Marketing & Sales Competence Center

Pricing Excellence

The key to profit
and market share

Roland Berger
Strategy Consultants

Pricing excellence – The key to profit and market share

Companies with outstanding price management are the best in class in their industries. They enjoy the biggest market shares and are able to build on them in spite of high prices. What is the secret of their success?

Price management has a powerful influence on profits. However, it's a tricky business, to say the least. Price is a subtle variable that depends on a number of different factors, many of them difficult to pin down exactly. They include factors such as subjective price perception by customers, customers' subjective willingness to pay, price modeling and the way prices are communicated.

Optimizing prices is impossible unless you understand – and master – their various subjective elements. The text-book approach to price optimization, based on the idea of customers' different "willingness to pay", works only in the classroom. In the marketplace, it's a very different story.

Different industries pose different challenges. Project business, for example, is relatively specific in nature and pricing will differ for each project. The spare parts and services business, by contrast, is extremely complex and can feature a hundred thousand different prices or more. The commodity business – supposedly more consistent – is different again. When it comes to pricing, the various businesses are worlds apart in terms of strategy, organization and methodology.

Few general rules apply to pricing, then. Nevertheless, here are some basic insights:

I. Price perception and price communication are more important than the real price

For the purposes of price optimization, it is not the real price that matters, so much as the way it is communicated and perceived. Successful price optimization involves reducing the perceived price and increasing the real price, in so doing resolving the supposed conflict between higher prices and satisfied customers.

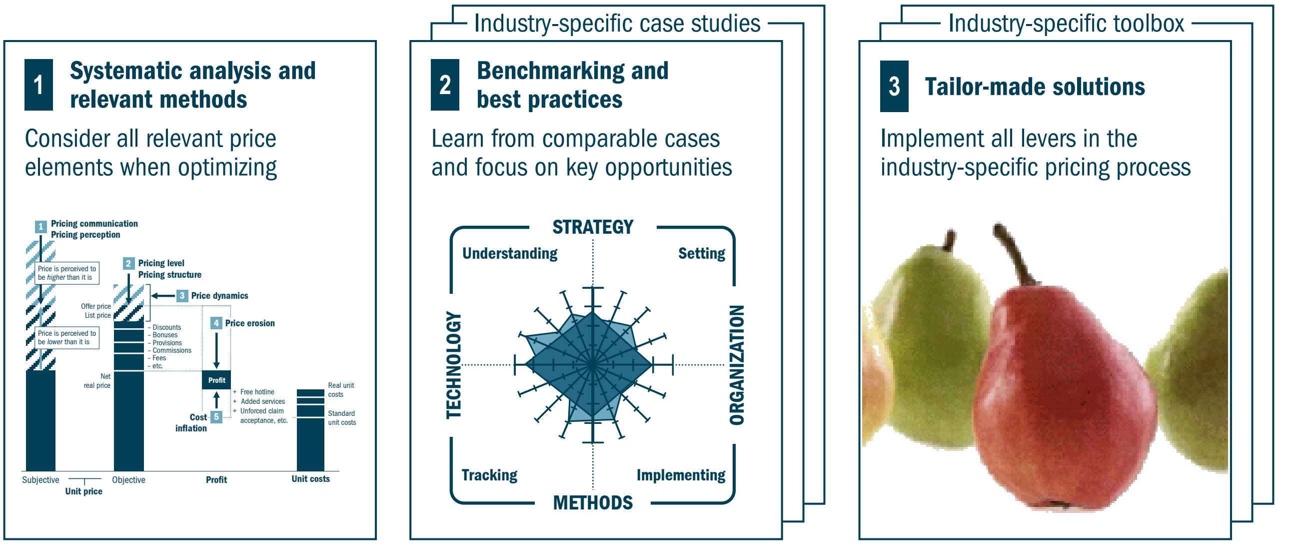
II. It is not customers' willingness to pay that determines the optimum price, but the price comparison with alternative products

Effective price management keeps a close eye on competitors' prices. It builds on price differences, not absolute prices. Customers don't react to absolute prices – they react to perceived differences in price. For this reason, cross-price elasticity is more important than price elasticity in itself in competitive markets. Customers' willingness to pay is largely irrelevant.

III. Optimum prices must take into account competitors' reactions

Pricing is not static. If it is to survive more than a few days, it must anticipate competitors' reactions. Competitors behave asymmetrically, often ignoring price increases but mimicking price reductions. Companies must take this into account in their own pricing.

Fig. 1: **The three pillars of pricing excellence**



The Roland Berger pricing excellence approach combines these rules for optimizing pricing with industry-specific best practices and tailor-made solutions.

The first pillar: Five success factors

In an initial systematic analysis, we ensure that our clients examine all the relevant areas for pricing: price perception and communication, pricing level and structure, price dynamics, price erosion and cost inflation.

These are the five key areas where companies can take action to optimize prices. In the first three areas, Roland Berger offers unique solutions that time and again bring palpable results.

In the fourth and fifth areas – price erosion and cost inflation – we use established methods. The key to success here lies in getting the individuals responsible closely involved in the implementation, turning them into multipliers.

1. We help our clients to improve price perception and communication in a targeted way

The prices perceived by customers – in both B2B and B2C environments – often differ significantly from the actual prices. Inexpensive spare parts, such as individual screws or parts cheaper than EUR 1, go essentially unnoticed by customers. Here, the pricing options differ from the options for high-profile parts or services. How prices are communicated is also crucial to their perception. For example, in the automotive business it makes a tremendous difference if you communicate the car price (e.g. "EUR 24,900"), the cost of financing (e.g. "Only EUR 199 a month") or the interest rate (e.g. "Starting at 1.99% a year"). Price perception can be managed in a similar way in B2B selling and consumer goods.

The Roland Berger pricing excellence approach is based on perceived prices. We help companies first of all to measure how the prices of their goods and services are perceived externally, and then to improve on them.

Most companies are blissfully unaware that real prices and perceived prices are two very different ball games.

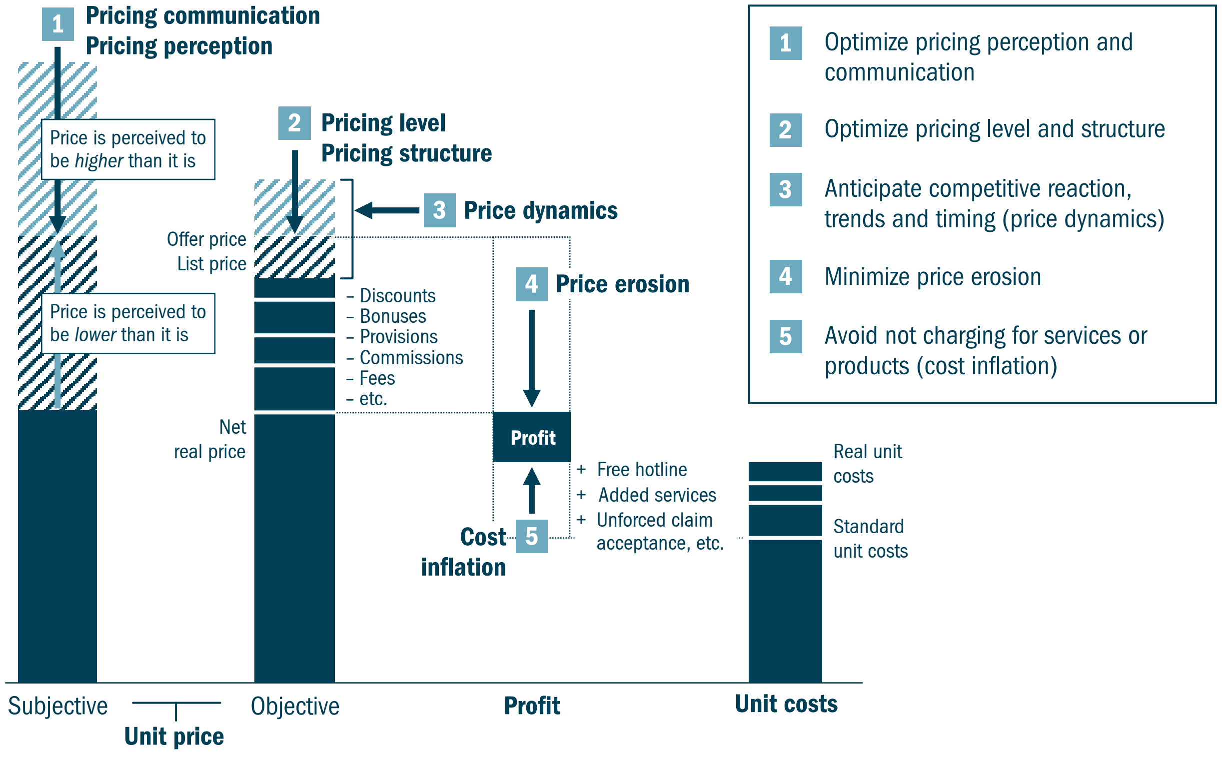
2. We help our clients optimize their pricing level and structure

Customers' willingness to pay for goods or services is largely irrelevant in today's competitive markets.

In fact, as a rule, prices are generally below the "willingness-to-pay" line. Instead, the Roland Berger pricing excellence approach focuses on differences to competitors, allowing companies to anticipate customer behavior. The key here is cross-price elasticity.

Sounds complicated? In simple terms, what we do is to compare the actual price of a product or service with competitors' prices on the one hand, and customers' "perception vector" on the other. We then combine the two values into a single recommendation – "change the price model", "stick to the current price", "raise the price", or "lower the price".

Fig. 2: **The 5 success factors in pricing**



3. We help our clients to spot price dynamics early on

Competitors do not sleep. They react in an asymmetrical way and often undermine price recommendations based on static assumptions. Our pricing excellence approach analyzes competitive reactions and trends in a dynamic market model.

Our way of calculating optimum prices and customer reactions is a highly effective extension of traditional methods. It is light years ahead of conjoint measurement.

Working with a professional market research firm, we collect the necessary mass market data. Often, our client will select a firm for us to work with. As a rule, however, we interview key customers ourselves on more of an equal footing. Key customers often require a delicate approach.

4. We help our clients minimize price erosion

Reducing price erosion is a no-brainer. The challenge lies in implementation. The million dollar question is: Does the company have a consistent, performance-oriented system of terms and conditions, and does it avoid price leakages from uncontrolled discounts, bonuses, provisions, commissions and the like?

5. We help our clients to avoid cost inflation

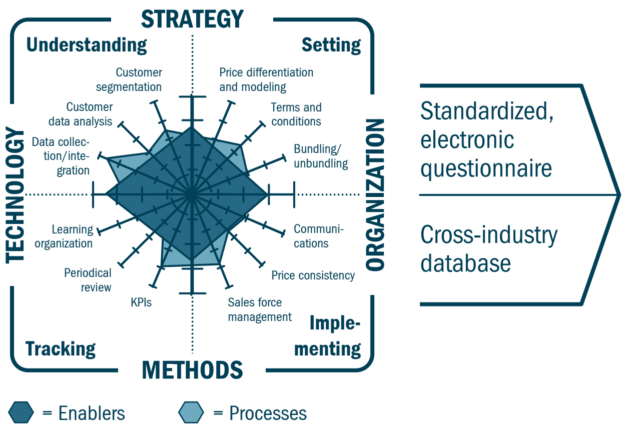
Cost inflation causes margin pressure. Companies must continually check that their offering does not give "too much" added value to customers and if they can save on costs – by shutting down free hotlines, cutting overly generous goodwill gestures, enforcing contractual commitments, and so on.

The second pillar: Benchmarks and best practices

The Roland Berger Pricing Pilot helps our clients measure their pricing performance and then compare it with benchmarks. It includes an internal company check between different divisions, an industry check with competitors and a best-practice benchmark with the "best of best" in pricing across different industries.

The Pricing Pilot measures how well the four enablers – technology, methods, strategy and organization – are integrated into pricing. It also reveals the effectiveness of the 12 key pricing processes at the company in question.

Fig. 3: **Evaluating performance and finding best practices with the Pricing Pilot**



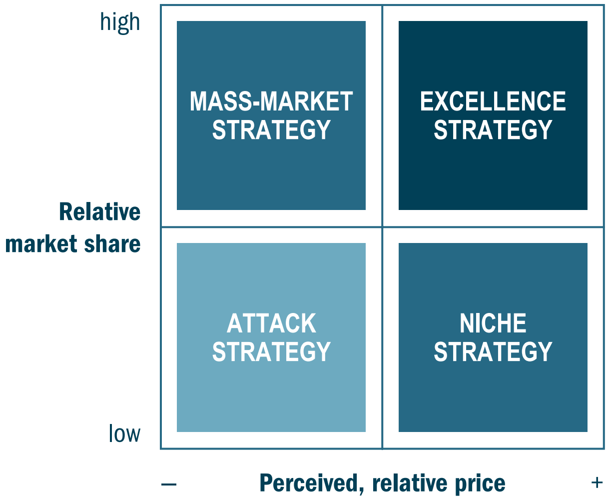
- > Broad analysis of the **understanding of pricing** in the organization
- > Evaluation of **industry-specific pricing relevance** from an internal perspective
- > Evaluation of **company-specific pricing performance** from an internal perspective
- > Comparison with **best-in-class** and **best-practice benchmarks**

Our key learning from projects using the Pricing Pilot has been that, typically, companies do not define their pricing strategy clearly enough. This failing leads to what is commonly known as the "hog cycle" – when demand grows, companies raise their capacities rather than prices, and when demand falls, they lower prices. Generally this sort of behavior leads to a downward pricing spiral in the market as a whole, with the result that prices reach unacceptably low levels.

As a slightly more kosher alternative to the hog cycle, we propose four strategies for optimizing pricing:

> A mass-market strategy (low prices, big market share),
> an attack strategy for market entry (low prices, small market share),
> a niche strategy (high prices, small market share) and
> an excellence strategy (high prices, big market share)

Fig. 4: **The Roland Berger price positioning matrix**



Each of these strategies makes sense in specific market situations. Problems arise when several companies in one industry try to achieve the same strategic position – or simply plop themselves down in the middle somewhere with no clear strategy. Unfortunately, this is not as rare as one might hope. Worse still, some companies haven't the faintest idea what their price position is, lack any semblance of a pricing strategy, and so resort to ad hoc or opportunistic pricing.

Entire industries today are blighted by opportunistic pricing and the absence of real price strategies. The upshot is devastating price wars.

Companies often lower their prices in the short term to try to compensate for falling volumes. However, if all companies in the market take the same tack, the overall price level becomes unattractive in the long term. The only way out of this dead-end situation is to follow a targeted niche or excellence price positioning strategy.

The third pillar: Tailor-made solutions

The levers available to companies for pricing are not just industry-specific. They also depend on whether we are talking B2B or B2C, project or product business, and so on.

Individual projects have a one-piece character, so firms don't need to calculate a "price response function" or the like. Their optimization strategies relate to evaluating the probability of later modifications to the project, generating follow-up business and dealing with the causes of lost orders.

In product business, our clients can implement the pricing excellence method. This approach to pricing looks at relative prices rather than absolute prices, perceived prices instead of real prices and considers dynamic competitor reactions.

For example, one of the most insidious problems in product pricing is that the internal perspective of the sales team can be very different from the external perspective of the customer. By showing our clients how customers actually perceive their prices, we help them to avoid stressing overvalued decision criteria in their marketing and to highlight previously under-valued criteria. Discount policies also frequently have room for improvement. Far too often, sellers have no incentive not to use their discount budgets. To avoid granting discounts without any proof of effectiveness, our clients cut their discounts down to the level of average usage, calculated over several years, and hold up agencies that make little use of discounts as an example of company wide best practice.

These are just two examples of the many different actions companies can take to optimize product pricing. Individual solutions need to be reached on a case-by-case basis, for different industries such as financial services, retail, consumer goods and spare parts. In addition, every company has its own specific situation and pricing strategy.

Pricing excellence – The key to increased ROS and profits

Market saturation, overcapacity, increased price awareness, stronger competition – these are just some of the major challenges facing companies in most markets and industries today. The Roland Berger pricing excellence approach can help you tackle these challenges head-on. One client of ours – a producer of packaging materials in the highly competitive commodity business – used our pricing excellence approach to improve profits by 39% annually, the equivalent of around EUR 8 million. Another client – a manufacturer of large-scale electronic equipment – achieved increased profits of 21% or EUR 11 million per annum. And a leading bank managed to increase profits from its retail business by 47%, with a cost-neutral growth in revenues and profits of EUR 258 million per year.

Companies can use the additional profit for marketing purposes and for increasing their market share. A typical four-month pricing excellence project covers its costs – and starts delivering – after just four weeks.