Driving performance through improved pricing

The North American Summit

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McKinsey&Company

A first thought

"The single most important decision in evaluating a business is ***pricing power****"*

If you've got the power to raise prices without losing business to a competitor, you've got a very good business.

And if you have to have a prayer session before raising the price by 10 percent, then you've got a terrible business.

Warren Buffett, Chief Executive Officer, Berkshire Hathaway Inc.

SOURCE: Press search

Reality quiz – what is the impact of pricing?

1 A 1% improvement in which of the following levers has the highest impact on profitability?

- ☐ Fixed costs
- ☐ Variable costs
- ☐ Price
- ☐ Volume

2 What is the average[1] uplift in operating profit from a 1% price increase?

- ☐ 5%
- ☐ 9%
- ☐ 14%
- ☐ 22%

3 How much additional volume do you need on average[1] to compensate for a 5% drop in price?

- ☐ 9%
- ☐ 19%
- ☐ 29%

1 Based on S&P 500 average economics

SOURCE: McKinsey Pricing Practice

Results

1 A 1% improvement in which of the following levers has the highest impact on profitability?

- [ ] Fixed costs
- [ ] Variable costs
- [x] **Price**
- [ ] Volume

2 What is the average[1] uplift in operating profit from a 1% price increase?

- [ ] 5%
- [ ] 9%
- [x] **14%**
- [ ] 22%

3 How much additional volume do you need on average[1] to compensate for a 5% drop in price?

- [ ] 9%
- [x] **19%**
- [ ] 29%

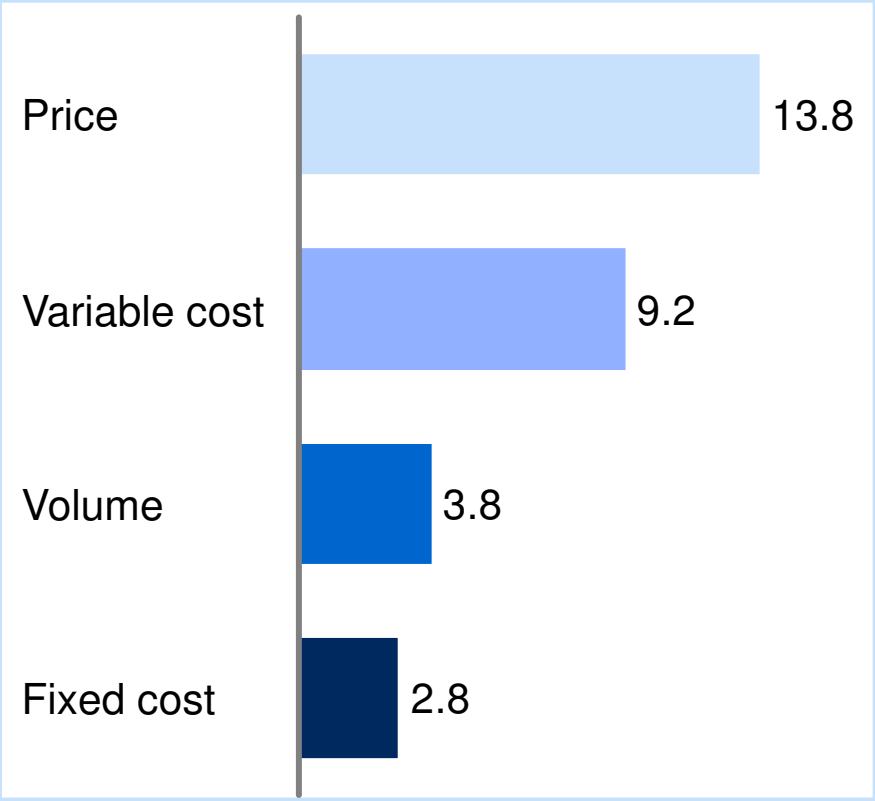
1 Based on S&P 500 average economics

SOURCE: McKinsey Pricing Practice

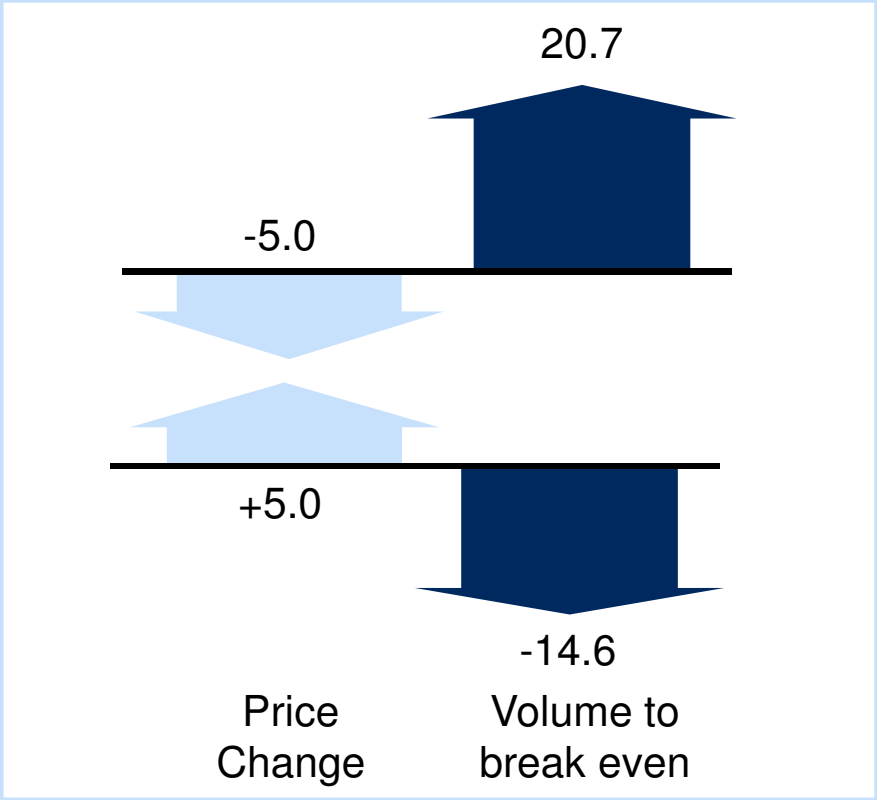
Improving pricing even 1% has significant impact on profitability, but it is a double edged sword

Percent

Improving price 1% has more impact on profit than other levers[1]



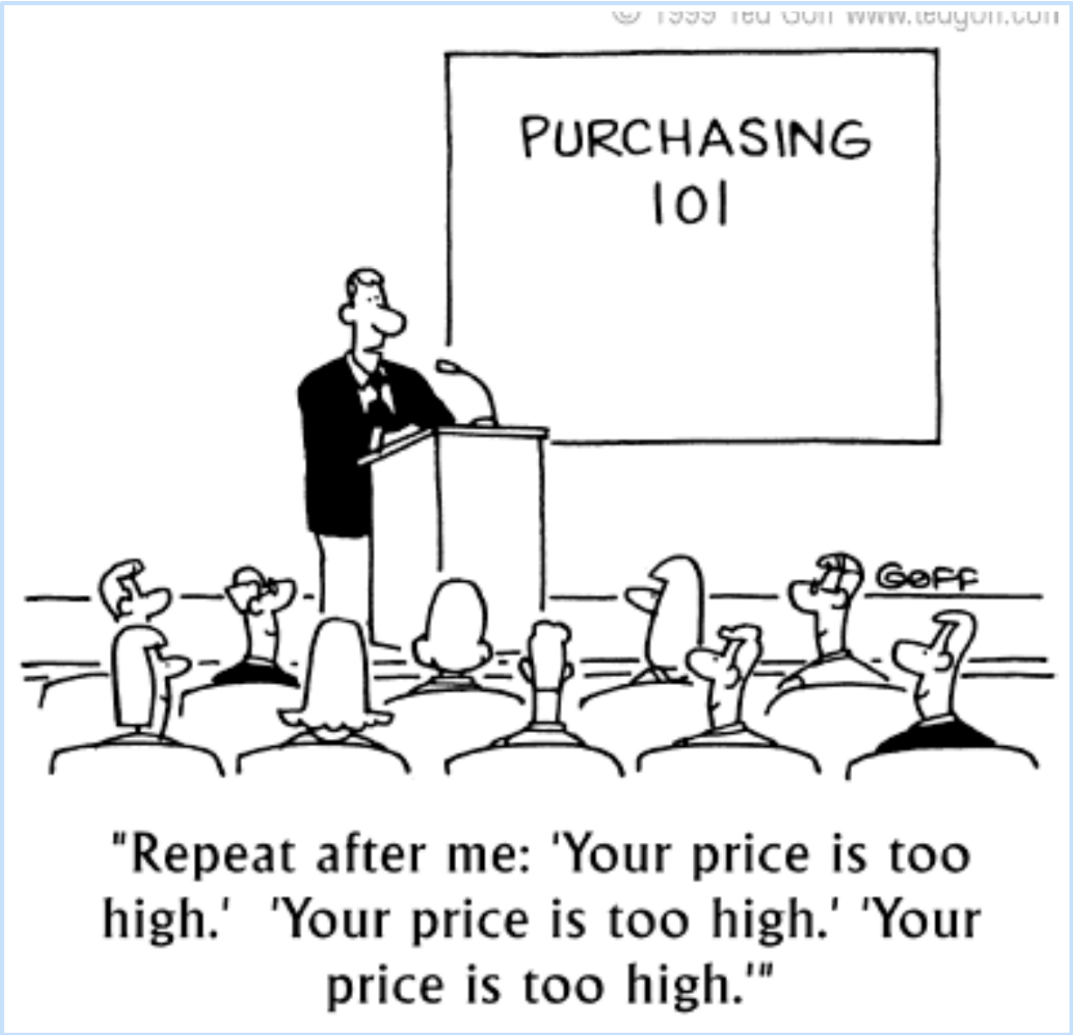
5% decrease in price decrease requires 20.7% increase in volume to break even
5% increase in price can offset even a 14.6% drop in demand[1]



1 COGS used as proxy for variable cost; SG&A, depreciation and amortization used as proxy for fixed cost

SOURCE: Based on S&P Global 1200 5 year average financials (2008-2012, focuses only on complete data sets, n=694)

Why pricing is hard…

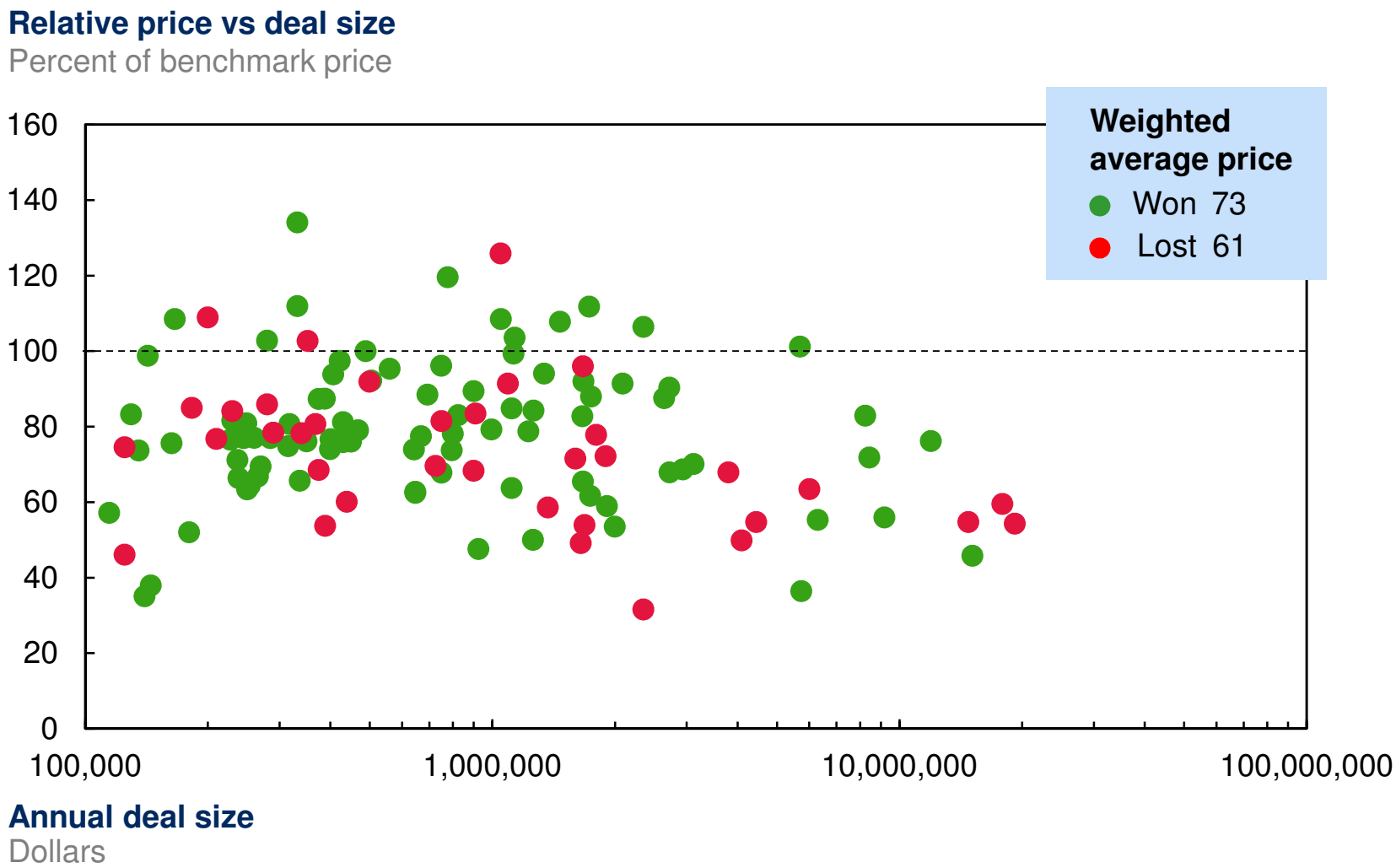


…and macro-trends are making it harder

Tools and Process	▪ Spend on e-procurement tools doubled in the last 6 years ▪ Emergence of third-party purchasing agents ▪ Options like reverse auctions & linear performance pricing
Transparency	▪ Consumers empowered with online information and price comparison tools, mobile price comparison applications, etc. ▪ Regulatory mandated disclosures (e.g., healthcare in certain countries)
Consolidation	▪ Global sourcing ▪ Consolidation of distribution channels ▪ Retailer consolidation with increased price competition
Competitive environment	▪ Ascent of quality private label brands ▪ Growth and concentration of discount retailers ▪ Sales person mobility

However, lower prices do not necessarily mean more wins

DISGUISED EXAMPLE



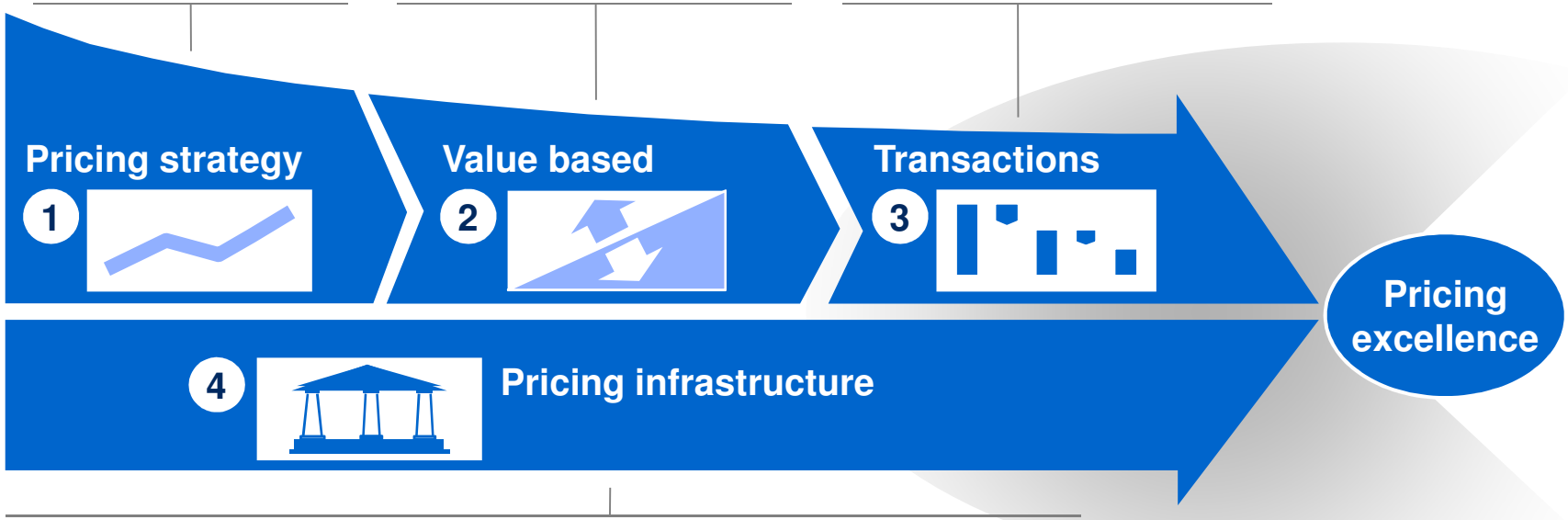
Pricing excellence should be built around 3 levels of price management, supported by the right infrastructure

Issues

What's the overall strategy for pricing based on market conditions and your strategy?

How do we maximize the value of our products vs. next best alternatives?

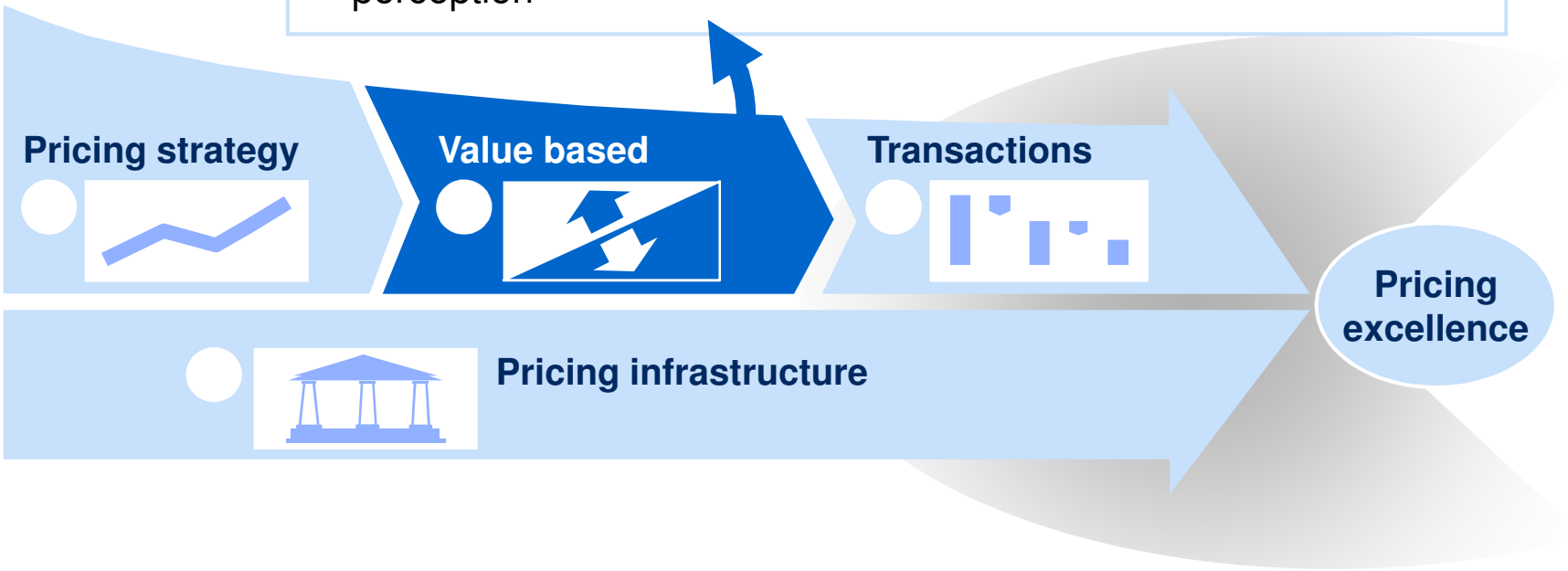
How do you decide the exact price to assign each customer sale?



What organizational structure, processes, incentives, tools, and support are needed to sustain pricing excellence?

2 Value-based pricing determines the optimal price given the features / benefits and the competitive alternatives

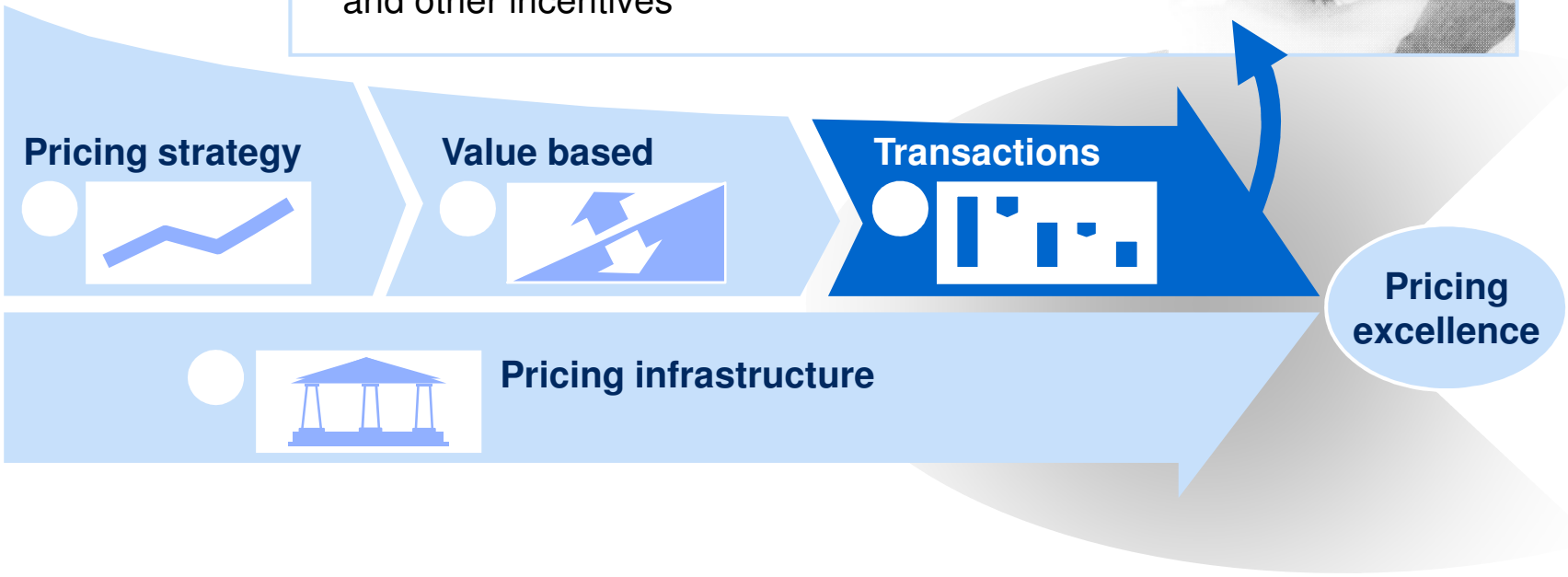
- Getting your **price position right** relative to competitors
- **Quantifying the value** of your products for a specific customer
- Creating and implementing customer/product **value maps**
- Identifying **variability in customer price** and benefit perception



3 Transactional pricing is about managing front line, customer-by-customer price execution

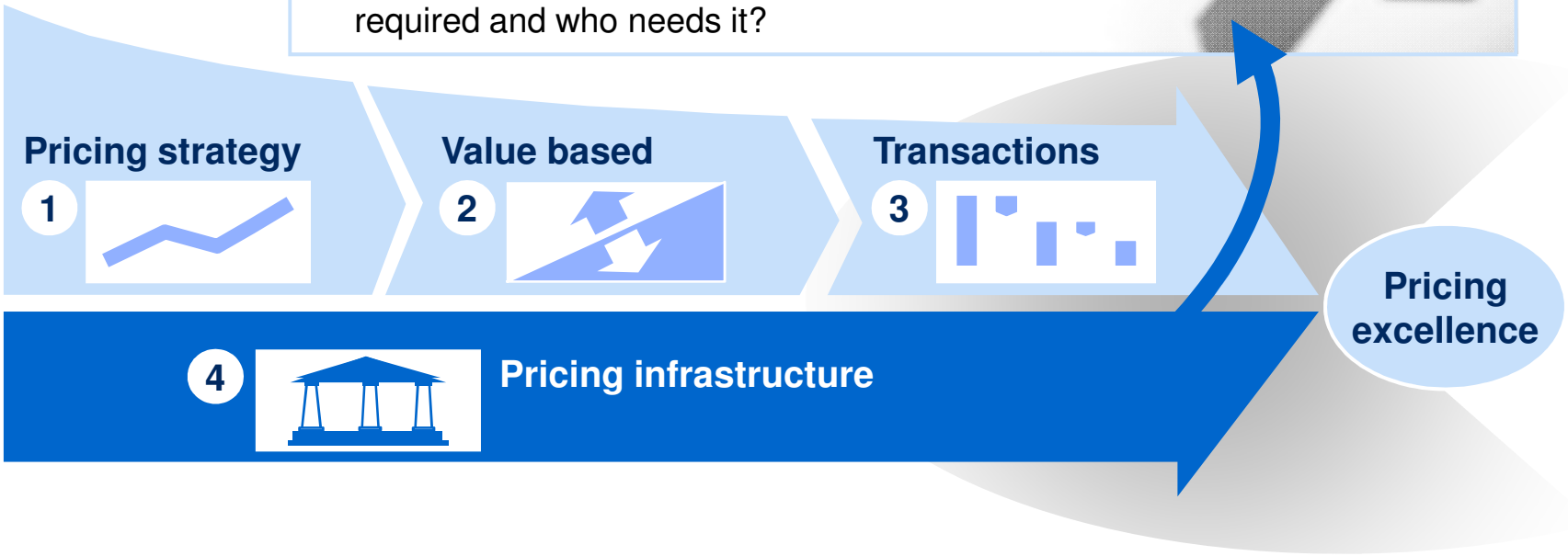
What is transaction pricing?

- Optimize the price / margin realized for each individual sale
- Reducing unnecessary loss from discounts, promotions, rebates, conditions, terms, bonuses, and other incentives



4 Pricing infrastructure includes five essential dimensions that all have to be in place to enable pricing excellence

- **Processes** – What are the most critical types of pricing decisions for your business?
- **Organization** – Who is running the pricing decisions?
- **Responsibilities** – Who determines which pricing decision?
- **Performance management** – How should we recognize and reward pricing performance?
- **Pricing tools** – What kind of pricing information is required and who needs it?



Unique characteristics of software and information based offerings create new pricing challenges

Increasing pervasiveness	▪ Exploding number of applications and use cases – well beyond traditional standalone SW ▪ IP is increasingly tied to software and information vs. physical components
Totally different cost structure	▪ Very low marginal production costs + relatively high upfront development costs create extreme pressure on businesses to capture share quickly – often through excessive discounting ▪ Potential for high customer switching costs further raises stakes
Less tangible benefits	▪ Value delivered can be hard to quantify and communicate for intangible goods like software ▪ Especially true when moving from mostly HW to combined HW/SW environment (i.e., overcoming “widget selling mentality”)
Much greater malleability	▪ Incredible flexibility exists to create and tailor different configurations with distinct customer benefits and pricing models ▪ Multitude of alternative pricing models and approaches available – many degrees of freedom, but which is best?

Potential new ways to unlock value in software / online offerings

- **Differentiation** (e.g., power by the hour)
- **Bundling in new ways** (ad + resumes + screening)
- **Ancillary services** (e.g., data, insights, advice)
- **Dynamic pricing** (e.g., according to shifts in supply / demand)
- **Performance-based pricing** (e.g., payment for # of applicants placed)

SOURCE: McKinsey

Case: Jet engine manufacturer changed basis of pricing to better serve customers and lock out 3rd-party vendors

Context

Company

- Multibillion dollar jet engine manufacturer
- Provides both engines and maintenance services

Industry

- Services priced on a time and materials basis
- Strong price competition from non-OEM services and parts providers, leading to commoditization

Action

- Changed pricing model to charge airlines on a business outcome based metric – flight hours of engine operation ("power by the hour")
- Determined services required by type of engine and application
- Assessed underlying risk by analyzing historical service data

Impact

- 33% of customers began buying with new pricing model
- Number of long-term service contracts increased significantly
- Service costs became highly predictable for airlines
- Pricing move resulted in sustained significant improvement in margins
- OEM was able to influence spare parts decisions creating significant barrier to entry of 3rd-party substitutes
- Other OEM competitors followed suit and adopted similar pricing model

Pricing dimension changed	From	To
Unit of measure & scaling	Time and material for service provided	Per flight hour of usage
Reward & risk management	Unpredictable service cost	Risk based predictable service costs

Case: Design software vendor changed pricing terms to create a more predictable revenue stream

Context ›››	Action ›››	Impact ›››
▪ Niche player looking to defend against stronger competitors ▪ Charged on a perpetual per seat license basis ▪ Massive discounting each quarter to close deals ▪ Few value-added options being purchased by customers (2-3 per customer)	▪ Changed license model from perpetual to subscription to smooth quarterly transitions ▪ Created prepaid term licenses to allow small development teams within target customers to pilot product ▪ Bundled widgets into packs (i.e., 50 for the price of 10)	▪ Stimulated revenue growth with more stable revenue streams ▪ Reduced need for heavy EOQ discounting ▪ Implemented full transition over two years (having projected 3-4 years)

Pricing dimension changed ›››	From ›››	To ›››
▪ Timing	▪ Upfront & perpetual	▪ Monthly subscriptions
▪ Packaging	▪ A la carte value added options	▪ Bundled packs of value added options (packs)

Case: Hotel business moved to revenue management model to better balance supply and demand

Context ›››	Action ›››	Impact ›››
▪ Pre-1980s hotels operated with simple rate schemes that often resulted in money being left on table during times of high demand (via under-pricing) and low demand (empty rooms) ▪ Following lessons learned from airlines, hotels sought to better balance supply (available rooms) with demand (bookings)	▪ Revenue management introduced to maximize revPAR (revenue per available room) ▪ Room rates married to so-called "Rate Levels" ▪ Revenue managers "open" and "close" rate levels depending on revenue build-to-date and anticipated future demand ▪ Lower rates used to stimulate demand off-peak and during slow days, while higher rates used to maximize yield during times of high occupancy	▪ By varying rates in line with demand, hotels are able optimize revenue over any given time period ▪ Most effective hotels constantly tweak their yield management "algorithm" over time to grow revPAR year-on-year

Pricing dimension changed ›››	From ›››	To ›››
▪ Scaling	▪ Essentially static/simple rate structure	▪ Dynamically changing rates based on supply/demand

Case: Business research company offered free trials to increase adoption

Context ›››	Action ›››	Impact ›››
Company ▪ Large business research company providing material online ▪ Diverse customer base with varying needs and financial resources **Industry** ▪ All players finding it difficult to convince consumers to pay for services	▪ Offered free content to demonstrate value of online information access ▪ Implemented large discount for long-term subscription ▪ Created segmented packages with different pricing levels and structures	▪ Significant trial of product leading to increased number of customers ▪ Became industry leader in pricing online information ▪ Net increase in spend by current customer base

Pricing dimension changed ›››	From ›››	To ›››
▪ Timing	▪ Payment required to access	▪ Free trial and content
▪ Packaging	▪ Single offering	▪ Bundled packages and pricing for key segments

Questions to consider in your business…

What frontline variance do you see in pricing or margin by customer, by product?

How well do you understand profitability by channel, customer, product, or transaction?

Do you understand how your customers perceive your prices and benefits relative to the next best alternative?

What elements most shape final price perception (e.g., list price, discounts, rebates, etc.)?

Where do your customers have ongoing unmet needs? What can you do to address them?

How are the pools of value shifting across the value chain? Which ones should you be getting out of? Into?