BCG OPPORTUNITIES *for* ACTION

Upend the Downturn with Strategic Pricing

- *The recent shocks to the global economy have whipsawed the main drivers of pricing: consumers' willingness to spend, competitors' prices, and company economics*
- *Strategic pricing is the antidote for downturns: it can help companies lower perceived prices, manage the risk of price wars, and respond rapidly to price changes*
- *Consumers respond better to discounts than to list prices*
- *You can win price wars by picking your battles carefully or avoid them by changing the rules of engagement*
- *Pricing is too strategic to be left to sales and marketing; empowered organizations must read the market's pulse and respond quickly to shifts in demand*

If your pricing strategy is more than a few months old, it's already obsolete. Companies are struggling to hold on as the roller coaster economy heads south. Consider how the current downturn is affecting the three primary drivers of pricing decisions:

- *Willingness to Spend.* Consumers across all income segments will be looking for ways not to spend as they struggle to stay afloat in tough times.
- *Competitors' Prices.* Pressured by decreasing demand and consumers' price sensitivity, competitors will be tempted to lower prices and wage price wars.
- *Company Economics.* Volatility in commodity costs and uncertainty about volume will continue to disrupt supply chain costs.

In the face of such challenges, strategic pricing can get your company heading back up—even when your competitors are going down. It can combat extreme price sensitivity with lower perceived prices, manage the risk of price wars, and mobilize the organization to respond rapidly to price changes.

Reduce Perceived Prices Without Cutting into Profits

Tight credit and plummeting asset values, coupled with job insecurity and higher unemployment, have put a big damper on spending. In a recent survey, The Boston Consulting Group found that 58 percent of U.S. consumers and 56 percent of E.U. consumers plan to decrease their spending by 5 percent or more over the course of 2009. They are on the lookout for deals, promotions, discounts, and bargains—and this trend will only intensify. Most companies will lower prices, which makes sense. Before you follow suit, however, consider reducing the *perceived* price point to avoid cutting into margins. You can do so in a number of ways.

Redesign value to align with lower prices. Now, more than ever, prices and value should march in lockstep. If consumers want lower prices, then redesign your offering to deliver less value. For instance, many consumer-goods companies have switched to slimmed-down packaging this year. Most consumers don't notice—and if they do, they don't mind because they are looking for lower prices, especially when it comes to nonessentials. If a tall latte is a bit shorter, so much the better. You can also save on costs by removing features that consumers care less about. And products can even be redesigned to meet a targeted low price, as Renault has done with the Dacia Logan sedan.

Unbundle product and service offerings. Attach small fees to services you've been giving away. Traditional U.S. airlines, which have been pressured by low-cost competitors and high-priced fuel, have started to unbundle services by charging passengers for meals, headsets, luggage, and even blankets. The purpose of bundling, after all, is to encourage consumers to buy more. But now that consumers are looking for less, unbundling works better for them.

Lock in and sell up. Companies need to be aggressive, not just in lowering prices to lock customers into contracts but also in moving them up to higher-margin products. By offering large discounts on cell-phone and service packages, mobile service providers commit consumers to multiyear contracts, which gives the service provider plenty of time to market additional products, such as ring tones and games. Health clubs, credit card providers, and even makers of printers and iPods have developed similar schemes. Some companies are old hands at this tactic, but many others are just beginning to experiment with it. For example, a cruise line recently discovered that customers who initially bought its least expensive package were quite willing to upgrade to a nicer cabin later for an additional price. Splitting the purchase decision into two smaller price points turned out to be very effective.

Increase prices and discounts. Consumers tend to be more sensitive to discounts than they are to list prices. In many markets, for example, products listed at a price of $99.99 with a 10 percent discount may sell better than those with a list price of $89.99. As consumers become more price sensitive, this effect will intensify—so that still more products could be sold at a list price of $112.49 with a 20 percent discount. Do the research to discover the nuances in price sensitivity in your own markets, and align your promotions and discounts accordingly. In most cases, you'll find that you can reduce the perceived price point without affecting the actual price.

Strategically Manage the Risk of Price Wars

Although you can lower *perceived* prices and maintain your profit margin in a downturn, the risk is high that your competitors will reduce their *actual* prices, thereby starting a price war. There are two ways to confront this threat. One way is to face up to the fight but pick your battles: assess each of your businesses and decide where it makes most sense to play defense or offense. The other way is to avoid confrontation by changing the rules of engagement with innovative pricing models that don't force you to go head-to-head against the competition. New pricing models often emerge during moments of crisis, so seize the opportunity.

De-average pricing across the portfolio. When it looks as if a competitor is about to lower its prices, you could take the offense and cut prices first—or play defense and react to the price cuts when they arise. In either case, de-averaging the businesses in your portfolio is critical. If competitors are likely to match your initial price reduction, it doesn't make sense to lower your prices still further unless you have a significant cost advantage. Price cuts are an excellent way to gain share, because competitors won't be able to follow you down the price ladder without eating into their profits. If you don't have a cost advantage, lowering your prices first without changing anything else results only in lower margins after competitors have matched your price cut. So offensive price cuts must be focused in markets and on products where your cost advantage is secure.

Defensive price moves, which will depend on the degree of market fragmentation and the share of the market you own, also need to be de-averaged by segment, region, and products. Markets in which you have low share will tend to be more price elastic, so they are a good place to lower prices and regain share in response to a competitor's attack—whether it's in a category, channel, or region. You'll be able to second-guess competitors better in markets with relatively few of them, whereas fragmented markets with many competitors can be approached simply by optimizing on the basis of price elasticities. That's why it's important to know both the strong and weak aspects of your portfolio.

Avoid price wars. You can circumvent price wars by changing the rules with new pricing models better suited to the needs of your customers rather than by reducing current prices. For instance, financing schemes for big-ticket durables—such as refrigerators, washing machines, and even automobiles—have been a staple of new pricing models in downturns. Leasing, rentals, and new business models that involve subscriptions, such as Netflix, are variations on the same theme.

Another way to avoid price wars is to change the rules of price competition by reducing or eliminating secondary fees. Bank of America's decision to advertise mortgages with no closing costs deflected attention away from the actual interest rate. The tactic also works in reverse: some U.S. credit-card companies have maintained relatively low APR rates but raised fine-print fees.

Mobilize the Organization for a Fast Response

Today, the economics of your business can change overnight. Lower sales volumes and the inability to reduce fixed costs quickly enough, combined with volatile commodity costs, can rapidly squeeze profits. And increasingly tight-fisted consumers can cause inventory to pile up while you shift the product mix to offerings with lower margins—all of which raises costs to serve. There are a few ways to avoid this double bind.

Monitor consumer behavior and competitors' prices more often. Beyond their price sensitivity, consumers will display other signs of tightening budgets, such as taking fewer trips to the supermarket to save on gas, switching to private-label products, and shopping in more affordable channels. The effects of some changes might be unexpected—for instance, more demand for bulk packages (shopping less frequently) and higher sales of home beauty treatments (avoiding pricey spas and hair salons). You can't rely on past experience to keep abreast of these changes. You have to empower an organization that can swiftly read the market's pulse and respond rapidly to shifts in demand. That will require frequent consumer surveys to understand changes in behavior and to measure price sensitivity in order to discover the optimum price point on profit parabolas. And to manage the risk of price wars and optimize price gaps, you'll also need reliable intelligence on competitors' pricing behavior—especially changes in pricing levels, promotional activities, and discounting schemes.

Make pricing processes more accurate and responsive. You need to be able to alter your prices and policies on a dime in response to market shifts. That calls for frequent price-strategy reviews with current data on costs to serve and account profitability. For instance, you should aggressively and swiftly manage swings in commodity prices—either up or down. Indexing prices to key commodity costs in times of volatility is a good way to protect margins. You should also monitor the *actual* price realization your sales force passes on to the market and beware of aggregate pricing indicators that fail to account for the full chain of pricing discounts. Suppliers should manage retailers' margins to reflect the relative velocity of sales: you'll want to insist on lower margins if that is appropriate for retailers' return on their investment in inventory. Finally, retailers will need to base prices not on the inventory cost but on the cost of replacing the items on the shelf.

Involve managers in pricing decisions. Now, more than ever, attention to pricing offers a unique "return on time invested" for your senior managers. With their direct links to sourcing strategy, competitive position, and the management of capacity and fixed costs, pricing issues have become too strategic to be left solely in the hands of sales and marketing teams. As your senior managers take on more responsibility for pricing, they must also "operationalize" the new processes: make objectives concrete and support them with an aligned system of incentives. Failing to adjust the sales-force incentive system (by reducing quotas, for example) could be perceived as unfair in today's market—and the last thing you want in a depressed market is a depressed sales force.

Whatever business you are in, the recent shocks to the global economy probably go far beyond the challenges you usually face in annual pricing decisions. We offer the following questions to help guide you and your senior managers as you prepare for the roller coaster ride ahead:

- Are consumers moving away from our products because we haven't adapted to their expectations for price and value? Can we enrich our value offerings?
- Do we know how price elasticity has changed since the downturn—or are we relying on outdated analyses?
- Do we know which competitors are likely to trigger a price war? Are we ready to cut costs so that we can lower prices, if necessary?
- Have we considered new pricing models to avoid price wars altogether?
- Is the organization prepared to respond to changes in the competitive environment swiftly and aggressively? Is general management involved?

Downturns don't have to be all bad news. They can be an opportunity to capture market share and secure long-term competitive advantage. Pricing is a critical and powerful lever in this effort. If you manage your pricing better than your competitors, your business could go up—even in a downturn.

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