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Crisis Pricing for the Downturn and After

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A recession is no time for pricing as usual. In a cycle of collapsing demand, volatile sourcing costs, and increasingly intense competition, you need all hands on deck to protect prices. And because these conditions are likely to remain (to some extent) throughout the anticipated slow recovery, it is imperative that companies stay in crisis-alert mode well into the new normal.

Most companies are uncertain about managing pricing as they come out of a downturn. Few plan for a recovery or pull the right pricing levers at the right time. They aren't prepared to price—either up or down—in response to changing market conditions or competitive dynamics. The companies that emerge from this recession as winners will be battle ready to defend their prices with disciplined processes that give them a competitive advantage when the economy turns around.

What a Difference a Downturn Makes

The forces of a recession can attack a company's pricing plans on a number of fronts. Three of the most critical are the following:

- *Price Leaks.* Most companies are resigned to some price leakage—the difference between the list price and the net price after trade spending, promotions, and other customer enticements are subtracted. In a stable pricing environment, a 50 percent leakage on a price increase of 2 percent subtracts only 1 percent from price realization, which can easily be made up with added sales volume. In today's more volatile pricing environment, however, prices might increase or decrease anywhere from 5 to 10 percent, so a 50 percent leakage deducts 2.5 to 5 percent from price realization. For instance, if a company raised a product's price by 5 percent to compensate for higher input costs, a 50 percent leakage would result in a 2.5 percent loss in earnings before interest and taxes (EBIT). Therefore, tighter pricing discipline is called for.

- *Volatile Markets for Key Inputs.* The increasing turbulence in commodity prices represents a huge challenge for companies. In more stable times, a manufacturer could set prices on the basis of fairly predictable input costs and market conditions. Today, many key functions need to be involved—including purchasing, finance, and operations—in order to link pricing decisions to sourcing costs and changes in supply chain management.

- *Rapid Changes in Demand.* Most companies have developed routines that take stock of economic indicators on a quarterly or even an annual basis. That is no longer sufficient when the spending behavior of anxious customers and consumers swings widely with the latest economic report. For example, comparing The Boston Consulting Group's worldwide surveys of consumers conducted in 2008 with surveys taken in the first quarter of 2009 shows consumers' intention to decrease spending jumped 14 percentage points in the United States, 21 percentage points in Japan, and 43 percentage points in Russia. In order to respond quickly to changes in customer and consumer price sensitivity, you need to track key indicators continuously.

Managers must prepare themselves to operate under "wartime" conditions for the duration of the financial crisis as well as after. That means being more vigilant, aggressive, and disciplined in their fundamental approach to pricing. They need to mobilize a SWAT team to make pricing a strategic weapon.

Consider the example of an industrial-goods manufacturing company that has set up a "war room" to implement strategic pricing with military rigor. Using wall-to-wall charts and complex graphs, a sequence of cross-functional teams meet in the room daily to dispel the "fog of war" by monitoring the flow of leads, quotes, and signed deals; targeting customers; and watching the win rate. These teams regularly collect information, purge it of inaccuracies, investigate anomalies, identify short-term indicators, and discuss longer-term trends. A dashboard, updated weekly, provides transparency for executives on overall sales volume, discounting trends, and the status of key accounts. As leads become deals, attention turns from winning customers to maximizing the contribution margin and cost-to-serve issues, such as how orders are scheduled for production in the factory and how they are stacked to ship.

Wars are fought with imperfect information. In contrast, the purpose of the industrial-goods manufacturer's war room is to make sure the information gathered is as complete and timely as possible in order to avoid costly overdiscounting. Additionally, the war room helps the company price competitively to maintain or gain market share, which ensures that the sales force has the best possible advantage when bidding against competitors for particular customers or products. Finally, the war room provides early information to marketing about emerging product gaps or distribution issues. Such rigor in managing the sales funnel and pricing structure is rare, but its value has been obvious to other parts of the organization: they have set up their own war rooms to better manage through these turbulent times.

Companies can take three sets of quick, yet effective actions to defend prices, win unavoidable price wars, and position themselves for victory in the recovery.

Set Up Field Operations to Support Wartime Pricing Conditions

Napoleon Bonaparte famously noted that an army marches on its stomach. In other words, troops depend on the support of a supply line to provide them with food and clothing, as well as logistics, information, and battle plans. Similarly, a pricing organization can be only as good as the support it receives, so that is the place to mobilize first.

- *Establish a pricing committee.* This group should meet at least monthly and include a manager from each key function, such as finance, operations, sourcing, marketing, and sales. The group's job will be to monitor each pricing policy as it is rolled out and refine it as necessary.

- *Institute new pricing guidelines for all business units.* Strict procedures will greatly reduce price leaks and bring discipline to the pricing process. The guidelines should stipulate parameters for payment terms, maximum discounts, policies on free goods, freight charges, and approval procedures. If they do this right, most companies could see as much as a 1 percent increase in EBIT.

- *Double or even triple the time spent preparing for key negotiations.* Customers are primed to drive hard bargains, so you need to arm the sales force to withstand the pressure. One company prepared account packages for its top 25 deals and devoted senior management's attention to making sure the firm won all 25. Payback has been more than ten times the investment.

- *Build a quick-and-dirty data-collection process.* Many companies already have sophisticated information-technology systems that track and analyze the internal data they require for pricing. But they might also need supplemental data—such as price realization targets and monthly results by product, region, and client account—to provide a new perspective for a short-term condition. In that case, rather than invest in more expensive technology, companies could configure a Microsoft Office Excel–based tool to deliver relevant data by business line, market, and competitor. Even for organizations that have major gaps in their pricing-data collection, an Excel-based tool might be all that's required in the short term to gather the information senior management needs to determine price changes or prepare key proposals.

- *Develop financial plans on the basis of realistic price assumptions.* Too often, price realization is not embedded in financial forecasts, and assumptions turn out to be aspirational objectives rather than predictions based on hard data. Research conducted by BCG in 2009 indicated that although 70 percent of the global companies surveyed expected customers to become more price sensitive over the coming year, 40 percent were implicitly forecasting an increase in price realization.

- *Review sales force incentives and price realization targets frequently.* When markets change rapidly and drastically, make sure expectations continue to be aligned with new conditions. Targets for sales volume and price realization that were set 12 months ago—when the market outlook was much brighter—can be extremely demoralizing to a sales force that is facing much tougher conditions. In the media world, for example, the unexpected depth of the economic crisis made 2009 advertising-sales targets unrealistic and saddled sales teams with impossible goals. Learning from this experience, a few media companies are now considering adjusting sales targets every six months instead of annually.

Strategically Manage the Risk of Price Wars

Although you can maintain profit margins in a downturn by lowering perceived prices, the risk is high that competitors will reduce their actual prices, thereby starting a price war. Price wars—the tank battles of pricing strategy—can easily turn into wars of attrition in which everyone loses. Several factors determine the risk of a price war, so you should be on the lookout for the following signs of impending battle in each of your markets and areas of business:

- *You are the market share leader.* Companies with high market share have more to lose and less to gain than their smaller competitors if prices decline. For example, if a market share leader lowers prices, the volume it gains amounts to a relatively small percentage increase in its market share. In contrast, if smaller competitors reduce prices, the volume they gain can give them a relatively large percentage increase in market share. Market share leaders must be on the alert for smaller players that act aggressively on pricing and shouldn't necessarily match their prices.

- *You have relatively low variable costs.* If a company's variable cost position is much better than that of its competitors, it can gain market share by reducing prices. Competitors will not be able to keep up over the long term, and the increase in volume for the cost leader can be profitable. However, the cost advantage should be at least 10 to 20 percent in order to be credible and prevent competitors from fighting for too long.

- *Your industry has low capacity utilization.* When there is excess manufacturing capacity in an industry, the need to produce and sell more volume is great, making it more likely that competitors will follow suit if any player lowers prices. Unless capacity is taken out of the market, the marginal cost of selling incremental volume is so low that incentives to reduce prices tend to be difficult to resist.

- *Your prices are transparent.* In some sectors, such as the airline industry, changes in pricing are highly visible to both customers and competitors. Therefore, when a player raises or lowers its prices, it is likely to trigger direct responses from competitors. An increase in pricing transparency can be particularly harmful, as customers who become aware of lower prices will demand similar pricing conditions. Long-term pricing transparency can have a positive effect in the business-to-business space, as it minimizes the risk of an individual sales representative overdiscounting because he is concerned competitors might be pricing even lower.

When price wars are inevitable, a company has a few choices. One option is to face up to the fight but pick its battles: assess each of the businesses threatened and decide where it makes most sense to play offense or defense. Another option is to avoid confrontation by changing the rules of engagement with innovative pricing models that don't force head-to-head competition. In fact, new pricing models often emerge during moments of crisis. Companies can pursue one or more of these options when faced with a price war:

- *Playing Offense.* When it looks like a competitor is about to lower its prices, you could go on the offensive and cut prices first. But before you do, you must analyze the cost factors of the businesses in your portfolio to determine where your cost advantages lie. If competitors are likely to match your initial price reduction, it makes sense to lower prices still further only if you have a significant cost advantage. In such situations, price cuts are an excellent way to gain market 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 prices first without changing anything else results only in lower margins after competitors have matched your price cuts. So offensive price cuts must be focused in markets and on products where your cost advantage is secure. U.S. grocer Whole Foods Market, for example, matches the prices of Trader Joe's, a low-cost competitor, only with its Whole Foods "365" private-label items; not all of the products in Whole Foods stores are priced to match Trader Joe's.

- *Playing Defense.* Defensive price moves, which depend on the size of your market share and the degree of market fragmentation, also need to be de-averaged by segment, region, and product. For instance, when premium-brand manufacturer Procter & Gamble decided to introduce Tide Basic—a low-price version of its top-selling brand—it launched the product in only 100 stores throughout the southern region of the United States. Markets in which you have low share tend to be more price elastic, so they are good places to lower prices and regain share in response to a competitor's attack—whether it is in a channel, region, or category. You will be able to second-guess competitors better in a market with relatively few of them, whereas fragmented markets with many competitors can be approached simply by optimizing on the basis of short-term price elasticities. Therefore, it is important to know both the strong and weak aspects of your portfolio.

- *Avoiding Direct Combat.* 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 consumer 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 interest rate. This tactic also works in reverse: some U.S. credit-card companies have maintained relatively low annual percentage rates but raised late charges and other fees found only in the fine print of credit card agreements.

Identify Tactics to Manage Price Perceptions

Some companies are reducing prices to new lows in order to stimulate consumer demand, but cutting prices in a downturn can be risky. In many cases, promotions fail to generate sufficient incremental volume to offset the margin reduction on sales that would otherwise have been made at the regular price. (See the exhibit "Cutting Prices Is Tricky—Do the Math.") A CEO of a large department-store chain recently reported remarkable sell-through on drastically marked-down items, but he was unable to generate sufficient sales to make up for the margins he sacrificed. What is more, price reductions can simply pull demand forward from the future—at much lower margin levels—rather than create new demand.

A better way to address the price-volume tradeoff is to lower *perceived* price points rather than *actual* prices. Consider this a stealth tactic that helps to maintain or increase volume without actually lowering prices. A BCG survey conducted in Europe earlier this year found that the retailers that consumers identified as having lower prices in fact had prices that were 1 to 2 percent above average. There are many

Cutting Prices Is Tricky—Do the Math

	The increase in sales volume necessary to compensate for reducing prices	
Gross margin on variable costs (%)	**With a 10 percent price cut (%)**	**With a 20 percent price cut (%)**
30	50	200
50	25	65
70	17	40

Source: BCG analysis.

ways to lower perceived prices while maintaining margins similar to those of competitors with higher perceived prices:

- *Unbundle product and service offerings.* The purpose of bundling different products or services into a single offering is to increase customer retention and encourage consumers to buy more. But now that consumers are looking to spend less, companies such as computer manufacturers have begun to offer "naked," or unbundled, products. One approach to unbundling is attaching small fees to previously free services. For example, airlines have begun to charge for everything from snacks and blankets to additional leg room.

- *Increase both prices and discounts.* Consumers tend to be more responsive to discounts than they are to list prices. In many markets, for example, more products are sold at a list price of $99.99 with a 10 percent discount than are sold at a list price of $89.99. As consumers become more price sensitive, this effect will intensify—so still more products could be sold at a list price of $112.49 with a 20 percent discount. When companies raise list prices and offer discounts—as opposed to cutting prices—they not only protect their margins but also safeguard the perceived value of their products.

- *Price to match customer economics.* By linking price to a key indicator or index, companies can help reduce downside risk for their customers and minimize their uncertainty. Mall developers, for example, may tie store rental prices to retail-sales volume, and some hotel companies are linking fees paid by property developers and managers to occupancy rates.

- *Develop harpoon offers.* Business-to-business companies, such as industrial-equipment manufacturers and service providers, are often in a position to win a customer's business and then negotiate final price and features later. Competitive bidding is a good example. A company might offer an aggressively low price based strictly on the client's specifications. Then, after it wins the bid, it can gather more data on the client's operations and propose an attractive offering that adds value for a slightly higher price. The ability to move clients up the value ladder after a bid is won is a key sales skill that can increase price realization by two to three percentage points. This approach is especially useful for getting past the sourcing department fortress without sacrificing margins. Business-to-business companies aren't the only ones that can benefit from this strategy. Some travel companies use a similar lock-in-and-sell-up approach. After signing up vacationers for their least expensive package, sales representatives contact the customers before the date of the trip and offer an enticing upgrade on accommodations and services for a slightly higher price. Splitting the purchase decision into two parts, each with a smaller price point, has proved to be an effective way to maintain margins.

- *Institute performance- or value-based pricing.* Companies can increase the attractiveness of their product offerings by charging on a value-added basis, such as the pay-per-click advertising model that some Internet companies have developed. Along the same lines, pharmaceutical companies have successfully started to sell vaccines with prices linked to economic and medical benefits rather than based solely on cost of goods. It takes longer to work out agreements with payers, but the price realization has been five to ten times that of previous generations of injections.

There is no way around the fact that pricing is complex—too complex to rely solely on quick fixes. Yet the current economic environment demands immediate action. If you have not already set in motion the protective actions we have suggested, time is running out. Quick fixes are better than no fixes. Furthermore, because consumer frugality and fluctuating commodity prices are likely to continue into the recovery and even beyond, you should hard-wire these activities into the organization for the long term—they will be an indispensable pricing advantage in the new normal.

Although most companies have concentrated on cost reduction during the economic slowdown, a focus on pricing can be a much more powerful way of improving growth, profits, market share, and competitive position. And winning on all four measures is the best position to be in when the recovery comes around at last.

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