements: pricing strategy, list price setting, dealer discounts and customer discounts.

## Pricing strategy

OEMs need to have a set aim when carrying out spare parts pricing. Do they want to support sales of goods overall (in other words with low cost of ownership) or do they intend to maximize aftersales profits? The aim will determine the approach. Often OEMs are very much linked to original equipment and services providers (OESs) or independent aftermarket prices, when it comes to competitive positioning. There is no doubt that we will see plenty of ultra-low prices of parts from unidentifiable sources. If that is the base for price decisions, price reductions are inevitable.

Leading OEMs segment their parts into product groups and determine the price strategy of each product group based on a set of pre-defined criteria such as safety relevance, price image, competitiveness etc. (See Figure 1). The resulting price positions are reviewed and validated on a regular basis.

## List price setting

This appears fairly straightforward. Let's assume, for example, the cost for manufacturing and logistics of a company is $100. A 30 percent markup seems decent. So the part is priced at $130. Is it easy? Yes. Is it correct? No, because it does not take market factors, especially customer willingness to pay, into account. There are many well-known examples in the vehicle industry, where OEMs and OESs set prices for their innovations too low and regretted it.

**Pricing is about value extraction. When it comes to list price setting, one needs to really understand which value drivers determine the intrinsic value (list price) from the customer perspective.** Take v-belts for example: the primary value drivers are length and number of belts (single vs. double). Thanks to the regression technique, among other analytic methods, the discrepancies in existing prices can be revealed and corrected to re-construct the should-be prices (See Figure 2).

It should be emphasized that list price setting is very important for professional pricing, as it sets the starting point of what is known as a pricing waterfall (a scheme that depicts all prices along the transaction chain, from list price to end customer price).

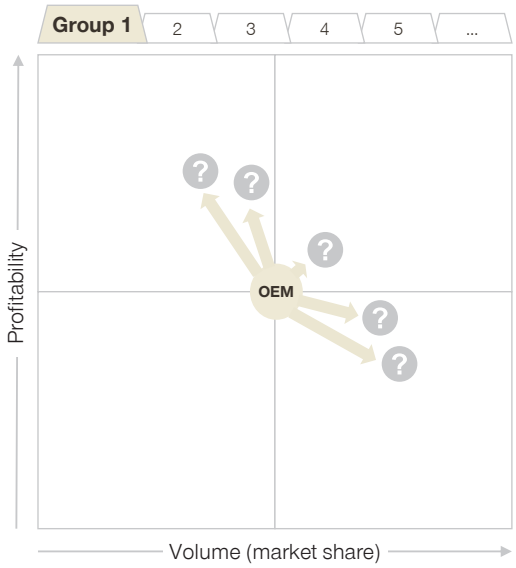
## Dealer discounts

OEMs of off-highway-vehicles rely on dealers for distribution and customer care. Dealer discounts can be used as an effective tool to influence dealer behavior. Unfortunately, in many cases dealer discounts are historically grown and lack logic of any kind. Either there is no differentiation across parts categories or there is huge discount variation for no apparent reason.

There is no one-size-fits-all system. The

CONTINUED ON NEXT PAGE →

Figure 1: Pricing strategy by product group

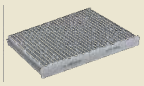



| Macro indicators | Source | Price change indications |
|---|---|---|
| Growth potential | Data, experts | Price decrease – Price increase |
| Competitive positioning | Competitive data | Price decrease – Price increase |
| Perceived vs. real position | Survey, comp. data | Price decrease – Price increase |
| Impact on TCO | Survey, experts | Price decrease – Price increase |
| International price △ | Company data | Price decrease – Price increase |
| Demand elasticity | Company data | Price decrease – Price increase |
| Cost and profit situation | Company data | Price decrease – Price increase |
| ... | ... | Price decrease – Price increase |
| ... | ... | Price decrease – Price increase |
| ... | ... | Price decrease – Price increase |
| **Group orientation** | **Strategy workshop** | Price decrease – Price increase |

- Each product group or aftersales category is rated across relevant macro indicators
- The lower the criticality index, the higher the likelihood prices can be increased (and inversely)

Figure 2: Value-based list price reconstruction

- Diameter
- Width...



- Active carbon (yes/no)
- Size...

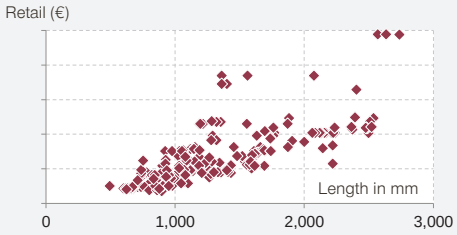
- Length
- Single vs. double belts...

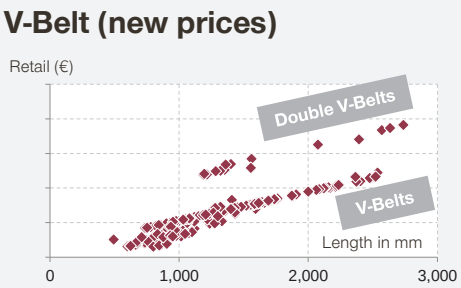
- Fuel type
- Weight
- Pre-heating
- Equipment segment...

- # of cylinders
- Top or bottom
- Steel or alum.
- Sensor
- Weight...

...

- ...
- ...
- ...




**Additional perspectives can be considered, such as customer drivers (e.g. visible parts or not) or market drivers (e.g. demand trend, global competitive landscape, etc...)**

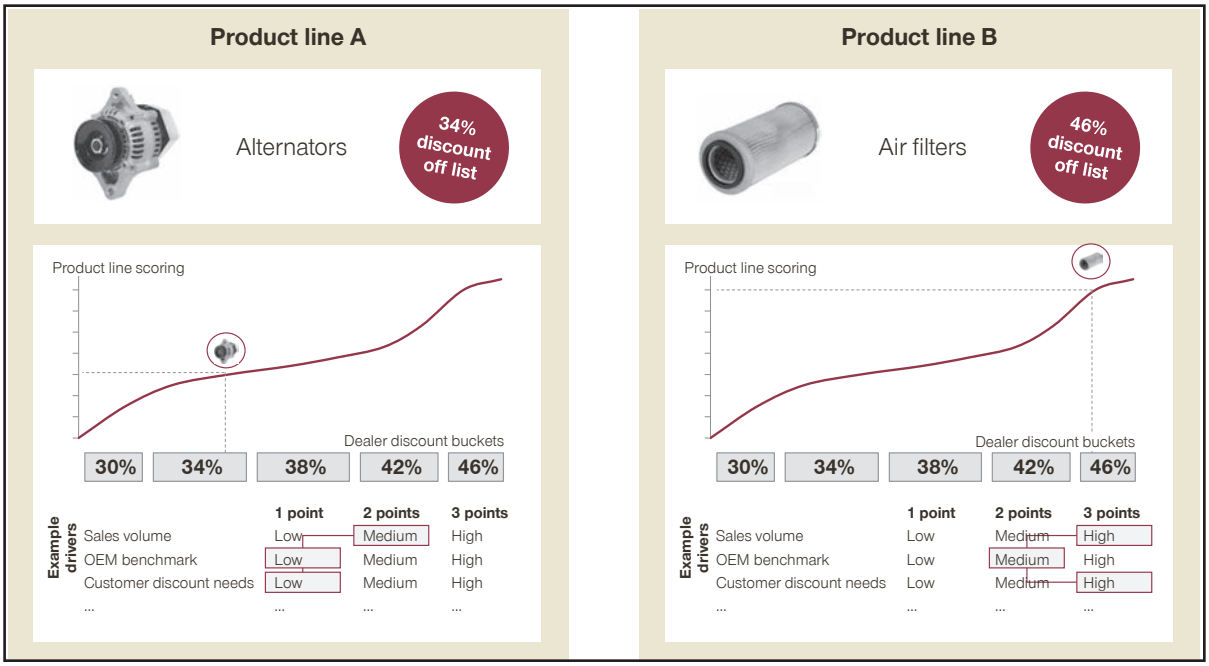
CONTINUED ON NEXT PAGE ➔

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

one that fits is the best. That said, a good discount system comes from knowing what you as an OEM want to achieve and understanding how to get your dealers help you achieve it.

Leading OEMs tend to break down discretionary discounts into discount elements that are clearly linked to certain market indicators and dealer performance. Depending on the parameters of the market indicators (e.g. degree of competitive pressure and dealer performance, realized sales volume), dealers will "earn" the discounts they deserve. In the meantime, they will have the incentive to work harder to earn greater discounts. See Figure 3 for an example.

Figure 3: Market-driven dealer discounts



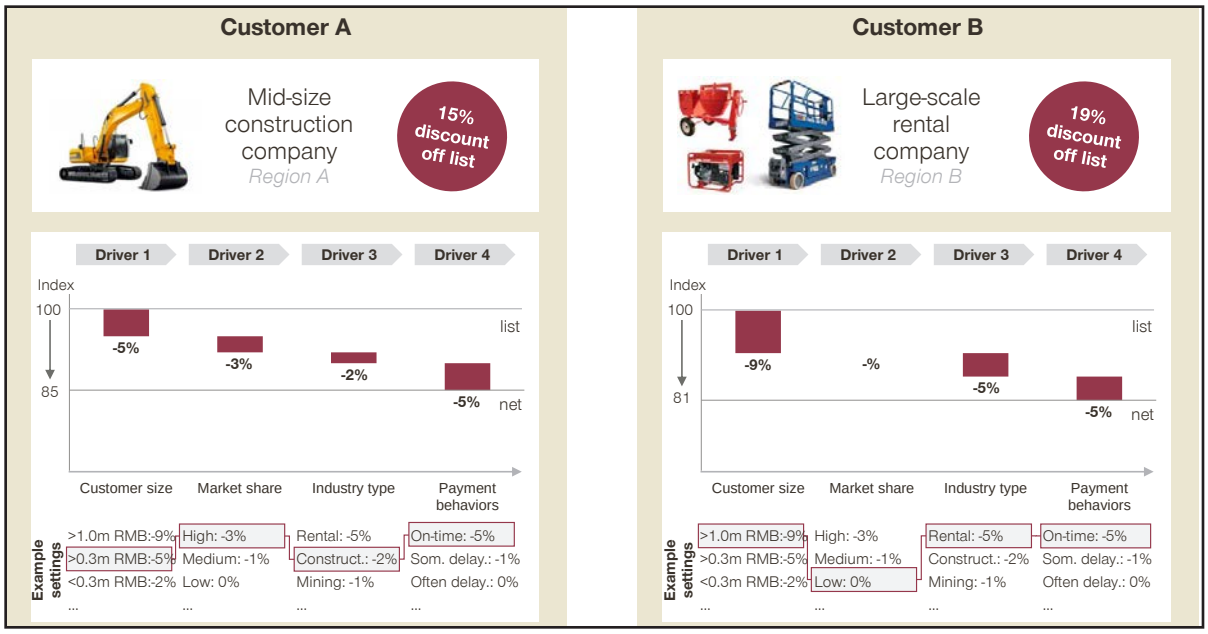

## Customer discounts

Customer discounts form the last step of the price waterfall. In the majority of distribution networks, OEMs have no direct control over street prices. Frequently, customers with similar user profiles in different regions end up paying very different prices for the same spare parts because the dealers do not always think alike – one of the root causes for a grey market. This also often leads to unsatisfied customers.

Although OEMs may not wish to meddle in their dealers' business, best practice shows that OEMs can bring about positive changes to customer and dealer satisfaction, by recommending customer discounts that are, for example, based on explainable customer-specific discount drivers such as sales revenue, sales potential, industry type or historical payment behavior. See Figure 4 for example.

Spare parts pricing is a multi-faceted topic requiring considerable time and effort to manage effectively. But simply put, the main target is to increase prices without harming customer satisfaction, sales of goods overall, and market share. To do this it is important to be aware of where prices are sensitive and where they are not. This is much like pressing a fakir into a bed of nails without hurting him – some parts are more vulnerable, others can take more pressure.

Figure 4: Derivation of deserved customer discounts



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

# Five Value Charts that Make an Awesome First Impression

*One of the keys to implementing successful pricing strategy is equipping your sales team with the proper tools to communicate value to clients and prospects. It is critical for the sales team to focus prospects on the overall value of your product or solution, rather than focusing on price and equating value with discounts or "getting a good deal." In this article, the author shares five chart formats that can help the sales team communicate value in prospect meetings. Author Ed Arnold is VP, Products at LeveragePoint. He directs product design and development and drives the go-to-market strategy for LeveragePoint. He can be reached at info@leveragepoint.com.*

First impressions matter, especially during an initial meeting with prospective customers. They matter because it's your best chance to convince customers that your solution can deliver superior value. But exactly how you communicate your superior value is a challenge when a customer seems unmotivated to change or automatically equates value with getting a great deal.

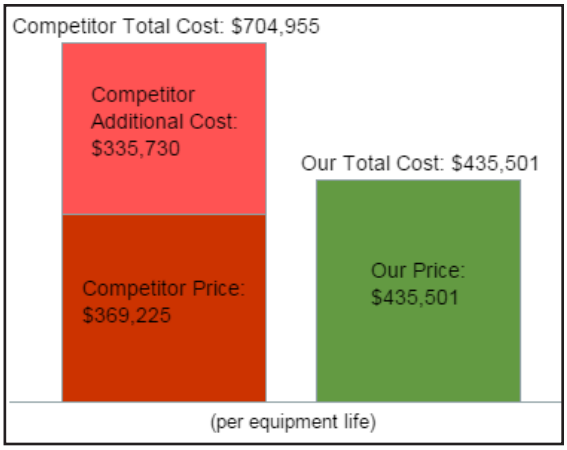
**Your first impression needs to grab the customer's attention by demonstrating a compelling value story that ties your solution to their overall business success.**

A great way to tell the story is with a compelling value chart. Experience has shown that the essential characteristics of an effective value chart are:

- Easy to Understand
- Shows Them the Money
- Highlights Your Unique Advantages
- Opens a Discussion About the Customer's Issues
- Easy to Tweak to Reflect the Customer's Issues (and Your Unique Advantages)

Below are five different charts for taking your prospect's attentions away from price and focusing it on your competitive value that have been proven effective:

Figure 1: The Competitor Hidden Cost Chart



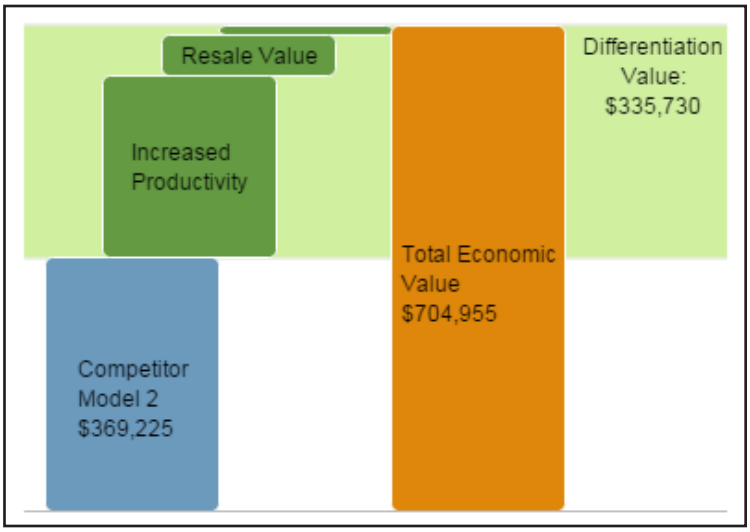

### 1. The Competitor Hidden Cost Chart

The best thing about the chart in figure 1 is that it tells a nice "you get what you pay for" story. Using this, a sales person can confidently make the claim that their solution actually costs less than the competitor when all the true related operating costs are factored in. A chart like this will certainly catch the customer's attention and lead to questions about how the additional costs were calculated, which should be provided in other charts or tables. It's important to keep in mind that although this looks similar to TCO (total cost of ownership) charts, there is a difference. Here, the competitor additional cost is really comparative, not absolute. For example, if part of the competitor additional cost is higher fuel costs, then the amount included is the difference between the competitor and our offering – as opposed to the totals for both. In other words, the fuel costs for our offering would not be included in the green bar on the right.

### 2. The Economic Value Estimation (EVE) Chart

The chart in figure 2 is an excellent choice if your customer is already familiar with value charts such as large OEMs who buy from specialty materials and component manufacturers. Based on the Economic Value Estimation (EVE) methodology, this chart's key feature is the highlighted differentiation value area (light green) and $ amount, which immediately steers the conversation away from your offering price (in fact offering price is absent from this chart). It also sets the stage for a deeper conversation about the specific sources of the differentiation value, namely the specific value drivers (dark green steps). As you can see in this example, increased productivity is a huge value contributor, therefore an obvious place to begin the value discussion.

Figure 2: The Economic Value Estimation (EVE) Chart




### 3. The Value to Customer Chart

The chart in figure 3 is a recent innovation developed

CONTINUED ON NEXT PAGE →

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

after feedback from the pricing community. It combines the best attributes of the previous two charts, namely the specific value drivers and side-by-side price comparisons. A key feature of this chart is explicitly calling out "value to customer." Using this, the sales person can confidently say that the customer gains much more economic value (shows them the money) by using our offering even at a slightly higher price.

### 4. The Multi-Year Financial Chart

The chart in figure 4 works best when your offering is a multi-year capital expenditure. It combines the traditional financial-based investment approach with a value dimension that appeals to financial decision makers because it uses standard metrics of payback and net present value (NPV). So it's a format that is easily understood by these stakeholders. This chart clearly distinguishes initial outlays versus annual costs/value to customer. At the far right there is a dark green bar which shows total value to customer, which can lead to a more in-depth discussion about specific value drivers.

### In Conclusion

Choosing which chart is best for your offering depends in part on your customer and sales process. Some field testing and refinement may be required before you hit upon the right portfolio of charts. Often we find that chart styles evolve over time, so be open to continual improvement.

Therefore, the right marketing and sales tool is essential for producing these types of charts on a timely basis and linking them to other materials.

Figure 3: The Value to Customer Chart

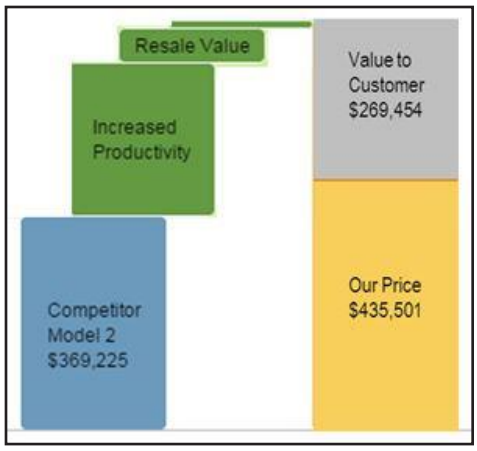
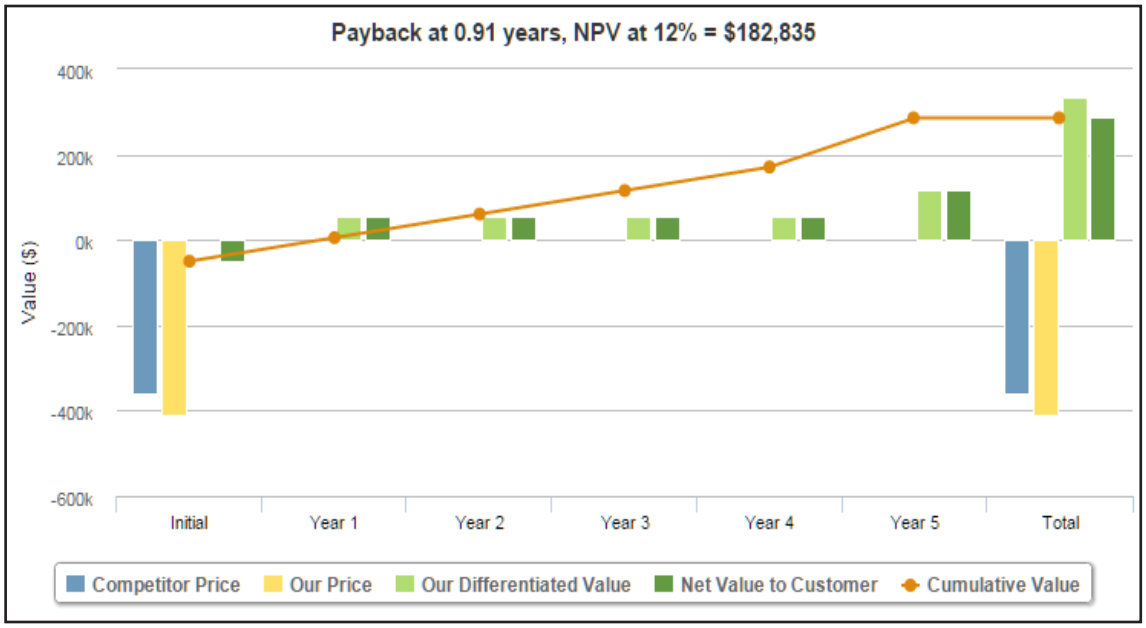



Figure 4: The Multi-Year Financial Chart




### 5. The Total Cost of Ownership (TCO) Chart

Total cost of ownership (TCO) charts, as seen in figure 5, are widely used across industry to show cost comparisons between two (as well as three or more) alternative solutions. All acquisition-related and operating costs are stacked up and displayed side-by-side. The visual implication is that the shortest stack wins and therefore this makes the value story telling a very easy task. So for simple annualized cost comparisons this chart is excellent. However one drawback is that it does not handle either revenue value drivers, or less tangible drivers, like risk, very well.

Figure 5: The Total Cost of Ownership (TCO) Chart