OLIVER WYMAN

BEWARE THE PRICING MYTHS

Busting myths to grow profits in distribution businesses

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“Pricing is at the heart of our proposition. It needs to be very clear and accurate…

it is absolutely essential to everything; if we get it right it provides huge dividends.

Pricing is very high stakes; there aren’t many things more fundamental.”

– CEO

In many B2B businesses, pricing decisions make senior managers anxious. They're tricky to get right, and the stakes are high: it's difficult to know which prices will attract business without hurting the bottom line, particularly when faced with thousands of customers, hundreds of products, and a wide range of local competitive environments. Given this complexity, it's not surprising that so many businesses tell us they struggle with pricing. One executive summed it up neatly: "Although pricing is one of the most basic things we do, it's also one of the scariest."

So it's rare for senior managers to examine their pricing practices to see whether they're doing all they could for the business. Usually, they aren't: because although "tried and trusted" pricing rules might seem safe, these rules weren't designed to cope with the complexity and competitive intensity that characterizes business today. In fact, they may not even have been right to begin with. By sticking to a set of outdated beliefs, or myths, about pricing, many businesses undermine their performance to the tune of millions of dollars a year.

This paper looks at five of the most common pricing myths we hear and explores how, by "busting" them, executives have been able to unlock a powerful and profitable competitive advantage.

MYTH 1: PRICING DECISIONS ARE BEST HANDLED BY THE FIELD

REALITY:
Companies can't afford to let the sales force fly solo when it comes to pricing.

Why shouldn't companies leave pricing decisions to the field? After all, the sales force is closest to the action, meeting customers and battling competitors daily. Surely, nobody in headquarters can keep up with so many customers, products, and competitors. And, really, isn't it the sales force's job to negotiate prices?

Of course, salespeople are critical to establishing relationships, pitching new products and managing service. But when it comes to pricing, companies can't afford to let them fly solo. Salespeople simply cannot see the same kind of systemic insights that headquarters can, from customer price sensitivity and "walk away" points, to how best to price products versus competitors in order to drive profits. Moreover, customer frustration can result from a localized sales force setting prices that seem inconsistent and illogical.

Consider the industrial rental company that provided its salespeople with regional catalogs and the freedom to price as they wished. On the surface, customers received individual treatment and gross margin seemed reasonable. In reality, salespeople were either pricing purely on instinct or drowning in incomplete information. They lacked effective guidelines and had limited knowledge of what clients truly valued -- or the cost of delivering that value.

As a result, many deals were underpriced or even lost money at the EBIT level.

This is not an anomaly; we have observed many companies in various industries dealing with similar issues. The best solution, we have found, is to keep salespeople empowered to negotiate prices, but to support them with insights from the center. It all hinges on a central team turning insights on customers, products, and markets into simple but effective guidelines and tools for the sales force to drive profitable growth.

EXHIBIT 1: A distributor found its standard SKUs, whose prices were set centrally, made higher margins than its unique, differentiated SKUs. The unique SKUs were priced locally, missing the premium they deserved.

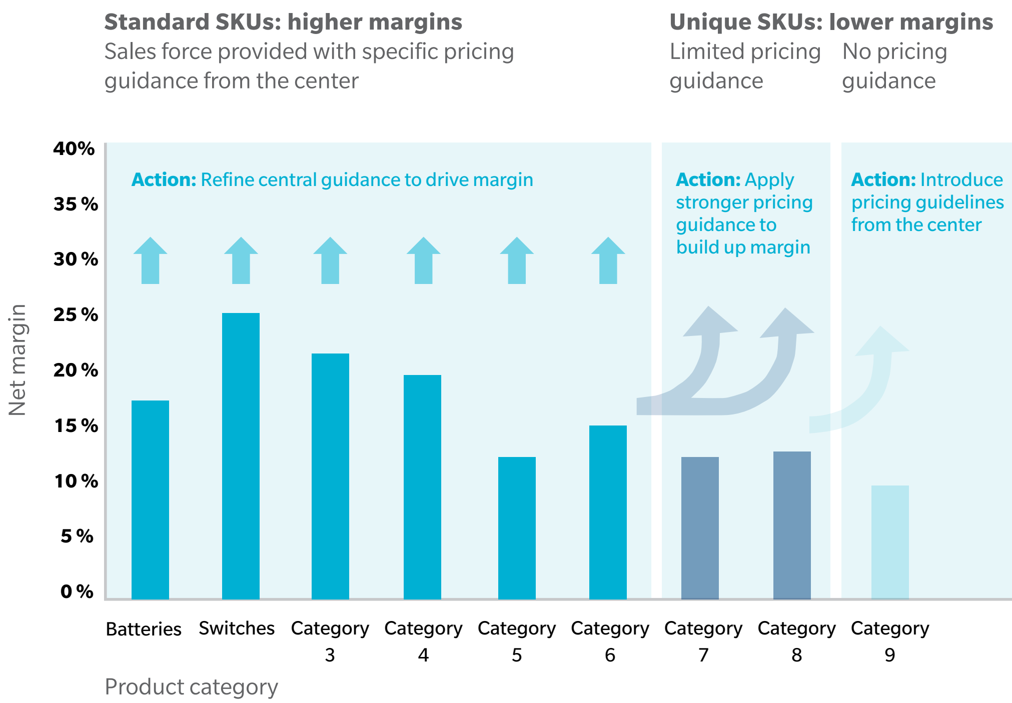


Exhibit 1 shows an example of central insights being used to guide local actions. An electrical distributor was giving its sales force inconsistent pricing guidance across its product range. Prices for the standard range were specified centrally. Pricing the unique and differentiated products was left to the sales force, with limited or no central guidance. When we profiled the margins earned on different products, we found that the centrally priced, standard products earned the highest margins. The unique, but locally priced products were not earning the premiums they deserved. These insights helped the center guide the sales force into raising prices on the unique products, without significantly affecting volume.

This work helped drive EBIT growth worth 1.5% of revenue.

MYTH 2: "COST PLUS" IS THE SAFEST BASIS FOR SETTING PRICES

REALITY:

Cost-plus pricing is not always as safe as it seems.

A cost-plus approach seems like an effective way to set prices. It normally ensures companies consistently reap a markup above their costs. It is also straightforward for management to set up and for salespeople to execute. Moreover, unlike value-based pricing, it does not rely on a complex analysis of competitors, products, and customers. But in our experience, cost-plus pricing is not as safe as executives might think, and many companies have missed profit opportunities or even lost money because of it.

The problem is that many businesses lack a good understanding of their true costs. Take one of our outsourced service clients. The company took pricing and account management decisions based on the gross margin of its products and an average allocation of cost to serve. When the costs to serve were linked back to the accounts responsible for them (as seen in *Exhibit 2*), it soon became clear that the average allocation had been misleading. Actions taken with the old average allocation had often been risky or even harmful. The new, "true", allocation fixed this issue and unearthed a set of loss-making accounts. **Tackling loss-making and low-profit accounts alone was worth around $4 million of additional EBIT on a base of ~$50 million EBIT.**

Hence cost-plus pricing is not always as safe as it might seem. **In fact, it can cause a business to lose money on some of its accounts without realizing it.**

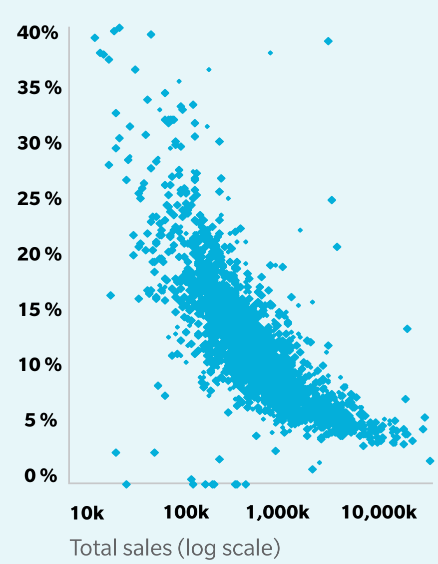
EXHIBIT 2: Moving from an average cost allocation by site to a true allocation helped this company identify mispriced accounts.

"Standard" cost allocation: logistics

Pragmatic "true" cost allocation: logistics

Key changes

1. Vendor funding allocations
2. Logistics costs allocated based on true drivers of in-bound logistics
3. Activity based overhead allocations



MYTH 3: TRACKING COMPETITOR PRICES IS NOT WORTH THE EFFORT

On the surface, tracking competitor prices seems so complex as to be overwhelming, with so many competitors, products, and types of customers to monitor, not to mention frequent price changes. However, the process can be made much less daunting by splitting it into two fundamental tasks: systematic collection of competitor prices, and a central system for data management and analysis. Implemented properly, the insights gained can pay out within just six months and enable much greater long term returns, making the process well worth the effort.

Consider a distribution client of ours that was reviewing its product prices. Feedback from the field indicated prices were uncompetitive, but the executives were wary of overreacting and giving margin away. They wanted to know how competitors were really priced, but this seemed impossible given the thousands of products and clients involved. That was when the executives realized they were sitting on a goldmine of data. Many sales bids involved a partially open comparison between their prices and those of competitors. Moreover, many competitors regularly published catalogs revealing the "shape" of their pricing and putting an upper limit on individual prices.

To harness the information, the firm set up a small central team to collect and compare competitor prices with in-house products. The data yielded valuable insights that could then be relayed to the sales force, including where products were really over or under priced. Over the course of a few months, the initiative created a real competitive edge. Not only did it assist formal bids, it also gave a good view of pricing versus the market over time, informing the pricing strategy. The data also triggered a series of promotions, targeting products for which the company was competitively priced. All told, the initiative supported EBIT improvements worth half a point of sales, more than offsetting the upfront cost.

REALITY:

Pragmatic use of readily available information can produce insights that pay for themselves several times over.

MYTH 4: “QUICK WINS” ARE TOO RISKY TO ATTEMPT

REALITY:
Real value can be driven quickly by focusing on pragmatic actions and being systematic.

What company wouldn’t want to improve its margins in a matter of months with some pricing “quick wins”? But as any experienced executive knows, such price changes are fraught with pitfalls. On the one hand, rapid, across-the-board price hikes often upset customers, leading to defections or the “cherry picking” of lower margin products that remain competitively priced. On the other hand, tailoring price changes to individual customers and the products they buy takes time, making gains anything but “quick.”

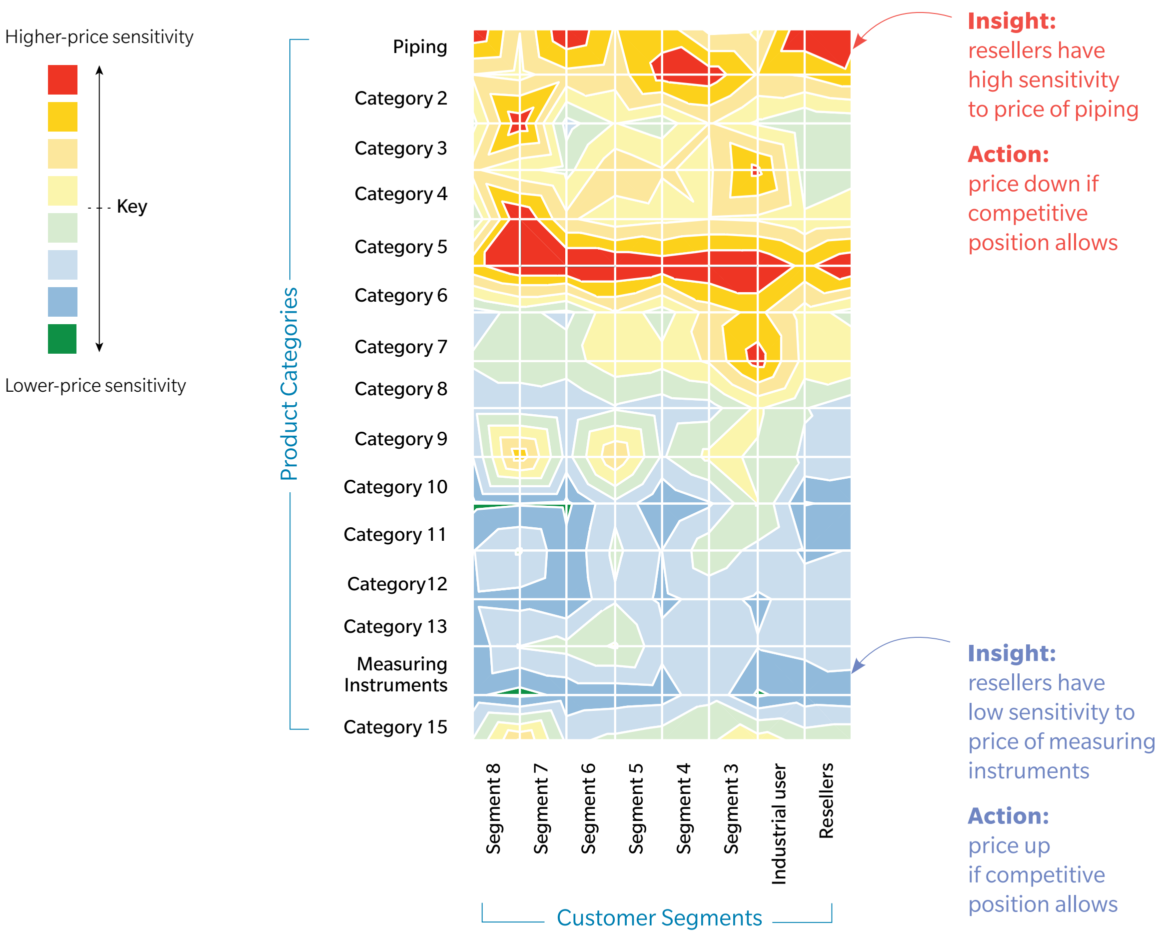
Indeed, in our experience, many “quick wins” programs end up being a waste of time, and fail to achieve the targeted impact. But when companies avoid sweeping changes and focus instead on insights and pragmatic actions, we have seen impressive results.

In one example, an industrial distributor was under pressure from competitors undercutting its prices. To counter that threat and to build a “war chest” of cash, the firm launched a 90-day “quick wins” plan. During the first month, it examined readily available internal data for the telltale signs of opportunities, such as:

- Unprofitable accounts once cost to serve had been properly allocated
- Customers not buying the full range of products they needed
- Expensively priced products with high price sensitivity

Exhibit 3, taken from another distributor, illustrates this type of analysis. It shows how sensitive different customer segments are to price changes on the products they buy, highlighting opportunities to boost profits by raising some prices (with limited impact on volume) and lowering others (driving significant volume uplift).

EXHIBIT 3: An illustration of how differences in price sensitivity between product categories and customer segments can be used to identify pricing opportunities.



In the second month, the industrial distributor developed simple, practical campaigns to address the opportunities. To sell extra products, for example, price points were set and sales pitches, processes, and training prepared. The final month was used for building buy in, training, implementation, and support.

A key success factor in the final month was the formation of a small central team to track the program's progress and adjust course where necessary. This included measuring the impact of price changes on margin and volume and refining some of the changes. Overall, the program drove an annualized EBIT improvement of ~$25 million on a sales base of ~$2.5 billion - a true set of quick wins.

MYTH 5: PRICE INCREASES ABOVE INDUSTRY INFLATION ARE LIKELY TO FAIL

REALITY:
Above-inflation price rises require careful orchestration of product pricing, sales execution and customer communication.

Many companies are wary of increasing their prices above industry inflation levels, often because of past failures in trying to do so. Customers always resist price rises and, without the justification of inflation, they often refuse the increase or take their business elsewhere. Moreover, some contracts stipulate the use of industry inflation metrics to regulate price changes. But what if a company's products are under-priced to begin with or its costs have surged due to the expense of providing value-added services?

The truth is that above-inflation price rises are indeed likely to fail unless they are implemented deftly. Consider the food service company whose costs of serving customers rose above inflation. In response, executives implemented several rounds of across-the-board price hikes in quick succession, all of which failed to stick. Then the company tried a different approach.

First, it placed a four-month moratorium on price increases to build back customer trust. Next, instead of implementing a "blanket" price hike, it tailored increases to individual products based on their inflation, price sensitivity, and competitive environment. Crucially, when putting those price increases into effect, sales people avoided "going in high" and negotiating down: instead they communicated the target increases with clear justification for why they were necessary, which strengthened client trust. And lastly, executives closely managed the performance of the sales force in landing the increases. This allowed them to implement a price rise that was on average 2% above inflation, all during a recession.

While impressive, such results are not unique. Indeed, we have seen other businesses take this approach in different industries to achieve increases 3% or more above inflation.

Note: Examples disguised to protect client confidentiality.

In all these situations, cutting through complexity and myth to improve a company's pricing capabilities proved to be more achievable than one might think. Many companies, for instance, already have the data they need to move away from cost-plus pricing or to start tracking competitor prices. To be sure, developing the capabilities to use that data is not trivial, but we have seen companies succeed and reap the rewards. Such businesses often have several things in common:

- Centralized capabilities that regularly analyze internal and external information to understand customer, market and product trends
- Robust processes and easy to use decision-support tools to turn insights into clear guidance for the sales force
- Leadership from the top, with senior executives emphasizing the importance of the program, and frequently communicating successes and new learnings

For these types of companies, there's no time to rely on myths; they're too busy maximizing their profits and outpacing their competitors.

So, is it time to ask yourself what myths might be holding back your company's profitability?

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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