Pricing in a Proliferating World

Juggling thousands—or even millions—of price points, calls for common systems, greater transparency in performance, and an organizational balance between centralization and decentralization. The essay below discusses these challenges in-depth and shows how companies can meet them. The authors of this piece are members of McKinsey & Company's global marketing and sales practice: Kevin Bright (associate principal, Toronto office), Dieter Kiewell (principal, London office), and Andy Kincheloe (associate principal, Atlanta office). This article has been reprinted with permission from *The McKinsey Quarterly*, which is available online at: www.mckinsey quarterly.com/home.aspx.

The exploding number of brands, channels, and distinct customer segments means that many companies must now juggle hundreds of thousands—in some cases, millions—of price points while seeking to maintain consistent pricing strategies and communications across an ever-increasing number of products and outlets. For a broad variety of manufacturers that sell to consumers and businesses alike, this proliferation has made pricing more difficult but the rewards for managing it well much greater.

The proliferation of channels and the microsegmentation of customers have driven the typical consumer packaged goods (CPG) company to create new brands and stock-keeping units (SKUs) as it attempts to limit channel conflict, address unmet needs, and reach for underserved consumption occasions. In extreme cases, some CPG manufacturers with a number of brands and SKUs—selling through various channels at both regular and promotional prices across different geographies—have tried to manage as many as 20 million individual price points each year. In food service, where prices might move on a daily or weekly basis, each transaction may carry a unique price point, elevating the number of pricing decisions to more than 100 million. And sheer transaction volumes aren't the only issue. The introduction of new discount, rebate, and trade allowance categories, combined with customer-specific trade terms negotiated by powerful retailers, has driven down the number of "standard" transactions, further complicating price management.

The environment of business-to-business companies is no less thorny. A leading manufacturer of lighting equipment, for example, manages more than 450,000 SKUs across ten major brands as it tries to meet local market preferences and remain nimble in the face of increasing domestic and overseas competition. Direct-sales representatives, key-account-management teams, and third-party agents sell these products to contractors, local distributors, distribution chains, consortia of small distributors and retailers, and, not least, large home center chains. With more than three million pricing opportunities annually, the challenge of making the right pricing decision every time is enormous.

Traditional models for managing prices are clearly inadequate for these and many other situations. Distributed responsibility for pricing decisions across functions and geographies leaves no one managing the total price-profit-volume equation. Without a common process for making pricing decisions across different brands and channels, as well as a common set of data to support these decisions and monitor performance, pricing becomes unmanageable. The results are inevitable: pricing performance varies enormously among business units, channel conflicts lead major customers to demand price protection, and brand managers compete among themselves for the same consumers and shelf space.

In light of these issues, we explore here the new operating model many companies need to realize the full potential of today's state-of-the-art approaches to analyzing and improving pricing performance.[1] [Editor's note: See "Creating Consistency" on page 18 for a detailed look at pricing new products.] The model has three characteristics: better visibility into pricing performance and clearer performance standards; a common system for pricing across brands, channels, and segments; and organizational balance, with a central pricing group that integrates the model throughout the company but doesn't make every decision. In many cases, the model will require substantial changes in the way companies make daily pricing decisions, as well as changes to systems, organizational roles and responsibilities, performance metrics, and incentives. Making these changes stick calls for real dedication and, frequently, a new performance culture focused on pricing.

Visibility into the Performance of Pricing

For many companies, generating even simple bottom-line price and margin reports for individual customers or SKUs is a monumental task exacerbated by the proliferation of brands, channels, and segments. Companies frequently find themselves with a variety of systems that capture key pricing data. Integrating the data is difficult and time- consuming—and therefore rarely done. With so little information available centrally, it isn't surprising that sales forces have even less information when it is most critical—at the point of negotiation. Few companies have tools to help the frontline sales force manage or improve pricing.

This lack of visibility increases the likelihood of wide variations in price points for similar products across disparate channels and customer segments. What's more, the level of discount offered usually isn't related to the size or importance of individual customers, as might be assumed, and raises the risk of channel conflict and arbitrage. In industries ranging from CPG to building products to commodity chemicals, examples abound of very small customers receiving huge discounts and, invariably, of companies serving unprofitable customers. In some cases, the variation among accounts is so significant that companies fear that imposing greater order and structure on frontline pricing could disrupt their business.

Given the importance of incorporating clear information as well as the growing need to bring pricing decisions closer to customers, an integrated database and frontline tools for pricing are essential ingredients of success. Unfortunately, despite the increased sophistication of pricing software, companies still have great difficulty extracting the insights they need to improve their performance in this area.

The information required to develop these insights—product volumes, list prices, promotional spending, trade allowances, payment terms, and data on the cost of products, for example—typically resides in a broad array of isolated systems run by finance, sales, logistics, and customer service. At the lighting company mentioned earlier, for instance, managers had to pull data from more than 35 sources to develop a comprehensive profit-and-loss statement for products and customers.

Since compiling and integrating so much disjointed information is a daunting and time-consuming task, it's not surprising that many businesses lack even the most basic insights into profitability at the more granular levels. This failure can prevent the best companies from optimizing their pricing and discount levels. How can you manage pricing when you can't compare net prices across markets or don't know whether a particular price level will leave you with a profit or a loss? Since a one percent shift in overall prices can affect profits disproportionately, rules of thumb and gut instinct aren't sufficiently reliable for fine-tuning prices.

Creating Transparency

The answer is to combine a laser-like focus on the most important information needed to make pricing decisions with a simple process that integrates this information so that salespeople can use it. One leading beverage company regularly captures and synthesizes accurate field pricing data, including prices, promotions, and shipments at the retail level. This company also enlists its vast field sales forces to calibrate pricing on a market-by-market basis. By methodically capturing information in a pricing database and support tool, a company creates a consistent set of data to guide its decisions and measure their impact. Both aspects are vital, since visibility and accountability go hand in hand. A Fortune 500 building-products manufacturer, for example, saw that the amounts paid by customers receiving its highest and lowest prices varied by more than 40 percent, even though its products were largely considered commodities. This company faced a common problem: a strong traditional focus on volumes combined with scant pricing data meant that the sales force drove down prices to win deals. Once the company installed a relatively simple software package to integrate its pricing data, it could institute a compensation structure that rewarded gross margin dollars and percentages (in addition to volumes), thereby improving the alignment between the incentives of the sales force and corporate profitability.

After creating visibility, a company must bring this information to bear on decisions. Consider, for example, the very large distribution company that designed a new process its sales reps could use in making on-the-spot pricing decisions. This process not only used discount guidelines that varied by account type, product type, deal size, and geography but also provided for decentralized—though consistent—decisions. *To work, however, pricing guidelines for the company's 30,000 products had to be easily accessible to more than 1,000 salespeople. The answer was a relatively simple frontline pricing tool that showed sales reps the range of their pricing authority and displayed historical pricing for the customer at hand as well as recent pricing for comparable accounts.*

The pricing tool, supporting interactions between the frontline force and the central pricing group, was a critical link in the new process. Whenever sales reps wanted discounts outside these guidelines, the tool alerted these individuals to forward the deal to the central organization for evaluation. Discounts beyond the guidelines were rarely approved, and competitive pricing data played a key role in evaluating these requests. By centralizing the decision-making process for exceptional cases, the organization minimized unnecessary discounting and reduced the frequency of frontline pricing disparities—including those among separate locations of large national customers—for highly visible SKUs.

Understanding Trade Spending

Software that makes the impact of trade spending more visible can also improve the performance of pricing. Many CPG manufacturers annually manage hundreds of thousands of individual promotional events or other initiatives across a wide range of retailers, brands, and SKUs. The return on these investments varies a good deal. Usually, it is correlated with some combination of promotional price, duration, frequency, the use of point-of-sale displays and features, geography, customer, product, and time of year. Combining internal shipment and trade-spending information with syndicated store data linked to each event is tedious and time-consuming. As a result, most CPG companies measure the performance of only a very small percentage of their events, and even these efforts are inconsistent, since they vary from account manager to account manager.

Some leading packaged goods companies, by contrast, have made the return on their promotional investments a key component of the pricing system. To examine more events, these companies have deployed promotion analysis tools that provide regular and consistent measures of the way events perform. Such tools give the frontline staff immediate feedback that guides future investments. The companies can also review and synthesize their events centrally, which helps them to develop better overall promotional strategies and to allocate funds across brands, channels, and customer segments more effectively.

Institutionalizing Core Pricing Processes

If a lack of visibility makes it difficult to monitor and enforce good pricing, inconsistent processes across an organization further complicate the execution of pricing. As the products and channels of companies become more complex, each silo within an organization develops its own approach to making important pricing decisions, such as pricing new products, negotiating the pricing of deals, and managing trade funds. Without consistency across the organization, a company can't leverage best practices, shift and promote talented workers effectively, or present a uniform image to customers who make purchases in a number of product categories, often from different salespeople.

To ensure consistency across silos over time, it is critical to identify and standardize the two or three most important pricing processes and to institutionalize them across the business. *By formally establishing a consistent set of core pricing processes, companies can deploy best practices and process improvements more quickly and make key pricing and promotion decisions more transparent.* Other benefits include predictable planning cycles, standardized communications to key retail and distribution partners, and a system of internal checks and balances to avoid poor decisions and potentially illegal pricing actions.

The Process Problem

The pricing of new products offers a clear example of the challenges generated by the traditional disarray and shows how an embedded pricing process can address them. New brands, products, and packaging have proliferated as companies respond to changing consumer tastes and shifting retail dynamics. Such companies commonly introduce their new products at price points near those of their existing ones, thus cannibalizing the portfolio. Instead of increasing their market share, they divide it among a larger number of SKUs, each competing for the same shelf space, consumer acceptance, and internal resources. Ironically, considering how critical these decisions are, companies often set prices for new products on an ad hoc basis just before they hit the market, with limited or no pricing research to support them.

Manufacturers selling to businesses face an equally profound problem, which frequently stems from introducing new versions of products without effectively retiring the older ones. The net effects are increased inventory costs, greater management complexity, and declining production efficiency. A major medical-device manufacturer's experience shows some of the problems. This company faced very short product cycles, usually lasting 12 to 18 months. Whenever it launched new versions of a product, it aimed to shift 80 percent of the sales volume to them within 6 months. Yet the company also continued to sell older versions and allowed the sales force to offer deeper discounts to make them attractive to interested customers. These price cuts encouraged such customers to stay with older products. In addition, the company risked dragging down the price of new products, since such heavy discounting could have tarnished the value perception of an entire line. Despite annual R&D investments of hundreds of millions of dollars, the average price for every product line the company offered was declining each year.

Manufacturers selling to businesses face an equally profound problem, which frequently stems from introducing new versions of products without effectively retiring the older ones.

Creating Consistency

Companies can respond to these challenges by institutionalizing a pricing process for their new products as part of the pricing system. A leading consumer electronics firm showed how this can be done in the face of common obstacles. The company sold a range of products targeted at different customer segments that frequently overlapped. Further complicating the picture, each product group had its own manager and its own approach to product pricing, and there was relatively little interaction among silos. To create consistency across the entire organization, the company established a new process—used by all product-management teams—based on four core principles:

1. Pricing must play a role early in the product-development cycle, and any new product must either address a portfolio's gaps (such as price point gaps or underserved segments and channels) or explicitly replace an existing product.

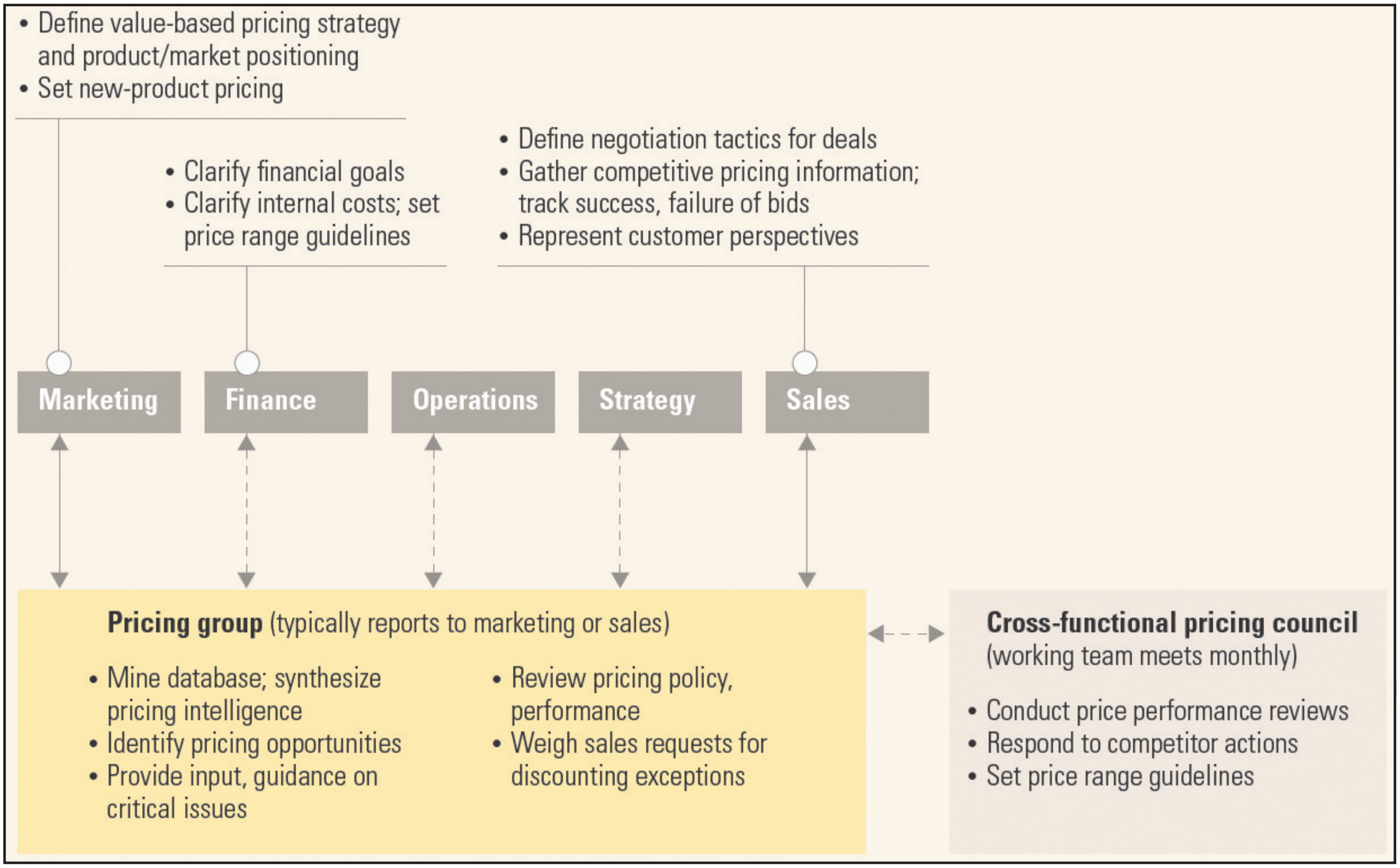
2. New-product introductions represent opportunities to increase prices overall.

3. Whenever possible, product managers must commission research on consumers to understand their price sensitivity and the perceived value of a product relative to competing alternatives.

4. Plans to introduce any replacement product must include a clear strategy for the end-of-life management of the existing one.

These four principles became the centerpiece of a clear process the company could repeat again and again to manage the pricing of new products throughout its portfolio. The process led not only to better pricing decisions for individual products but also to a more cohesive product portfolio, with fewer conflicts and less redundancy.

Exhibit 1: Integrating Pricing Strategies (Pricing Organization Model, Selected Activities)



Pricing new products is just one example of the kind of core pricing processes that companies can standardize across their operating silos. Each company should identify the two or three most critical pricing decisions it faces and focus its efforts on institutionalizing the processes needed to make them. By concentrating investments in process design, training, and support systems on relatively few pricing processes, companies can build capabilities that truly differentiate them from their competitors.

Striking an Organizational Balance

As companies try to make their pricing performance more visible and to institutionalize core pricing processes, the question of who manages and maintains the infrastructure becomes increasingly important. If most pricing decisions remain decentralized, who makes sure that strategy and tactics are integrated across brands, channels, and segments? Who maintains the central pricing database and mines that data to create reports and identify pricing opportunities? Who trains the organization's people in the elements of the pricing system? Leading companies have answered these questions by creating a central pricing organization—a center of pricing excellence—that maintains basic systems and functions and can collaborate with the rest of the company (exhibit 1).

Top of Form

To be effective, the pricing organization must be led by a full-time manager who is well respected within the company and has strong interpersonal skills, since the role involves frequent work with sales, marketing, finance, customer service, and operations. While the organization needn't be large to be effective, it must have the ability to perform several key functions. First, it should mine the database and produce regular reports for top managers. Second, the group must collect and synthesize pricing intelligence, which may include consumer research, market studies, and publicly available information about competitors. It may also weigh exceptional discounting requests from frontline sales reps and make recommendations or even final decisions. Last, the organization could be charged with identifying pricing opportunities and leading cross-functional teams to capture them. Whatever its responsibilities, its roles and objectives must be defined clearly.

Collaborating While Selectively Centralizing

A close look at a case involving a leading consumer electronics manufacturer highlights several key roles for a central pricing group. This company, a leader in a nascent but rapidly growing product category, has fewer than a dozen major products on the market. All have a very short life cycle, and prices can vary widely depending on the sales channel. Each product once had separate managers, as did each of the company's three major channels: distribution, retail, and key accounts. Product managers were responsible for managing the price level and trajectory of their products, and channel managers had relatively unfettered authority to discount products to their customers. The results were predictable: unclear product positioning, cannibalization, significant price variations for individual SKUs, internal tension between sales and product management, and margins that contracted quickly as products matured and were discounted in channels.

To begin addressing these issues, the company created a pricing organization staffed by a pricing leader and two pricing analysts. The organization's first job was to craft an overall pricing strategy to guide the positioning of the company's products relative to competitive offerings.

Next, the organization worked with the consumer insights group to commission external market research, which could be repeated annually, on the entire product portfolio. Of particular importance was the development of price elasticities and cross-elasticities for each product.

After developing this data, the pricing group worked with the product managers to reset prices for the company's entire line. That repositioning alone increased the company's operating margin by more than 20 percent. Then the pricing group took the new price list and developed a set of guidelines and a consistent process for discounting across all channels.

In addition, the group developed a set of standard reports that provided the sales force and management with feedback on overall pricing trends, the attainment of prices for each major market and region, competitive pricing dynamics, and the performance of individual products. The net result was a more cohesive and coherent approach to pricing, from top-line strategy to frontline execution.

Coordinating Action through a Pricing Council

More and more, companies are supplementing the pricing organization with a cross-functional pricing council, typically chaired by the pricing leader and including executives from brand, product, sales, and channel management and from customer service, finance, and operations. Meeting every month or two, such a council serves as a central clearinghouse for pricing issues. Among other things, it resolves conflicts across sales and operational silos, refines and coordinates strategy for pricing, reviews the performance of pricing, and responds to major competitive moves. It also identifies broad pricing opportunities—such as across-the-board price increases or the repositioning of the whole portfolio—that cut across multiple brands or channels.

Opportunities to capture value by differentiating prices across proliferating brands, regions, channels, and SKUs are too large to ignore, while the costs of neglecting these opportunities or of trying to address them with piecemeal efforts are substantial. With a new model for price management, companies serving consumers and businesses alike can enhance the role of pricing as a strategic and tactical lever for creating value.

Notes

[1] For a comprehensive treatment of pricing strategies and tactics, see Michael V. Marn, Eric V. Roegner, and Craig C. Zawada, *The Price Advantage*, Hoboken, NJ: John Wiley & Sons, 2004.