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Pricing

Staying power

By Greg Cudahy, Thomas G. Jacobson and Tiago L. Salvador

Now that pricing is seen as a primary contributor to better performance, many companies are applying advanced technology and setting up new teams so they can price more effectively. But that's not enough. Here's how to make pricing a sustainable part of management's strategic repertoire.

And although many companies are quickly developing a sense of their customers' willingness to pay based on demographic and geographic factors, on their own these and other capabilities cannot consistently test or track the effectiveness of various pricing moves. In a word, most of today's pricing capabilities are simply not sustainable.

When it comes to pricing, even the most sophisticated companies tend to stumble at one of two stages in the process. Either they fail to develop a sound pricing strategy—that is, they don't put pricing in the strategic context of profit optimization—or they are unable to consistently execute their pricing strategy in disciplined ways.

But few companies actually have a rigorous pricing strategy. Yet without a foundation for how pricing will drive strategic market positioning, it's almost impossible to extract lasting value from, say, pricing and profitability optimization software. A company that segments its markets in simplistic ways may leave itself with little better than a "one-price-fits-all" choice. A competitor, segmenting more deeply and more often with detailed data cuts of customer behaviors, will have far more opportunities to fine-tune prices, and will adapt more readily as markets shift, thereby capturing more profit potential.

In short, the half-life of a pricing strategy is *very* brief if it is not properly embedded in

a supporting operating model that comprises process, organization and technology (see chart, page 3).

Although a handful of consumer multinationals have explicit strategies for how they manage product pricing across geographies, customer segments, product lifecycles and specific buying occasions, many other companies take a far more scattershot approach. It is the rare company that has thought about sophisticated pricing sufficiently to have it encoded in its business strategy and operations.

The need to embed strategic pricing into business strategy and operational activities can lead to difficult discussions with senior executives. Tectonic shifts in today's marketplace—globalization, for a start—frequently provide the impetus for those discussions.

Say, for example, a Chinese company introduces a competing product in your home market and sells it for a third of the price of yours. Your top team's response must be strategic and tactical at the same time—right now. It could be catastrophic if you simply match the newcomer's pricing. The conversation must revolve around topics like mechanisms for shedding costs; tying product development more closely into pricing and profit optimization activities; and pricing products bundled with services.

The second factor that trips up many companies is execution. A company may have highly effective pricing algorithms, yet its senior managers still rely on the exchange of simple spreadsheets to enable some of their most critical decision making. In a recent study of pricing practices in the semiconductor industry, for example, Accenture found that 77 percent of executives said their companies use spreadsheets designed to compensate for pricing system shortcomings.

Rational, emotional, political

Execution fails when companies have no way of surmounting the barriers to appropriate action, whether they are trying to implement a coordinated pricing function or keep one running. In our experience, there are three inter-related sets of obstacles: rational, emotional and political.

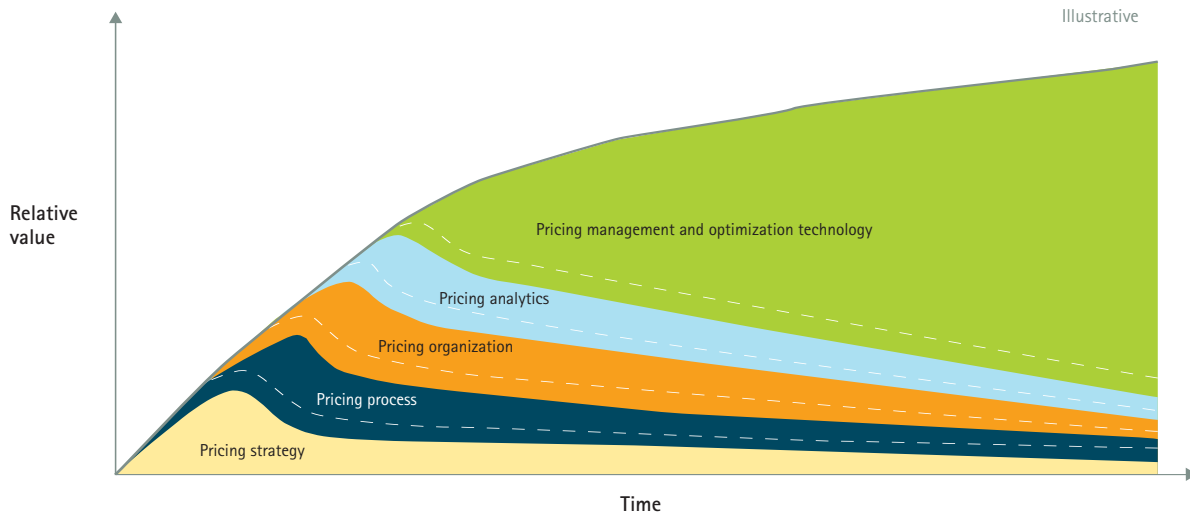
Rational obstacles are arguably the easiest to identify and deal with. They involve the availability and accuracy of data and the algorithms and analytics that are used to make pricing decisions. For instance, a company might need data that doesn't currently exist or have data that is so out of date that it is useless. If the cost data is two months old and the data on competitors is seven months old, it's almost impossible to generate meaningful insights.

Emotional factors often masquerade as rational obstacles. An electronics manufacturer, with no shortage of smart analytical staff, recently failed to get traction from its pricing software. The trouble was the tools were complicated, and while the findings they produced were accurate and predictive, they were initially second-guessed and then were viewed as not relevant to the business. The simple fact was that the salespeople didn't like the tool because they felt it impinged on their autonomy and credibility; soon there were plenty of reasons for the tools' failure. Essentially, the manufacturer failed to address the intangibles that prevented the sales force from becoming part of the solution.

On the political side, it's easy to forget that a change in control of the pricing function can represent a huge shift in power. Regardless of how effective they are, the managers who have historically owned market pricing are constantly on the lookout for threats to their authority.

A strong strategic foundation

Pricing strategy is not sustainable without a supporting operating model. Similarly, technology investments are useful only if they are built on a strong strategic foundation.



Source: Accenture research

If they do not sense the balance of power shifting away from them, they may be the first to try to covertly undermine initiatives designed to align pricing with performance.

Companies do not need to fall into these traps. In fact, pricing leaders are starting to build solid foundations for sustainable pricing capabilities.

They don't view a core competency in pricing and profit optimization simply as a means of raising average selling prices. They see it as a way to enhance long-term shareholder value, fine-tune the product mix, reduce selling and distribution costs, trim inventory and improve capacity utilization. In other words, they view it as a way to give customers what they want.

These high performers think and act in closed-loop terms—working to a pricing cycle that allows them

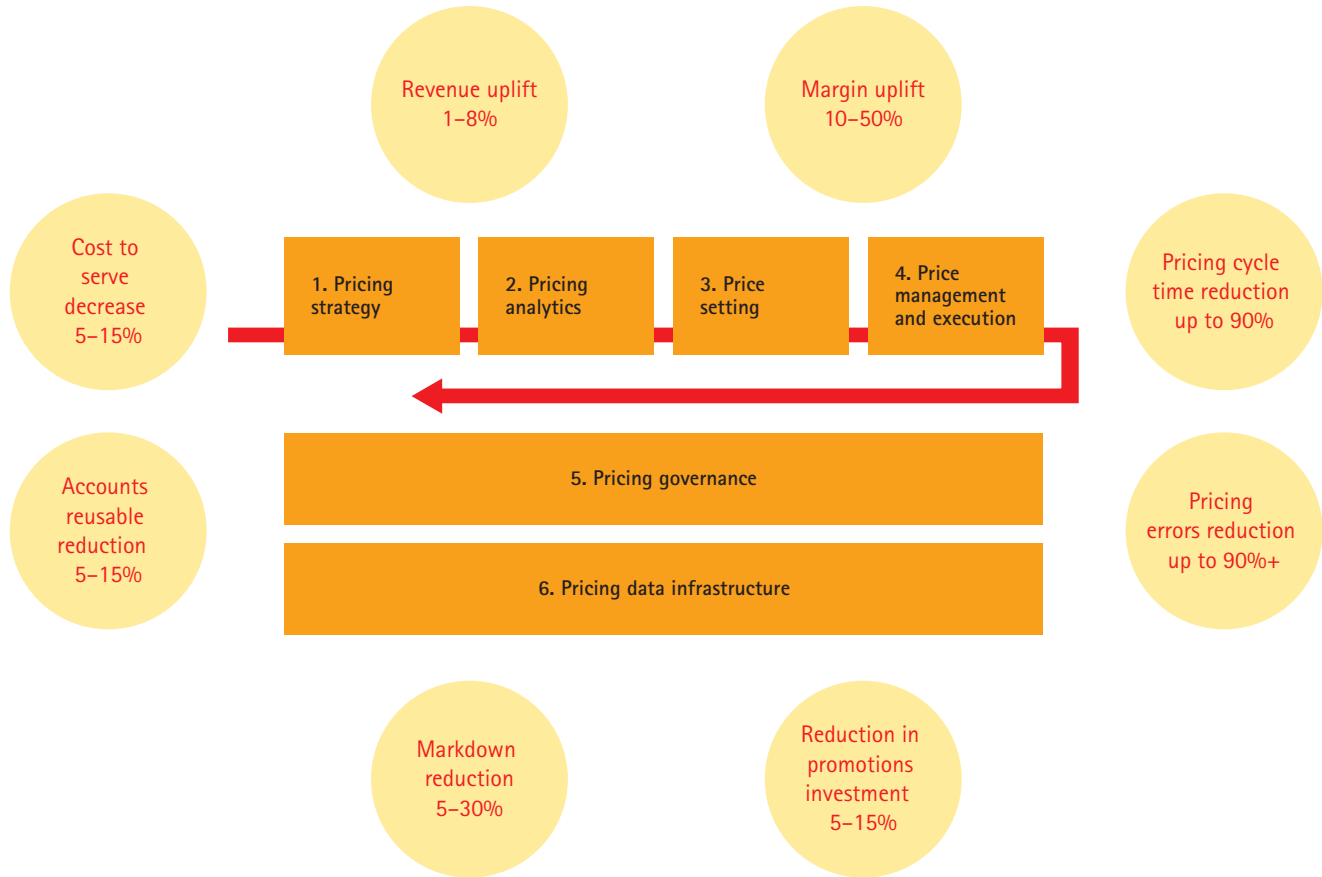
to continually refresh their pricing strategies, optimize prices, put those prices into action, capture more information from the results and analyze the data so it becomes actionable insight for new iterations of the pricing strategy (see chart, page 4). In short, the leaders are continuously learning about price points and sensitivities in their chosen markets—and especially about the *efficacy* of their pricing approaches overall.

Accenture has identified four practices that underpin a sustainable approach to what we call closed-loop pricing.

1. Anticipate and mitigate potentially disruptive emotions and politics. CEOs have plenty of ways to monitor progress when they call for cost cuts. Not so when they call for growth, whose milestones are easily obscured by rational, emotional and political issues.

A closed loop

Companies that are able to execute pricing competency as a closed loop realize significant gains. The figures depicted in the circles represent typical improvements realized by companies we have worked with; the ranges represent roughly the middle two-thirds of their operations. For example, companies have increased revenues from 1 percent to 8 percent or margins from 10 percent to 50 percent.



Source: Accenture analysis

Case in point: When the CEO of Parker Hannifin Corp., a Cleveland-based manufacturer of motion and control technologies, wanted to push through a companywide pricing initiative that diverged from the traditional “cost-plus” approach, he met with furious pushback, especially from members of the company’s sales teams, who believed they stood to lose if prices were raised.¹

However, by setting up a full-fledged pricing function headed by a new executive role—vice president of

corporate strategic pricing—Parker Hannifin’s CEO steadily embedded pricing into the fabric of the company. Prices were raised in many areas—in some cases by as much as 60 percent—to reflect market opportunities. The outcome: The company’s new pricing approach has helped boost operating income by \$200 million since 2002, elevating its return on invested capital from 7 percent to 21 percent in 2006.

Emotions and politics often thwart the best-laid plans of executives

¹ “Seeking Perfect Prices, CEO Tears Up the Rules,” *The Wall Street Journal*, March 27, 2007.

Emotions and politics often thwart the best-laid plans of executives and undercut the authority of newly appointed chief pricing officers.

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In the pricing arena, where a company is typically dealing with deploying a whole new set of capabilities and not just an organizational refinement, this can be devastating. Even geographic differences—selling styles in Germany compared with those in Japan, for instance—can spark conflict between regions.

High performers plan for the eruptions before they happen. Sponsoring executives are selected because they are proven change agents. Just as important, they are familiar with a wide range of scenarios involving emotional and political resistance, and they are armed with well-tested solutions and with sets of rules to fall back on should their primary approaches fail. Strong governance is the key element in the deployment of effective pricing capabilities.

2. Actively manage the pricing portfolio at the microsegment level. High performers recognize that successful pricing decisions occur at the microsegment level.

The value of finely detailed and *constantly refined* market segmentation can't be overstated. Yet it is still not widely understood. In Accenture's recent study of pricing activity in the semiconductor industry, 40 percent of respondents said they do not know the cost to serve each of their company's different products, channels or segments. Moreover, only 40 percent store some or all of their pricing data in a central system that is accessible to all relevant parties at the company.²

A critical first step is discovering which microsegments are appropriate

to the business and how they change over time. A top US retailer recently learned how to organize the factors influencing pricing and put them in logical decision frameworks.

Starting with advanced customer segmentation along behavioral, attitudinal, geographic and value dimensions, the retailer linked product category roles to category tactics—gauging products by their relative importance to the company's most valued customers, for instance—before segmenting its stores according to their competitive environments. The company then set price bands, used its pricing and profit optimization tools to set SKU prices by category, and began measuring the responses at different levels—by sales to the customer, shopping basket volume, store throughput, product category volume and so on. It's also important to note that the retailer has set up a closed loop: The findings are fed back continually into its segmentation models. The key point is that you can't just analyze at the microsegment level—you've got to be able to *act* there too.

3. Optimize pricing across business and product lifecycles. Managing the pricing portfolio is a daunting task for many organizations—and nowhere more so than in business-to-business sectors, where old habits, such as cost-plus pricing, die hard and where sense-and-respond practices are alien and often impractical. The task is further complicated by swings in the business cycle. To sustain effective pricing practices over time, organizations need a mechanism to ensure that business cycle shifts are reflected in pricing philosophies and tightly tied to operational decision making.

(Continued on page 7)

² "Pricing Management Capabilities in the Semiconductor Industry," Accenture survey report, February 28, 2007.

A quick test of pricing's permanence

How much staying power does your company's pricing approach really have? You may rely on spreadsheets more than you think. Your answers to the following questions will help provide a quick self-assessment.

Pricing strategy

- Can you clearly and succinctly sum up your overall pricing strategy?
- Do you have differentiated strategies that properly address the intricacies of product, channel, geography and more?
- Do your people know what this means for their behaviors in the marketplace?
- Do you have defined "triggers" to prompt reevaluations of overall or specific strategies?

Price setting/negotiation

- Are your rule sets for pricing well documented, built into supporting processes and systems, and adjustable when new insights emerge?
- Can you differentiate pricing based not only on demand and competition but also on your own supply status?
- Are you using, or have you at least set a foundation for, the most appropriate algorithms for pricing optimization?
- In negotiations, do you have predefined roles that allow you to focus on optimal deal profitability while maintaining the customer relationship?

Pricing execution/management

- Can you adjust transactional pricing at least as fast as your most important competitors?
- Can you track compliance with pricing decisions across the lifecycle of a given transaction?
- Do you regularly know where your people can best spend their time to reduce pricing leakage?
- Is more of your time spent with your customer instead of in the office assembling the deal and getting internal approval?

Pricing analytics

- Do you have industrialized analytical capabilities (as opposed to spreadsheets and hardworking experts)?
- Are there configurable templates you can use to see the pricing metrics most relevant to your company?
- Are your analytics designed to prioritize changes based on timeliness and total bottom-line impact?
- Do you have a process for regularly reevaluating whether you still have the right analytics in place?

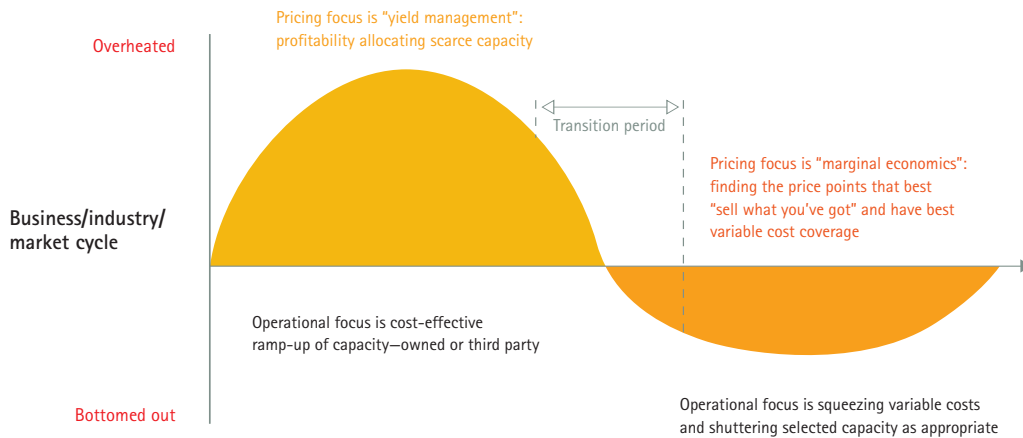
Governance/infrastructure

- Is it clear who owns the final decisions on prices? Transactionally? Strategically?
- Does your organizational structure enable the proper balance between profit and growth? Have the metrics been aligned to support this?
- Do supporting systems allow for a closed-loop process that enables your pricing capability to continuously refresh?
- Is there a plan for adding increasingly granular data and capability over time?

If you answered "no" more than once in each of those capability areas, there's a better than even chance that you're already trailing your top competitors. If only a handful of your answers were negative, congratulations. But before you move on to other priorities, it might be prudent to ask why you recorded any "no's" at all.

Staying in balance

The business cycle affects pricing practices. Executives price to maintain a balance between supply and demand over the business cycle.



Source: Accenture research

(Continued from page 5)

The basic approach is to apply “yield management” when demand exceeds supply, then to shift to a pricing stance of “marginal economics” during periods of excess capacity while working with the supply side to cut costs or adjust capacity (see chart, above). The fact that these cycles can vary across geographies *and* industries makes for a very complex operating environment.

High performers excel at knowing when to manage the transitions as the balance between supply and demand changes, anticipating what’s happening long before their competitors do.

At the same time, companies must focus on where they are in the life-cycle of each product. It’s no mystery that when a product is new and perceived to be innovative, it can command a premium price. Where it gets tricky is when the market is nearing saturation and competitors are crowding in—a point at which availability and

quality start to get trumped by price (see chart, page 8). High performers’ pricing strategies acknowledge and accommodate the transitions.

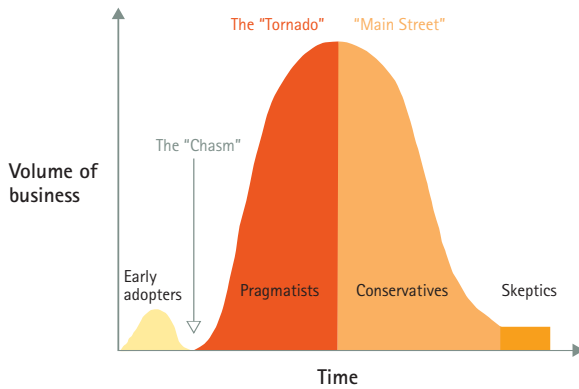
4. Use technology to focus your scarcest resource on the activities that matter most. Leading organizations know an effective pricing capability needs top pricing talent as much as it needs investment in software tools and infrastructure. Then they push to use both sets of resources better than their competitors do—using the software to automate the routine decisions (a retailer’s post-holiday sales markdowns, for example) while leaving the more volatile and higher-impact decisions to the scarcer resources: their talented pricing analysts.

This, in fact, runs counter to conventional practice. Pricing staff gravitate naturally to the more familiar work, regardless of its value or impact. Pricing technology must be used to take the first cut, quickly prioritizing what is best handled by human decision making.

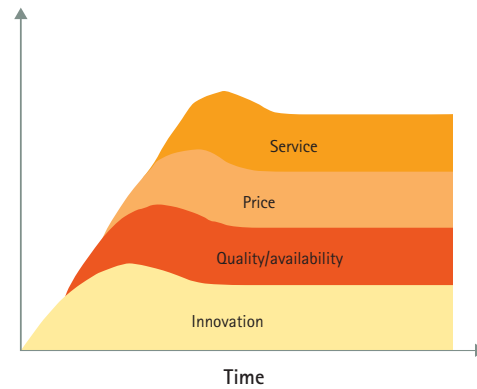
Pricing rules must change over the product's lifecycle

As the competitive dimensions for a product change over time, so must the way prices are set.

Product/service offering lifecycle



Competitive dimension over product offering lifecycle



Source: *Inside the Tornado*, Moore; Accenture research

Pricing and profit optimization software from DemandTec, PROS, Vendavo, Zilliant and other providers can easily handle tasks such as assessments of deal profitability, including promotions, terms and value-added services. It can automate ongoing customer-specific pocket price/margin analysis and

implement action plans to address price leakage. It can automate deal management processes, with clear controls and streamlined approvals. Most important, the software can embed the “closed-loop” process in the fabric of the company. People, however, are still the most important factor in pricing decisions.

There are not many attractive alternatives to developing a sustained pricing capability. Cost cutting has pretty much run its course. Prices have never been more transparent to customers—and will only become more so. Frankly, if the economy weakens, it won't take much for companies that have only begun to build new pricing skills to regress to a fire-sale pricing approach.

The best starting point for the journey toward a sustained pricing capability is a candid and objective assessment of where the company is versus best practices. Before that assessment becomes part of a formal workstream, though, it's worthwhile to run through a quick self-assessment exercise (see sidebar, page 6).

Leaders in pricing see what's needed now. They understand what durable pricing competencies can do to help them weather economic downturns—and ride economic and market upswings far faster than their competitors. They are well aware of the effort and commitment required to embed such competencies. And they aren't shy about tackling the myriad emotional and political obstacles that stand in their way.

These companies have both the way and the will to excel at developing a sustainable pricing capability. For each of them, pricing is about to become a critical component of their distinctive capability, one of the building blocks of high-performance business. It's one more thing for their competitors to sweat about.

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