Pricing in a downturn

The value of a structured pricing approach

In today's economic environment, most companies are focused on projects that provide immediate payback. Proactive executives are currently engaging in typical downturn-management activities such as cost cutting and working capital management. However, with such a focus on costs, one of the most impactful short-term initiatives, pricing, is often overlooked, even though pricing initiatives can drive a greater return than cost reductions.

The fundamentals of pricing in a downturn are not different from the fundamentals of pricing in a growing economy. In a downturn, the seller's focus tends towards margin management and value captured in return for differentiated performance. Companies that focus appropriate attention on pricing can improve their margins on every transaction – every day.

The common perception during an economic downturn is that pricing will necessarily exhibit a deflationary trend, and ensuing gross margin and profitability will have to suffer along with that trend. Companies expect that embattled customers and aggressive competitors will put downward pricing pressure on industry products and services. However, a downturn can actually offer companies a good opportunity to review their pricing strategy across their different customer segments, to analyze their pricing methodologies and determine the portfolio of products and services that drive profitability. While competitors succumb to customers' requests for continuing price decreases amidst the tough economy, a smart approach to pricing can actually make a company improve, or at least protect, profitability while at the same time providing customers with what they need.

B2B pricing

In B2B business, suppliers often commit to long term contracts. This means that pricing decisions that are made during poor economic conditions can have lasting consequences. A company that is willing to close the deal at almost any price in this economy will most likely overestimate buyer price sensitivity, setting prices too low and regretting the action for a long time to come.

In B2B business, the customer typically has purchasing requirements, and unlike a consumer, does not usually have the option to buy nothing. Hence, elasticity in the B2B space takes on a different form from most academic discussions of price elasticity. Understanding the tradeoffs that buyers make between buying decision criteria such as quantity, price, quality, availability, reliability and post-sales support can help a company create a structured game plan for pricing in a downturn that will help it go from survival mode to success mode where both share and profitability can be protected.

B2B businesses usually do not take advantage of sophisticated price segmentation techniques. Management will typically declare a couple of characteristics that they think might be important, e.g. account size, geography and strategic importance. This strategic importance attribute is the one that justifies a company's decision to drop the price (and margin) as low as they want to get the deal. Instead, structured quantitative segmentation techniques can reveal the most accurate segmentation attributes and provide a basis for intelligent pricing to truly maximize margins.

FIGURE 1. Arthur D. Little tailors our clients' pricing programs based upon a proven pricing approach

Arthur D. Little pricing approach

Source: Arthur D. Little

The value of better pricing

Pricing typically offers significant improvement potential because pricing is too often perceived as unmanageable. When salespeople make pricing decisions, they:

- Often base their decision on "gut feel," reactively, or simply "to get the deal"
- Think that the "market sets the price"
- Rarely use data to full potential
- Don't measure pricing using the most appropriate metrics and have little incentive to do better
- Use price to solve non-price problems

B2B companies with complex product slates and diverse customer lists that have fully implemented pricing improvement programs have experienced profitability improvement benefits ranging from 3-5% of revenue. These kinds of returns are available to managers who design and execute disciplined pricing strategies and processes, and measure the results to continuously improve.

Pricing approach

Arthur D. Little's approach to pricing excellence is a proven five-step process.

Diagnosis

Our approach generally begins with a pricing diagnostic that can help to identify which improvement levers exist in an organization through qualitative and quantitative analysis. The outcome of this quick diagnostic includes a business case estimate of the benefits potential, a comparison of current performance against best practices and a tailored improvement program that focuses on strategic pricing and tactical pricing improvements.

Strategic pricing

Following the diagnostic, structured steps can be analyzed and put into action according to the identified improvement levers and by fully understanding what customers value. In particular the analysis should include:

A. **Setting pricing objectives:** Pricing objectives must be aligned with overall corporate objectives. They include market share growth, new product/service positioning, profit maximization, etc.

B. **Customer segmentation:** This analysis includes setting the basis to use for customer segmentation (e.g. margin contribution, differentiated perceived value), and then segmenting the customer base into actionable segments, which leads to a focus on the right customers and identifying an appropriate differentiated offering (e.g. product attributes, price) for each segment.

C. **Differentiated value-added positioning:** In certain circumstances, companies can also protect themselves from price erosion by offering value differentiators that decrease the price sensitivities of customers.

Tactical pricing

In addition to strategic pricing steps, tactical pricing levers should also be structured and utilized for maximum impact. In particular, the steps should include:

A. **Pricing of standard offering:** A plan must be created on which products / services to offer the market, and how to differentiate this standard offering across customer segments. A margin-maximizing pricing analysis for each standard offering across the customer segments must be conducted, so that value can be communicated to justify the price.

B. **Value-added products and services:** Mechanisms should be put in place to maximize margin through value-added product and services on top of the standard offering. Mechanisms include value-added enhancements that create value between the customer and company, and certain incentives to customers to improve their service performance.

C. **Customer communication:** Communication with the customer base through the sales force is a critical component of tactical pricing in order to ensure that customers' interests and sensitivities are met.

D. **Sales tools:** Specific tools and processes should be identified that will support the sales force in their pricing negotiations.

Margin drivers

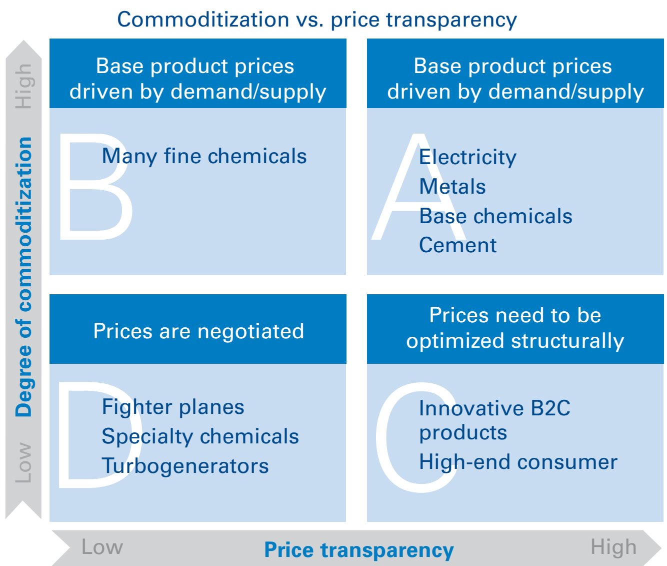
The key levers to improve margins depend on the combination of the degree of commoditization and degree of price transparency in the market. The differentiation in margin drivers will primarily be driven by two factors: the degree of product commoditization and the degree of price transparency.

A. **High product commoditization and high price transparency:** In industries such as electricity, base chemicals and cement, base product prices are driven by basic supply and demand factors. Management can improve margins thru proactive market management, reactive pricing tactics and intelligent pricing and discounting of value-added services.

B. **High product commoditization and low price transparency:** In industries such as fine chemicals, base product prices are also determined supply and demand factors. In addition to proactive market management, reactive pricing tactics and optimized pricing and discounting of value-added services, management can also make use of segment-specific pricing to improve overall margins.

C. **Low product commoditization and high price transparency:** In industries such as high-end consumer products, prices need to be optimized structurally, and reactive pricing tactics, price optimization using volume/

FIGURE 2. The key levers to improve margins depend on the combination of the degree of commoditization and degree of price transparency in the market*



	A	B	C	D
Proactive market management	•	•		
Reactive pricing tactics	•	•		
Optimizing prices/discounts for value-added services	•	•	•	
Segment-specific pricing		•		
Price optimization given volume/price/margin relationships			•	
Understanding differences in willingness-to-pay and cost across customers			•	
Understanding of willingness-to-pay of individual customer				•
Value pricing at the customer level				•
Negotiation tactics				•

* Price transparency refers to the extent to which price information is public (rather than secret)

Source: Arthur D. Little

price/margin relationships and understanding differences in willingness-to-pay and cost across customers are the primary margin drivers.

D. **Low product commoditization and low price transparency:** In industries such as high-end aerospace, prices are negotiated and understanding the willingness-to-pay of individual customers, value pricing at the individual customer level and strong negotiating tactics are the primary margin drivers.

Deployment

Finally, to implement the pricing strategy identified through analysis, customer segmentation and the identification of strategic and tactical steps and margin drivers, training and change management is critical. Management often underestimates the organizational pushback that can accompany changes in pricing strategy and tactics. A proactive change management approach is necessary to overcome resistance. Steps include:

A. **Quick wins:** Quick-wins can deliver fast organizational buy-in and facilitate the change management process. Underperforming accounts can be identified per segment by comparing structured price levels against actual prices paid for immediate transparency on pricing improvement opportunities.

B. **Business processes:** The new pricing structure must be fully embedded into business processes by utilization of documentation, tools and sales force training. Process and incentive structure redesign to align with the new pricing structure is critical to deployment.

C. **Margin improvement tools**: Margin improvement tools such as operational pricing tools, pricing calculators and negotiation tools can be implemented to further support the sales force.

Conclusion

Unfortunately, 2009 turns out to be another tough year for companies as they struggle to maintain revenues and profitability in the face of severe economic unrest. Yet in challenging times, best-in-class companies create opportunity out of turmoil. Executives can find a strong and immediately impactful ally in pricing to help protect revenue and bridge the gap as cost-cutting measures take place.

By utilizing proven methodologies and taking an analytical, rather than a gut-feel, approach to pricing through sophisticated segmentation techniques and structured pricing steps, a company can create a truly intelligent pricing system to maximize margins, protect revenue and satisfy important customers, even in today's downturn economy.

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About Arthur D. Little:

Arthur D. Little, founded in 1886, is a global leader in management consultancy, linking strategy, innovation and technology with deep industry knowledge. We offer our clients sustainable solutions to their most complex business problems. Arthur D. Little has a collaborative client engagement style, exceptional people and a firm-wide commitment to quality and integrity. The firm has over 30 offices worldwide. With its partners Altran Technologies and Cambridge Consultants Ltd., Arthur D. Little has access to a network of over 17,000 professionals. Arthur D. Little is proud to serve many of the Fortune 100 companies globally, in addition to many other leading firms and public sector organizations. For further information, please visit **www.adl.com**.