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MAKING SCIENTIFIC PRICING ACTUALLY DELIVER

Capabilities, enablers, and margin uplift

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“I know there is a better way to do it, and I know that pricing can be the biggest thing we do this year to drive profits, but I’m not sure where to begin”.

– PRESIDENT OF A $2BN DISTRIBUTOR

3 Capabilities:

An understanding of...

- Cost dynamics and profitability
- Empirical price sensitivity
- Local price competitiveness

3 Enablers:

- Powerful yet practical pricing science
- Engage the business, particularly the sales force
- Organization, processes and tools to make it sustainable

Up to 3 points of margin

You may be in a similar situation: you may have experimented or trialed different ways of pricing; you may be unsure if you are using the right tools; you may be asking if you have a team with the right capabilities to win.

Adding to the uncertainty:

- Opinions in your business may be running strong about what has worked in the past or apparent lessons from other industries.
- You may be cautious about importing ideas from consumer sectors as pricing in those businesses has few similarities to a complex business-to-business (B2B) distributor.
- As your sales mix shifts to more services and solutions you realize that your approach to pricing products has limited relevance to your new offerings.
- You may also be considering a software solution that will 'solve your problems', but worry that it's going to be a 'black box' that you have little visibility or control over.

This paper summarizes the best approaches we have seen distribution companies use to improve pricing, and outlines a basic methodology which we have seen work successfully many times. The key? Firstly, developing a robust understanding of the powerful and practical science behind pricing, specifically: your cost dynamics, price sensitivity and local market competitiveness. Secondly, engaging the business – particularly the sales force – in the solution. Thirdly, building pricing competence at the corporate center, including better processes and decision support tools to sustain the benefits.

The focus of the paper is on the mass of mid-size customers which can make up 50%-80%+ of distribution businesses. Not the 'national accounts' or 'strategic partnerships' which due to their importance are always carefully negotiated one-offs.

WHY PRICING IS WORTH THE EFFORT: COMPLEXITY = OPPORTUNITY

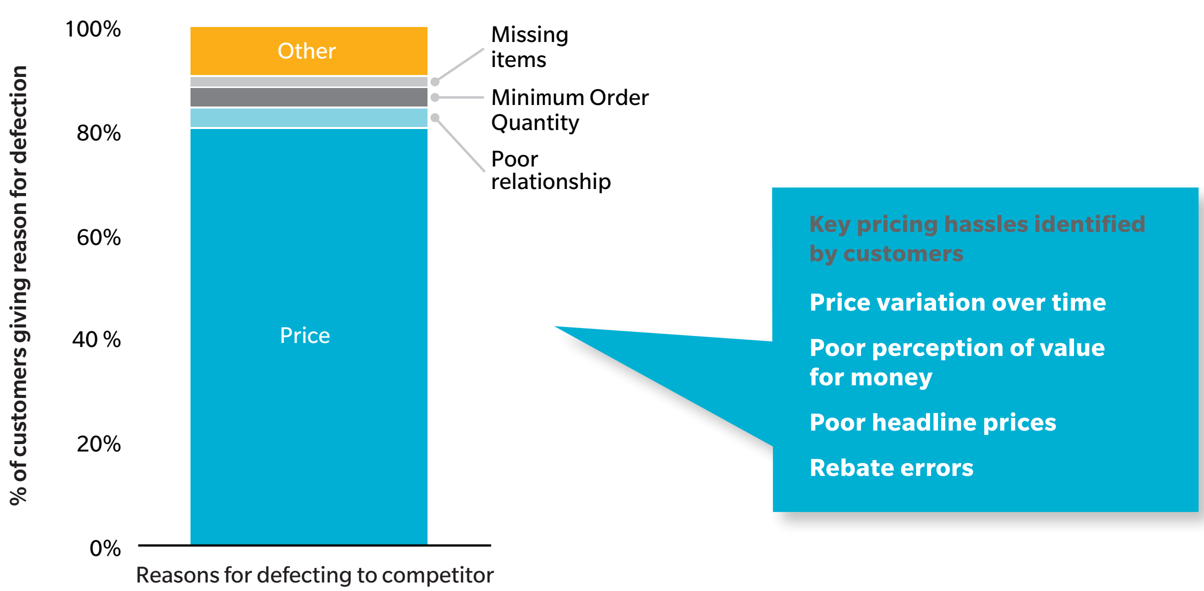
Simple principles
Complex analysis
Simple outcomes

Distribution businesses are extremely difficult to price well because they combine high degrees of complexity (1000s of products, many sites, many markets with different competitors, 1000s of customers), with the structural challenge of a distributed sales force with differing pricing beliefs and capabilities, complex terms and conditions, and customer specific propositions. Yet getting pricing right is critical: Figure 1 shows that in a typical distribution business pricing is cited by up to 80% of customers as the reason they switched suppliers.

After working with many distributors in recent years, we have learned something about cutting through this complexity to craft a practical pricing regime that works. It is based on simple principles, keeps only the required complexity contained in the center of the organization, and actually makes the sales force's life easier. In addition, it enables a critical role for senior business leadership to be able to steer pricing in a genuinely strategic way – either to take share without sacrificing margin, or to take margin without losing overall share and competitiveness.

FIGURE 1: In this distributor, 80% of lapsed customers cited price as the main reason for their departure

Reasons for switching foodservice wholesaler (survey)



1. POWERFUL YET PRACTICAL PRICING SCIENCE

The distribution companies with the best pricing outcomes are those who have a clear plan for shareholder value growth. They have selected a specific 'trade off' of margin growth vs revenue growth, and they are thoughtfully driving the business via a targeted mix of the elements below:

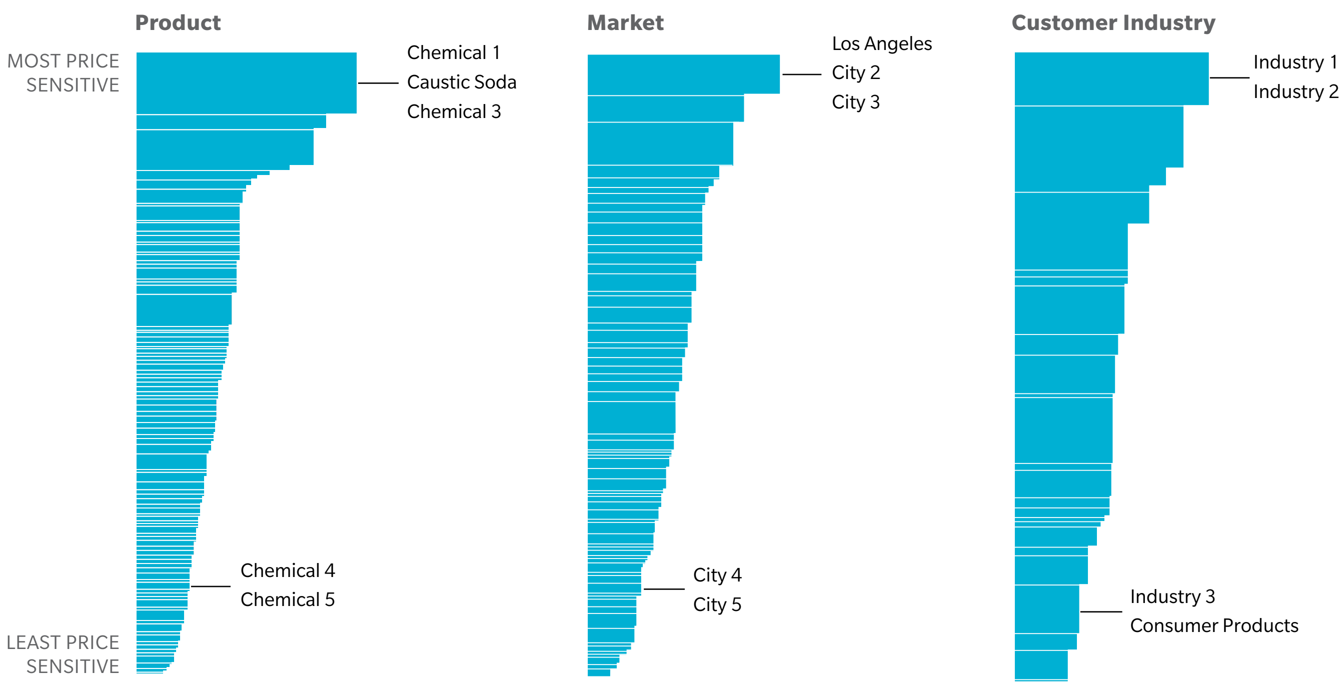
- New customer acquisition: Attracting and retaining more valuable customers, and increasing share in the most attractive customer segments
- Growing share of customer spend: Pro-actively cross-selling the right incremental products and services
- Mix management: Improving the mix of products and services sold, and up-selling to increase margins, particularly for low profitability customers
- Cutting churn: Rewarding valuable, loyal customers and retaining their business
- Cutting unnecessary price giveaways: Getting product prices right, and reducing margin leakage by the sales force
- Reducing cost to serve: Encouraging "win-wins" using rebates or fees to incentivize customers into lower cost to serve behaviors such as online ordering, alternative delivery slots, etc.

There are 3 key required capabilities to develop before you can set the right targets and manage your sales force to achieve them.

1. A solid understanding of cost dynamics and profitability. This doesn't mean "cost plus" pricing. Instead, it means having a detailed knowledge of all cost-to-serve components and dynamics, across all of the services and products you offer, and where you are really making money at a customer, product, and vendor level. This is the true foundation on which all pricing improvements stand. Data for this analysis usually exists, but is not always well used and understood.

2. An empirical understanding of price sensitivity. This is about how customers will respond to changes in price vs competitors in the market for specific products. Products, for instance, are never uniformly price sensitive. Customer responses typically vary in predictable ways according to factors such as overall item value, purchase frequency, degree of 'commodity v specialty', market share, and local competition (see Figure 2). Getting these factors right and pricing with as much specificity as possible in each customer-product-local market situation is the key. Real time pricing experiments are the best way to quantify price sensitivity, but a great deal can be achieved with good data, thoughtful models and experience.

FIGURE 2: Price sensitivity is not uniform... products can vary up to 10x in their sensitivity to price depending on which customers are buying them and in which markets you compete. This figure shows an example from chemical distribution.



3. Robust tracking of competitive prices. In B2B businesses, because much pricing is negotiated and 'private', competitive information feels hard to get. Yet we have found that much more data is already readily available than you might expect. Sources include capture by the sales force (e.g. in 'meet or beat' bid processes), published prices (particularly online catalogs), and competitor cost analysis.

Distributors with these 3 foundational capabilities are then in a powerful position to steer the business to better pricing outcomes. For example, low price sensitivity products, where margins are low and prices are below competition are obvious candidates for price increases.

2. ENGAGE THE BUSINESS, PARTICULARLY THE SALES FORCE

Too often we have seen pricing initiatives and tools created at HQ and ‘thrown over the fence’ for product or sales managers to implement. Unsurprisingly, the typical result is a high degree of skepticism from the field, low usage of tools, and limited if any impact.

How then to avoid this all too typical outcome? In our experience there are four key elements.

Decision support, not decision control

First, position the program as being about ‘decision support’ not ‘decision control’. The role of HQ is to enable each sales professional with pricing intelligence from hundreds of similar customer-product pricing outcomes, distilled into a simple target price range for that unique situation, alongside a select number of other key insights. It is then the job of the empowered sales professional to achieve the best pricing outcome they can, as they and only they are in discussion with that customer in that individual competitive context.

By the field, for the field

Second, share ownership of the journey. Fully engage senior sales leaders early on in program objectives and approach. Start with how the field are trying to do their jobs today, listen hard to their requirements and frustrations, and actively design the new processes around how they need to work. In our experience, the most successful programs adopt a ‘by the field, for the field’ mind-set in which a truly representative group of sales colleagues are deeply involved in process and tool design.

Agile development

Third, adopt an agile development approach. Once the science is cracked, get the first version of processes and tools designed and working in weeks, not months or years. Try them out with the field. Iterate and improve on a weekly-cycle, and get a full local pilot up and running a few weeks later. This enables much greater and faster learning, as well as hugely improved time to value compared to a traditional development process with many months to collect requirements and then many more months to design, develop and test remote from the field, before then releasing something that typically disappoints. The other key benefit of an agile approach is that the field are actively engaged, feel listened to, and foster a strong sense of ownership.

Visible quick wins

Finally, get some visible quick wins early. Stories of successful pilots and first waves of re-pricing should be shared broadly in the organization. Sales colleagues who are achieving stronger sales, better margins and greater incentive payments will tell other colleagues who are not part of the pilot. Word spreads and excitement builds. At this point the change process becomes straightforward as the new processes and tools are literally ‘pulled’ by other sales colleagues who want to adopt the new approach and share in the success.

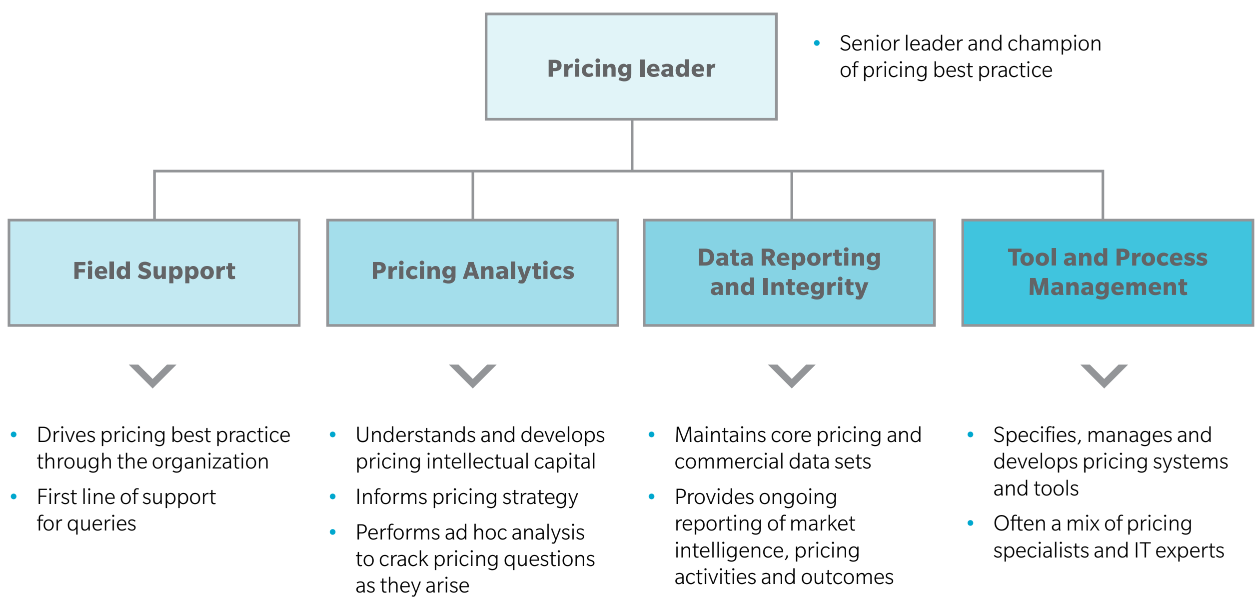
3. MAKE IT SUSTAINABLE: PRICING ORGANIZATION, PROCESSES, TOOLS, AND INCENTIVES

Getting the foundations built to support a robust pricing approach and engaging the business is only half the battle because pricing effectiveness is not a one-time fix. Distributors with the strongest pricing outcomes build sustainable capabilities to maintain pricing advantage versus competitors.

ORGANIZATION

Because many businesses lack a competency center for pricing, a common question is “what should our pricing team look like?” Best-in-class pricing is a difficult, technical, and quantitative capability that requires real expertise. The job of the pricing team is to own the science and tools, and to champion the processes and disciplines behind them. (See Figure 3). A very rough rule of thumb in complex distribution businesses is that each $250 million of annual revenue requires an additional full-time equivalent (FTE) specialist in the pricing team. The pricing leader needs to have senior status in the organization – comparable with any functional director or the SVP of sales – because he or she will have critical influence over business performance.

FIGURE 3: Example structure and roles within a pricing team



PROCESS AND TOOLS

The market for B2B pricing software remains fragmented with no accepted standard. In our experience, the tools that deliver the greatest value to the bottom line and fastest time to impact have been those with ‘agile’ builds that were driven in-house or by selected third parties in close collaboration with pricing decision makers.

There are several reasons why this approach seems to yield the best results. The main learning is that such agile builds – designed around the unique characteristics of the business and how the field need to work – can be powerfully energizing for the sales force. When compared to a lengthy configuration of off-the-shelf pricing software with already designed-in processes, the difference is stark. As one sales leader recently told us of an agile build, “It saved me time, helped me win more business at better prices, and made me more money. What is there not to like about that?”

A final critical learning is that, in distribution businesses especially, pricing logic should be kept outside the ERP. We have seen too many distributors either desperately frustrated because the legacy ERP cannot support the new pricing model or worse, many tens of millions of dollars over-spent on a new ERP implementation because of unnecessarily complex pricing logic built into their ERP where it does not belong.

INCENTIVES

Finally, distributors need to appropriately align sales incentive plans (SIPs) with pricing as well as sales objectives. Schemes with a low variable component and those that enable incentives to be earned several years after the original sale was made typically do little to drive focused growth. Similarly, SIPs that rely on sales colleagues having full visibility of gross margins tend to drive cost-plus pricing behavior at relatively uniform margin rates: as sales professionals always want to make the sale and typically have in mind a particular ‘minimum acceptable’ margin % that they can drop to.

In contrast SIPs with a significant variable component linked to differentiated pricing targets or 'deal scores' can be very effective at driving both sales and appropriate pricing behavior. However, there is never a single right answer to incentives. Typically SIPs evolve over time as both business objectives and the ability to report frequently on specific sales and pricing metrics evolve.

Agile builds can be powerfully energizing for the sales force

Pricing logic should be kept outside the ERP

FIGURE 4: Alternative approaches to pricing tools. Quite different approaches and outcomes that are often not well understood.

	Traditional pricing software	**Configure Price Quote**	**Build: In-house IT approach**	**Build: Agile approach**
Business objective	End-to-end price management	Complex offer price control	Control our own destiny	High impact decision intelligence fast
Pricing intelligence How smart are the prices? Do they drive margin/volume impact?	↑	↓	Addressed separately	Addressed separately
Process simplification Is the solution user-friendly? Does it improve the speed of quoting?	↔	↔	↔	↑
Business customization Is the solution customizable for specific needs of your sales force and customers?	↓	↔	↑	↑
Development time How long does the solution take to develop?	↔	↑	↓	↑
Cost	Medium	Low	High	Medium
Bottom line	**Intelligence varies by vendor, significant configuration of 'pre-wired' process**	**Fast to implement, lower cost, but limited value beyond point of sale 'control'**	**Highly customizable, long time to uncertain value**	**Highly customizable, high value, fast time to value**

SUMMARY

Making scientific pricing actually deliver in distribution businesses is a high value but tough problem because of the sheer product, customer and local complexity, and the need to deliver in a simple sustainable way through a field sales force.

There is a tried and tested way of getting the value out with three components:

1. Figuring out the right answer using powerful yet practical pricing science: true cost dynamics, empirical price sensitivity, and local market competitiveness;
2. Engaging with the business, particularly the sales force, in designing the solution; and
3. Putting the right organization, tools and processes behind the science to sustain the solution.

Pricing remains one of the most valuable and fastest to impact levers for most distribution businesses. With typically up to three percentage points of profit and five points of sales growth available, it is definitely a hill where 'the view is worth the climb'.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. Oliver Wyman's global Operations Practice specializes in end-to-end operations transformation capabilities to address costs, risks, efficiency and effectiveness. Our global team offers a comprehensive and expert set of functional capabilities and high-impact solutions to address the key issues faced by Chief Operating Officers and Chief Procurement Officers across industries.

In the Pricing, Sales, and Marketing practice, we draw on unrivaled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in distribution and wholesale: an obsession with attracting, serving, and growing customers, constant dedication to operational excellence, and a relentless drive to improve capabilities. We have a track record of helping clients win in this environment, creating real competitive advantage and driving significant growth. We believe our hands-on approach to making change happen is truly unique – and over the last 25 years, we've built our business by helping distributors and wholesalers build theirs. Oliver Wyman is a strategic advisor to the NAW and sponsors a number of NAW roundtable events for companies with revenues $1 billion +.

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