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PERSPECTIVES

Building a World-Class Pricing Capability:

WHERE DOES YOUR COMPANY STACK UP?

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Pricing: Rising to the Top of the Corporate Agenda

The game is changing. This is the conclusion reached by hundreds of executives participating in Monitor's Pricing Capability Benchmarking study when asked to reflect on the pricing challenges they face. From financial services to manufacturing to consumer goods, executives report that growing profits in today's competitive markets has become an ever more difficult task. For many, the challenge stems from globalization of markets that has unleashed new competitors with lower costs and innovative business models. For others, the change stems from the increased knowledge and sophistication of customers that have become expert at extracting price concessions.

Nearly all executives participating in the study report substantial changes in their competitive environment. The more astute managers also recognize that the structural shifts in the global marketplace are rendering many traditional approaches to pricing obsolete. They are beginning to ask critical questions about the role of pricing in their overall business strategy:

1. How can I transform pricing into a strategic growth lever?
2. How do I enable my organization to make consistently sound pricing choices to increase long-term profits?
3. What is the ROI of building a more robust pricing capability?

To help address these questions, Monitor recently conducted a benchmarking study of more than 200 companies. The study sought to measure the impact of pricing strategy and pricing execution on profitability and revenue growth. The results provide compelling evidence that the ability to manage pricing strategically can be a source of competitive advantage that drives superior financial performance.

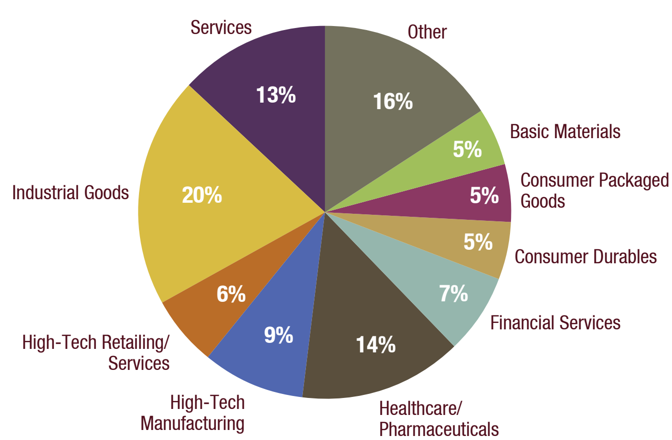
The senior executives who participated in the survey came from a broad spectrum of industries including healthcare, financial services, consumer products, manufacturing, retailing, high tech and services. They responded to a detailed survey assessing the nature of their pricing strategies, market structure, organizational performance (profits and revenue growth), pricing capabilities, incentives and more. Follow up interviews were then conducted to provide additional insight.

The participants revealed that having a pricing strategy is important, but not all pricing strategies are created equal. Leading edge companies focused their pricing strategy on maximizing their ability to create customer value and capturing that value through commercial excellence. As described below, the results provide a call to action for any firm that has yet to discover the benefits of strategic pricing.

The ROI of Strategic Pricing

The study involved several analyses to estimate the impact of pricing strategies and execution capabilities on business performance. The first analysis sought answers to two questions: 1) which pricing strategies are most highly correlated

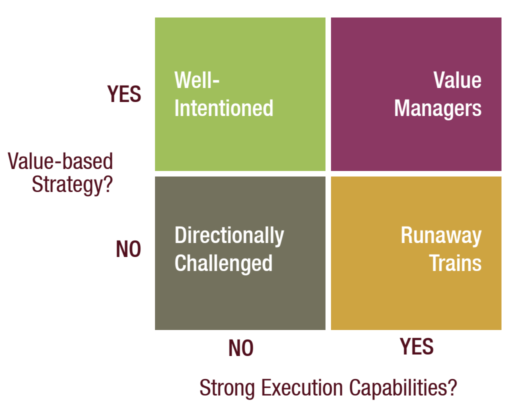
Figure 1: Participant Profile



with operating profit and 2) what is the bigger driver of profitability: good strategy or effective execution? Pricing strategy is a complex construct and, as a result, can be difficult to measure accurately. To avoid obscuring the results with an overly complex measure of strategy, we focused, instead, on the key drivers of pricing decisions such as customer value, costs, market share or quarterly revenue targets.[1] Pricing execution capabilities were measured based on the quality of each firm's pricing processes, decision tools, data and the skills of pricing decision makers.

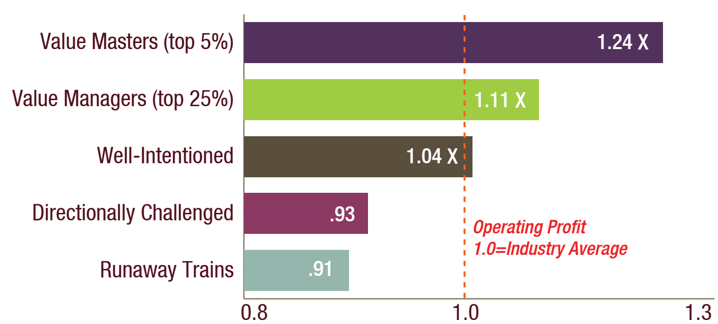
Our operating hypothesis was that value-driven pricing would be more effective than either cost or revenue driven strategies. To test that hypothesis, we broke the respondents into four categories based on the degree to which their strategies are value-based and the strength of their execution capabilities. This categorization led to the four organizational pricing archetypes shown below.

Figure 2:
Archetypal Pricing Organizations



Firm performance was assessed by measuring operating profits relative to other firms within the industry. Thus, manufacturing firms were compared to other manufacturing firms, consumer durables were compared to other consumer durables, etc. in order to eliminate the results being driven by industry specific effects. The operating hypotheses that a value-based pricing strategy and strong execution capabilities would be positively correlated with profitability were clearly supported as shown in Figure 3.

Figure 3: Operating Profit Relative to Industry Peers



The firms with the lowest operating profit were those pursuing non-value based strategies (e.g., cost or market share-driven, etc.) while at the same time exhibiting strong execution capabilities. We describe these firms as **Runaway Trains** because of the obvious analogy to a train barreling down the tracks in the wrong direction – the passengers may not get where they want to go, but they get there quickly. Interestingly, firms with non-value based strategies and weak

[1] Please see "The Strategy and Tactics of Pricing" 4th ed. by Thomas Nagle and John Hogan for a more detailed discussion of pricing strategies.

execution capabilities earned slightly higher operating profits than the runway trains. Although these **Directionally Challenged** firms lack an effective strategy, their weak execution capability limits the ability to make consistently misguided choices that undercut profits.

Much has been written about the shortcomings of cost-based and market share-based pricing strategies. However, this data is among the first of its kind to clearly link that choice of strategy to financial performance. Firms adopting non-value based strategies earn, on average, 8% lower operating profits than their industry peers; a result that was consistent across all of the industries included in the study. The case for a value-based approach to pricing has never been stronger.

We next focused on the financial impact of pricing execution capabilities for firms pursuing a value-based pricing strategy. The data shows that firms pursuing a value-based strategy that have weak execution capabilities have significantly better financial performance than firms pursuing non value-based strategies — even though they perform only marginally better than the industry average. Managers within these **Well-Intentioned** firms attempt to set value-based prices but often have to make strategy choices with poor quality data regarding customer value or competitive reference prices. Moreover, their managers were often not well trained in value-based pricing and lacked appropriate decision tools to support effective pricing decisions.

In contrast, **Value Managers** pursue value-based pricing with a strong execution capability and, as a result, earn 11% higher operating profits than the industry average. Follow-up interviews with several of these firms revealed that managers invest considerable time to collect data on customer value and turn that insight into actionable pricing decisions. Managers are much more likely to have had formal training in value-based pricing strategies and collaborate effectively between functional areas on pricing issues. In short, Value Mangers not only talk the talk, they walk the walk.

Although it was not that surprising that Value Managers earn disproportionately higher operating profits than their peers, we had expected the performance gap to be bigger. In follow-up interviews, executives in the Value Manager segment emphasized that building a strategic pricing capability required time, resources and sustained commitment to the journey. Further review of the data showed that the firms in the Value Manager segment varied widely on how far they had progressed on that journey.

Therefore, we repeated our analysis on the approximately 5% of sample that had achieved true excellence in their price execution capabilities and the results were dramatic. These **Value Masters** earned operating profits 24% higher than their industry peers and 33% higher than firms in the runaway train category.
For these firms, pricing is no longer a tactical function – it had become a competitive advantage.

Value Masters are more likely to have a formal pricing organization and take a consistent and disciplined approach to pricing decisions. They recognize that tactical pricing decisions can have long-term impact on the health of their industry and are the least likely of all firms to have engaged in a price war in the last three years. They work hard to understand customer value and translate that insight into better pricing and go-to-market strategies. When asked to describe his firm's pricing strategy, one executive replied "…pricing strategy is too narrow to describe what we do, we focus on value management and that starts long before you set the price." Although this is only a single example, it is indicative of the mindset that is helping some firms excel under challenging market conditions.

The results of these initial analyses raise an interesting question for the majority of firms not fortunate enough to be categorized as a Value Master or Manager. *What is the ROI of building a strategic pricing capability?* To answer the question, we analyzed a manufacturing firm (we'll call Tech Co) that fell into the runaway train segment. Based on Tech Co's revenues of $10.5B in 2007, the profit improvement yielded by the transition to strategic pricing would increase market capitalization of the firm by approximately $3.5B and increase their share price by 43%. Although this is a high-level analysis that assumes Tech Co. would capture the average increase from moving from Runaway Train to Value Master, it underscores the impact that strategic pricing can have on the value of the firm. Even if Tech Co. were only to capture half of that performance improvement, it is unlikely that the management team has many investment opportunities with greater upside potential.

Characteristics of World-Class Pricing Organizations

Experience has taught us there are two types of pricing strategies: the *"intentional"* strategy endorsed by senior management and the *"enacted"* strategy determined by the daily choices of sales, marketing and finance managers. When a sales person chooses to drop price in response to aggressive customer tactics, she is enacting a volume-driven strategy even if the stated strategy is to price for value. Similarly, a comptroller that institutes a policy that all products must earn a minimum margin or be removed from the portfolio is enacting a cost-driven strategy. Whereas countless books and articles have been written to help senior managers design better intentional strategies, considerably less attention has been devoted to the issue of how to ensure those strategies are enacted in the organization.

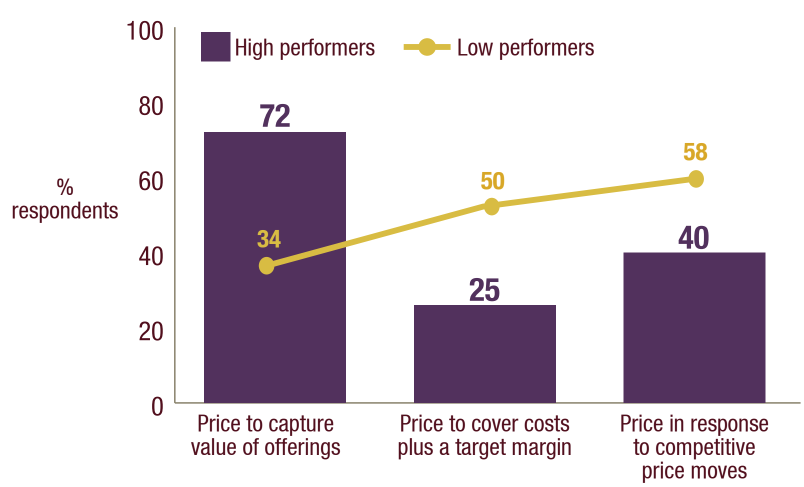
The second suite of analyses in the benchmarking study focused on understanding how pricing decisions are actually made in the organization. The analysis compared firms in the top quartile of operating profits ('high performers') with firms in the lowest quartile ('low performers') in order to identify which pricing strategies, practices and organizational characteristics are most highly correlated with profitability. The analysis identified four distinguishing pricing characteristics that we suggest are hallmarks of world-class pricing organizations.

Characteristic #1: Zealous Commitment to Value

Perhaps the most prominent characteristic of high performing firms was the consistent focus on customer value to determine prices. High performers let value determine the level at which they set prices more than twice as often as low performers did. Low performers were much more likely to price to cover their costs or in response to competitive price moves.

In some respects, it is surprising that managers pursue non-value-based strategies such as cost-driven pricing because the shortcomings are so obvious. Cost-plus pricing inevitably misses profit opportunities. For some high value customers, a price that is set by marking up costs a fixed percentage will be too low and leave money on the table. For lower value customers, that same price will be too high causing them to buy competing products. In essence, cost-driven strategies are based on the premise that the most effective way to set profit-maximizing prices is to turn away from the market and look internally to understand your cost structure. The data from this study provides powerful evidence that allowing costs be the primary driver of pricing decisions is detrimental to profitability.

Zealout Commitment to Value

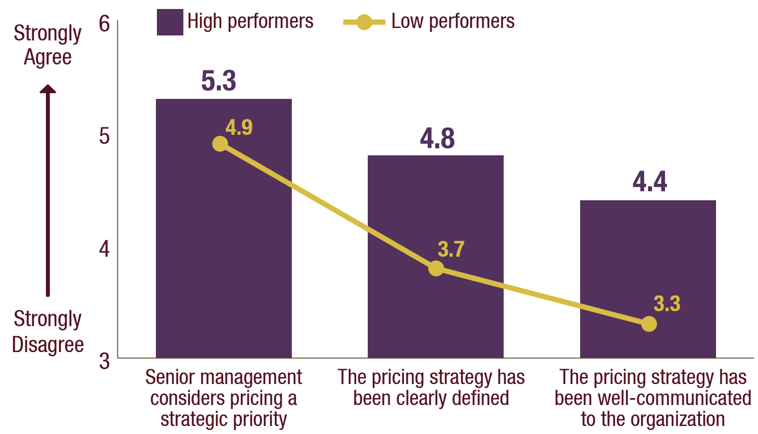


Characteristic #2: Organization-wide Understanding of the Strategy

There is virtually no difference between high and low performers in the stated importance of pricing to the strategic agenda. Differences arise in the degree to which that commitment to pricing translates into a clear strategy that is communicated to and shared within the organization. High performers are much more likely to have invested the time to develop a clear and actionable pricing strategy and, more importantly, to communicate it to the organization. The data shows that this step of communicating the strategy to the organization is a necessary, but not sufficient step toward strategic pricing.

Consider the example of the specialty chemical company that falls into the "well intentioned" segment. Although the executives aspire to be a value-based pricing organization, an examination of their pricing practices reveals a different story. The company's price book contains over 100 pages of blindingly small font and, according to the Marketing VP, is only understood by one person in the organization. Although considerable effort had been made to use customer value to set the prices, the rest of the organization was unaware of the price value linkage. Thus, a sales person trying to defend their prices to an aggressive procurement agent has little chance of success because he or she does not understand the strategy and does not have the necessary insight and tools to enact it.

Organization-wide Understanding of the Strategy



Characteristic #3: Effective Decision Processes

In a result driven era, executives are rewarded for choosing the "right" strategy to compete in challenging market conditions. To better understand "how" executives make those decisions, we examined various aspects of pricing strategy decisions. Specifically, we asked participants about the way in which pricing decisions were made and what steps would do the most to improve decision quality.

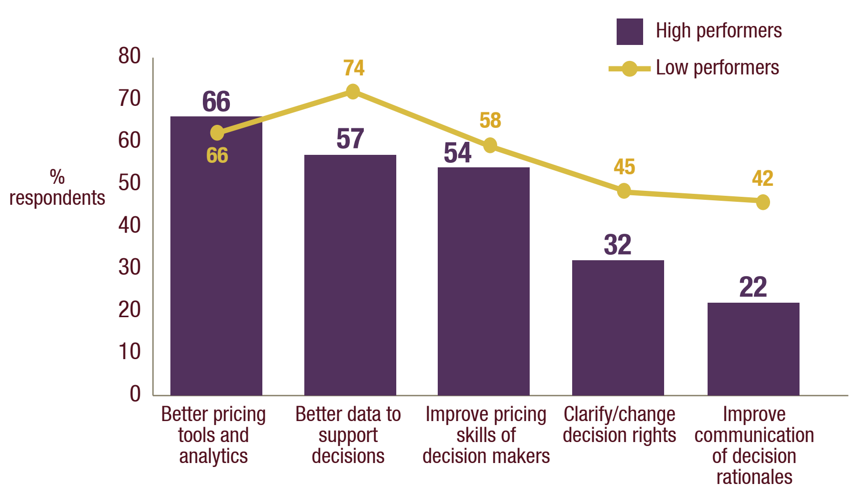
Both high and low performing firms stressed the need for better pricing tools and analytics to help managers make pricing decisions. Pricing tools are only useful when used in conjunction with good data, however. The number one problem facing low performing firms was the lack of quality data upon which to base their pricing decisions. Without valid data about customer value, competitors' prices, and relative product performance, it is impossible to make accurate value-based pricing decisions.

Pricing decisions are complex and can have long-term strategic impact on firms' performance. It is unsurprising, therefore, that high and low performers agree about the need to improve the knowledge and skills of decision makers. Differences arise, however, around the ability and commitment to execute strategies in a consistent and disciplined manner. Pricing decisions in low performing firms were reported to be more political and senior managers were much more likely to make ad hoc decisions that undercut the strategy. As a result of this inconsistent approach to pricing decisions, low performing firms were 30% more likely to have engaged in a price war than high performers.

Characteristic #4: Incentives and Objectives Aligned with Strategy

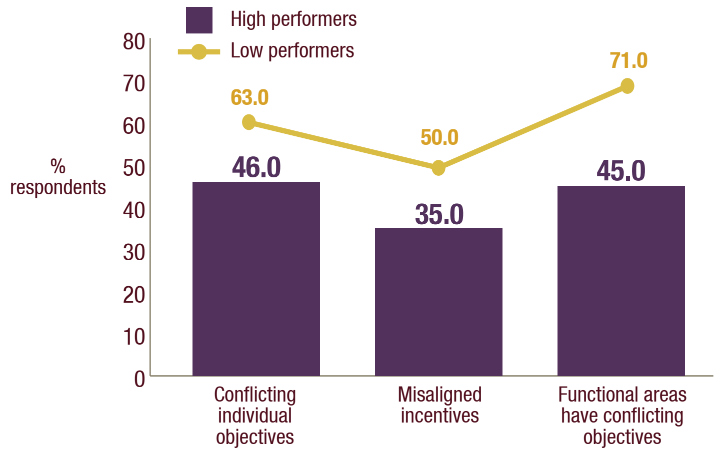
Because pricing is inherently cross-functional, misaligned objectives and incentives can form major barriers to implementing effective pricing strategies. A CEO focused primarily on increasing share price may be willing to undercut long-term price stability if price cuts are necessary to achieve quarterly sales targets that are visible to market analysts. A marketing vice president looking for greater market share may see price as a strategic lever to meet his objectives and capitulate to the demands of large customers for price cuts. On the other hand, a finance executive determined to maintain high margins may push for price increases and thus bypass otherwise attractive low-margin, high-volume opportunities.

Effective Decision Process



In each case, these executives are making decisions that are perfectly sensible when viewed according to their own functional interests, but may undermine overall company profitability and share value. The data shows that high performers benefit from incentives and objectives that are aligned with the strategy. By contrast, low performers have less consensus around pricing issues because of misaligned incentives and objectives.

Incentives and Objectives Aligned with Strategy



Conclusion: The Sound of Two Hands Clapping

What is the sound of one hand clapping? Silence. Similarly, neither pricing strategy nor price execution can work alone. The Monitor Pricing Capability Benchmarking survey shows that having a value-based pricing strategy and the capabilities to deploy that strategy are essential for a company that wishes to grow operating profits.

Without organizational capabilities and commitment, a strategy is nothing but words on paper. Without the right pricing strategy, having strong execution capabilities can actually be counterproductive and detrimental to success. Together, the right strategy with an empowered organization can deliver a powerful payoff – operating profits 30 percent higher than those of low performing firms. Given this potential payoff, pricing strategy and capabilities should be on the agenda of every CEO whose company competes in the global marketplace. Even strategic value managers can seek further improvement to match the operating profits of the top performing world-class firms.

For lower performers, collecting the data, building the tools and implementing the organizational framework necessary to execute a value-based pricing strategy may take time. For runaway train companies and those that are directionally challenged, the most important step is to recognize the benefits to be gained from change and begin implementing the processes and decision tools needed to get on the right path to success.

About
John Hogan

Dr. John Hogan is a highly sought-after speaker and author on the topic of marketing and pricing strategy. A partner at Monitor Group, Dr. Hogan is the co-author of the fourth edition of *The Strategy and Tactics of Pricing* with Tom Nagle. He has extensive experience working with firms to develop more effective marketing and pricing strategies in the computing, software, financial services, telecommunications, distribution and consumer packaged goods sectors. He has published numerous articles on pricing, marketing, customer value and managing B2B relationships, and is a former award-winning professor from Boston College and currently teaches in the executive education program at the University of Chicago.

About
MONITOR GROUP

Monitor Group has developed an organizational pricing diagnostic called ValueScan that can be used to benchmark your companies pricing execution capabilities against best-in-class firms. For more information about ValueScan or other pricing diagnostics, please contact Alexsandro Labatte (email: Alexsandro_Labbate@monitor.com).