



# *Worth Noting*

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***Worth Noting is the weekly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.***

## **Getting Pricing Right**

Pricing is one of the biggest levers on profitability at the disposal of senior managers. Innumerable reports show that getting the pricing of a product right leads to far more bottom line impact than most other management exploits.

Few companies would dispute the importance of pricing to profitability. But equally, few companies have processes in place to maximise the pricing opportunity. Often, pricing decisions are made by reference to such simple techniques as “costs of production plus x%” – a strategy which makes little commercial sense and ignores the value of the product to the customer. Who cares if the product cost \$100 to produce if it is worth \$400 to the customer?

In this issue of *Worth Noting* we look at some of the key issues which senior managers should consider when making pricing decisions.

## **Why it Matters**

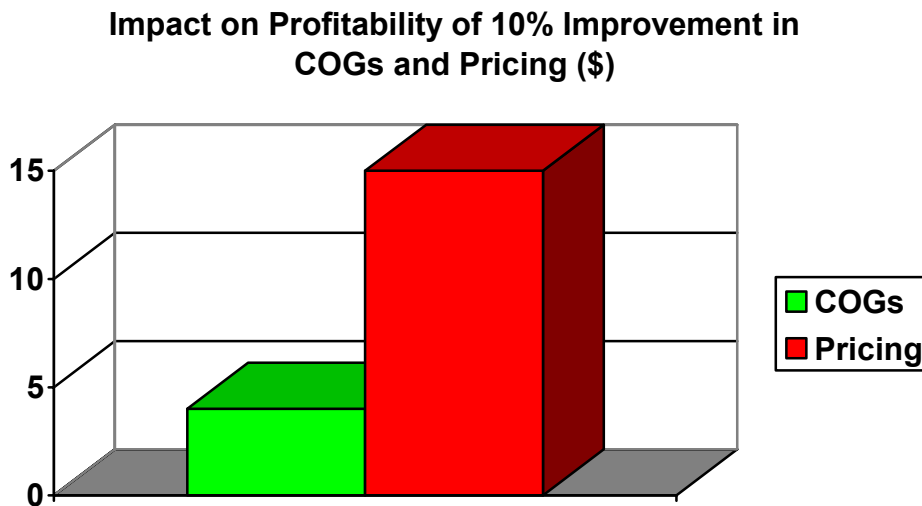
Let's look at a simplified example to demonstrate the benefits of sound pricing strategies.

Our example looks at the costs and revenues associated with a particular product and its standard pricing. Let's assume the product can be produced for a total cost of \$100. Of this amount, \$40 is Cost of Goods Sold (COGs), and the remaining \$60 accounts for the product's share of the fixed costs of operating the

business. Further assume that the product is currently being sold for \$150, providing a contribution margin of \$50.

If we assume that the business is well run and operating costs are relatively fixed, then management has two devices at its disposal to improve profitability: variable costs and pricing.

The chart below shows the impact of a 10% improvement (ie reduction) in variable costs and the impact of a 10% improvement (ie increase) in price.

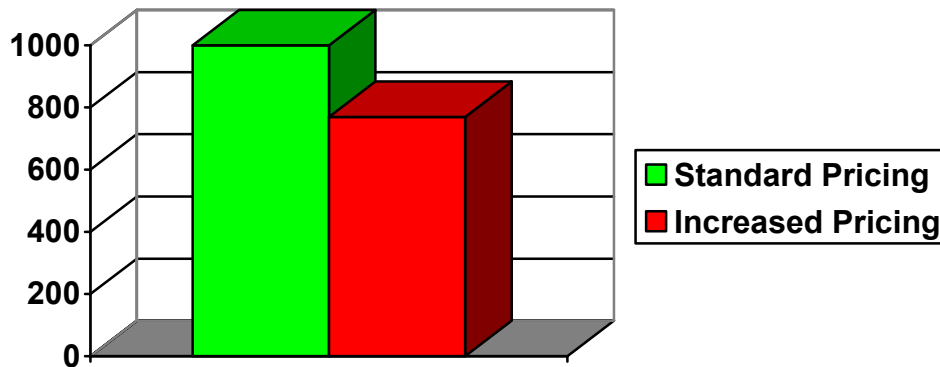


Because COGs represent a substantially smaller line item than price, an equal percentage improvement does not stack up to the impact of improved pricing.

Of course, this example is over-simplified. If it was easy to increase prices by 10%, things would be very straightforward for senior managers. Conventional wisdom has it that increased prices mean decreased customers – and the conventional wisdom is usually right.

So the real value of a pricing change can only be determined by assessing the impact of the change on overall contribution to profitability. Sticking with the example above, let's assume that before prices were changed, there were 1,000 customers for the product, each with a contribution margin of \$50. Further assume that prices were increased by 10% while all costs remained the same. With the price increase, contribution margin per sale increases to \$65. The key question is: how many customers can we afford to lose, while still increasing profitability?

### Number of Customers Required to Produce Gross Contribution of \$50,000



Under the revised pricing, 770 customers would produce a total contribution margin of \$50,050. With the initial pricing, 1000 customers were required to produce a contribution margin of \$50,000.

In other words, a *pricing increase of 10% could sustain a 23% loss of customers and still boost profitability*. The numbers will vary based on the price and underlying margin of the product, but the point remains that pricing is a very big lever for management, and one which is worth substantial focus in all companies.

#### **Some Ideas on Pricing**

Below we discuss the issues which, in our view, are most critical to making good pricing decisions.

#### **Understand the value of the product to the customer**

We would hesitate to even mention this issue, but for the fact that we so often see it ignored in corporations. It is also an area that executives sometimes find a little theoretical – better suited to the analytics of management consulting than the realities of operations. But forgive us for emphasizing it regardless.

The basic point is: make sure what you charge for the product equates to what the product is worth to the customer. This has little or nothing to do with what it cost your company to produce the product.

In many industrial companies, price is set by adding a margin to costs. Sometimes the competitiveness of the industry leaves little alternative to this, but almost as often a pricing opportunity has been missed by management.

Home renovations provide an interesting example of this issue. It is common for home owners to spend, say, \$50,000 on a house and increase the value of the house by \$100,000. The home owner would probably have been happy enough with an increased value of \$70,000, but the property market made it clear to them

that the renovation was *actually worth \$100,000*. So that's what they charged – who would sell a house for \$30,000 less than it was worth?

In other, less perfect markets, the seller does not have an auction system to tap into to determine customer value. A widget might only cost \$1 to produce, but may be worth \$5 to the customer.

Customer value will generally be determined by the uniqueness of the product – commodity producers are in a very tough position in trying to influence price. But for every Microsoft there are hundreds of companies that do not perceive the true value they bring to the table – outstanding support, fast delivery, reliability, and so on, are all factors that customers value immensely. Getting close to substantial customers to understand value is critical in determining price.

### **Strip Out False Features**

By “false features”, we mean product features that cost you money, but that the customer does not value. Maybe the customer doesn't care about the super-charged turbo features of your product: they never use them and wouldn't notice if they weren't there. Don't include them in the product and maintain the price – an effective price increase.

Sometimes a customer changes their mind, of course, and decides that the super-charged turbo features are valuable after all. If this occurs, the customer will be prepared to pay for these features – again, an effective price increase. And if the customer does not want the additional features, you have still improved your operating margin.

### **Move Pricing Decision-Making up the Chain**

In our experience, pricing decisions are made at relatively junior levels in major corporations. It is a lamentable fact that many senior managers concern themselves with matters such as mundane travel approvals but do not have a full grasp of the pricing of their key products. Pricing will affect profitability more.

It is also worth considering the analytical horsepower that your organisation has in place to deal with pricing decisions. Is the Brand Manager the right person to set price? Sure, they understand the competitive environment and the product's positioning, but are they strong financially? Analysing the financial outcomes of a move in price is at the core of the pricing process: one percent here or there makes all the difference. A sophisticated level of financial skills is required.

Brand and Marketing Managers are also in the position of being highly cognisant of competitors' moves. If toothpaste provider A slashes prices by 10%, won't most Brand Managers be very tempted to follow suit to maintain market share? Being so close to the action, it can be hard for marketers to take the step back and hold the line on price.

Our view is that pricing decisions should be made by a senior executive, with strong analytical and marketing skills. Deeply understanding the customer helps to determine consumer value; deeply understanding numbers helps to determine the long term strategy. Modelling elasticity is not simple, and the financial impact of getting pricing right is sufficiently large to justify the commitment of senior management focus.

### **Compensate Sales Staff Based on Gross Margin Contribution, Not Revenue**

In our view, this is elementary. For most companies, most of the time, top-line revenue is close to irrelevant. Of course there are exceptions: start-ups trying to build market confidence, incumbents seeking to grow market share in the short term, and so on. But at the end of the day, the value of companies is determined by free cash flow. And free cash flow starts with the contribution of gross margin.

Using revenue as a base for commission has the virtue of simplicity. We are unaware of any other virtue that it possesses.

Compensating sales staff based on gross margin contribution makes infinitely more sense, in our view. It is a basic principle of organisational design that incentives should be aligned to desired outcomes, and the organisation desires gross margin contribution, not revenue.

Let's take the example of a product which sells for \$12,000 and which has a total cost to the organisation of \$10,000 (excluding commission). The sales team is provided with a 3% commission on all sales.

In this example, a staff member who sells the product for \$12,000 receives a commission of \$360, which represents 18% ( $360/2,000$ ) of the product's total contribution margin. Given that the sales team member has sold the product for its full price, we would assume that the company is comfortable with the commission, meaning it is prepared to sustain a commission of 18% of the total contribution margin.

But what if the customer pushes back on price, and the staff member agrees to a final deal of \$11,000. Under the revenue-based scheme, the sales executive would receive a commission of \$330, which represents 33% of the total contribution margin ( $330/1000$ ). Why should the sales team member suffer such a small financial penalty when the company's gross contribution margin has halved? Shouldn't the commission halve also?

If the company set commission at 18% of contribution margin, the sales staff member would be in the same financial position regardless of which scheme was used if they sold at full price. But if they accepted a lower price to close the sale, their personal compensation would be effected in direct proportion to the impact on the company's gross contribution margin. A situation which, in our view, can only have a positive impact on pricing.

Pricing is an issue which, in our view, should be at the top of the priority list for CEOs and senior executives. Its potential to impact on profitability is well established. In this edition we have sought to highlight the biggest factors influencing pricing decision-making. The comparative lack of emphasis placed on pricing in most companies is troubling, but understandable: sometimes the actual price of the product seems incidental in the day-to-day minutiae of operations. But price is not incidental, it is central, and companies that get pricing right will continue to outperform the also-rans.