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THE KEY TO HIGHER PROFITS: PRICING POWER

Why executives should make pricing their personal mission

Georg Tacke, David Vidal and Annette Ehrhardt

Why executives should make pricing their personal mission

Imagine a world in which over 80% of companies have come under increased pricing pressure, and almost 60% of companies are embroiled in a "hot" price war. The vast majority of companies feel they can't justify a price increase above current levels of inflation. Even when they dare to raise prices at all, they manage to get only half of what they ask for.

What you just imagined is real.

These discouraging circumstances describe day-to-day life right now for thousands of companies around the world. At a time when every dollar, Euro, yen, or yuan in profit is precious, even some of the world's most prominent companies, such as consumer products giant Procter & Gamble, often struggle to make price increases stick. This struggle reflects weakness in pricing power, the ability of a company to get the prices it deserves for the value it delivers to customers.

But the excitement is unmistakable when a company does exercise pricing power effectively. In its second fiscal quarter (Oct-Dec 2012), that very same Procter & Gamble – which was ineffective at raising prices over the last two years – reported an increase in gross margins of 110 basis points "due to the impact of higher pricing and manufacturing cost savings." The company's optimism also rose sharply. The strong profit growth – combined with surprisingly strong organic sales growth – prompted the company to revise its financial forecasts upward for the rest of the 2012/13 fiscal year.

That turnaround did not happen overnight. It always takes a concerted effort for a company to develop pricing power and then see it pay off.

But exactly how strong is the link between pricing power and higher profits? And if it is strong, how do companies generate that elusive pricing power? The Global Pricing Study

2012, conducted by Simon-Kucher & Partners, the world's leading pricing consulting firm, provided us fresh insights into that link. Combined with our firm's experience over the last 28 years, these insights helped us develop clear and very specific answers to both questions, with implications for companies in all industries, regions, and categories.

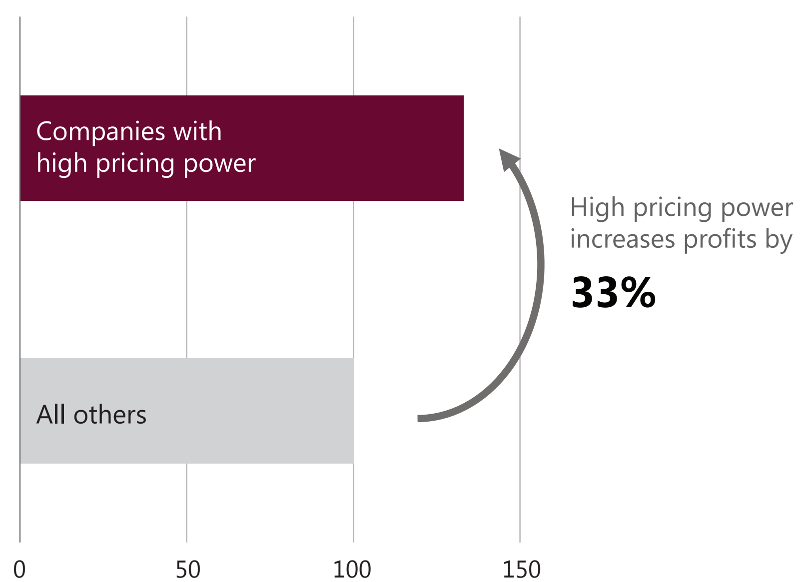
The Global Pricing Study 2012, a comprehensive survey of over 2,700 executives and managers in over 50 countries, made one fact clear: the wellspring of pricing power is the C-suite. Companies whose CEOs make a personal commitment to pricing – and who take an active role in it – have much higher pricing power and much higher profits than those whose CEOs do not have pricing high on their agendas.

In other words: profits jump when CEOs take an active role in pricing and make pricing personal. Higher pricing power increases profits by 33%, according to the study. Furthermore, companies with high pricing power are more likely to have a stronger profit outlook, more likely to raise prices, and more likely to make those price increases stick.

But only a minority of companies succeeds in generating pricing power, harnessing it, and sustaining it in today's era of low GDP growth in western markets and ongoing uncertainty in developing ones.

Pricing power

Average profit margin of last three years (index)



What do those select companies have in common? Of course, their C-level executives don't roll up their sleeves and perform day-to-day, nuts-and-bolts price setting. Instead, their C-level executives know that their express commitment and increased scrutiny on any issue will exert a strong influence on their company's mindset. They can change the internal mindset on pricing in the same manner.

When an executive makes pricing improvement his or her personal mission, it automatically becomes a corporate one. This translates into pricing power and profit improvement when they:

- Establish and enforce clear accountability for pricing strategy
- Support the development of a pricing organization with transparent pricing processes
- Ensure that revenue models reflect both the value their business units deliver and the costs they incur
- Communicate their pricing strategy and pricing identity, as the company's pricing ambassadors, internally and externally

That's the golden combination that allows pricing power to develop and work its bottom-line magic in today's economic climate.

This eBook explains how to achieve that golden combination, by putting those four points into action. It serves as a mandate for change for C-level executives who want to take a closer look at their own organizations and start to generate, harness, and sustain more pricing power, then reap the higher profits that go hand in hand with it.

Think back to the circumstances at the beginning of this eBook. As a C-level executive, you have two options

- **intervene** to escape the circumstances, thus enabling your organization to turn pricing from an underperforming asset to a powerful advantage
- **accept** those circumstances, which is tantamount to accepting perennial underperformance, with all the consequences that it brings in today's uncertain economic climate.

If profit growth is an essential part of your company's mix of objectives, then you really have only one option: to intervene.

Intervention requires an element of courage, which you not only need to demonstrate personally, but also transmit to the rest of your organization. The rewards for showing this courage and seizing the initiative are substantial. Experience shows that the firms that increase prices *first* are likely to enjoy increased profitability compared to those that continue to delay price increases.

"Sara, have sales do that thing where profits go up."

Michelin CFO Marc Henry said his company "is the prime mover regarding price increases" in the tire industry. Michelin also usually takes home the biggest share of the industry's profit pool, with an EBIT in 2011 of $2.5 billion vs. $2 billion for Bridgestone, even though the latter company had higher revenue ($31 billion vs. $28 billion) than Michelin. Goodyear, meanwhile, earned around $800 million in EBIT on revenues of $22 billion.

The commitment and courage required of C-level executives is significant. There is no doubt about that. But the stakes and the rewards are high. When higher pricing power translates into 33% higher profits, it is hard to imagine a better investment for your company to make than to follow the change mandate in this eBook.

CHANGE #1

Establish and enforce clear accountability for pricing strategy

Companies whose C-level executives take an active role in pricing are 35% more likely to have high pricing power, and 30% more likely to expect strong EBITDA growth over the next three years.

The first area of change to achieve that level of pricing power is to take a much more disciplined approach to pricing strategy. That begins with consistent leadership and guidance from the top down. Executives who help their companies create and sustain higher pricing power provide clear, consistent direction and guidance on pricing. They also establish and enforce clear accountability for pricing strategy throughout the whole organization.

Accountability, in turn, starts to take root when you demand that each business unit delivers an *explicit* pricing strategy. But you have to build up to that level, step by step. Each C-level executive must learn what kind of guidance each business unit needs, and also learn how to conduct a more robust discussion around pricing, *before* a team takes a decision, and not just afterwards. As an executive, what should you ask for? How do you challenge the pricing strategies in a constructive way?

The very first step – proven to be effective in so many contexts – is to work with a more rigorous definition of "pricing strategy" and to put commitments and numbers down in writing.

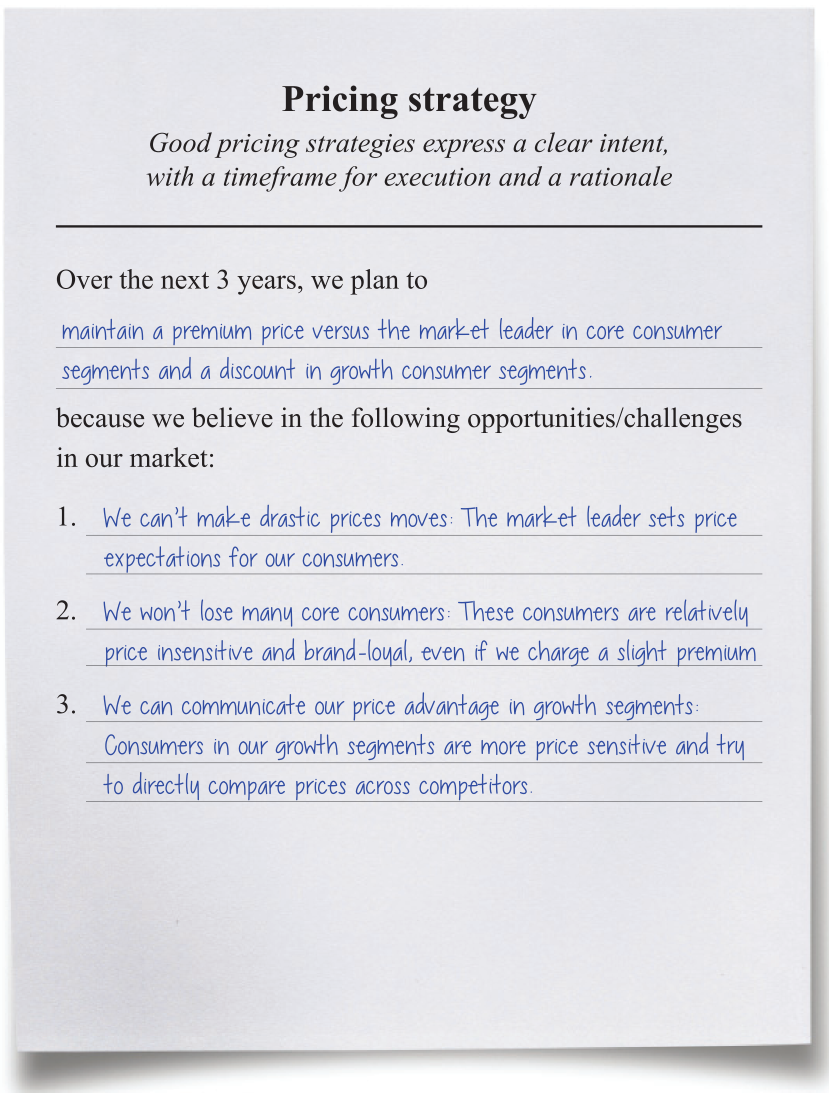
What is that rigorous definition? A pricing strategy must include these elements:

- a clear intent
- a quantified direction for prices or price changes
- a timeframe for execution
- the word "because"

"Because" is essential. It forces the strategy to draw on evidence from your company's financial and marketing objectives, your segmentation, your products' perceived value, your portfolio, and your competitors' moves.

In fact, a pricing strategy must derive directly from your company's overall objectives. Without unequivocal guidance from you on what matters most – revenue, volume, absolute profit, margin, or market share – it is hard for your teams to deliver explicit pricing strategies, and even harder for you to provide guidance on how to make adjustments. Your overall strategic direction will depend on changes in demand or customer segments, in the competitive situation, and in your own positioning. In that sense, your targets – and hence your guidance – is often relative rather than absolute.

What does this look like in practice? You'll find two sample strategies below:



Pricing strategy

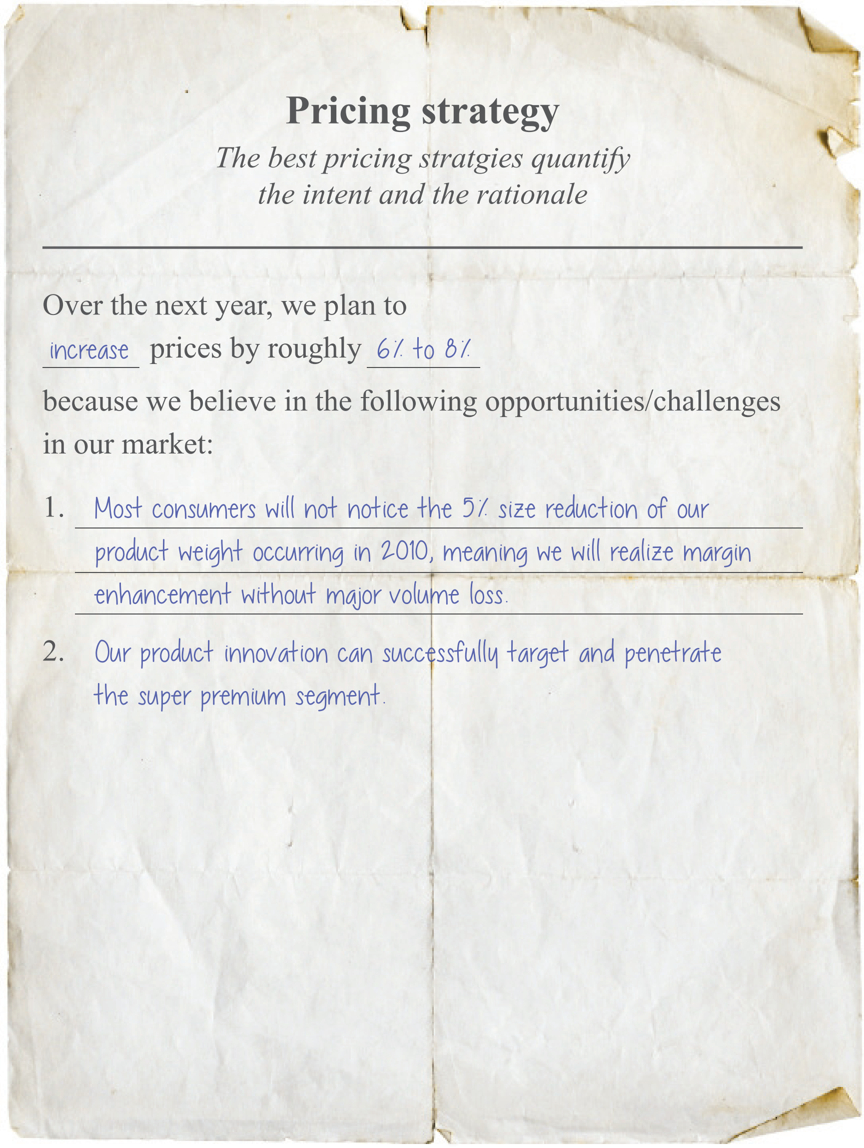
Good pricing strategies express a clear intent, with a timeframe for execution and a rationale

Over the next 3 years, we plan to

maintain a premium price versus the market leader in core consumer segments and a discount in growth consumer segments.

because we believe in the following opportunities/challenges in our market:

1. We can't make drastic prices moves: The market leader sets price expectations for our consumers.
2. We won't lose many core consumers: These consumers are relatively price insensitive and brand-loyal, even if we charge a slight premium
3. We can communicate our price advantage in growth segments: Consumers in our growth segments are more price sensitive and try to directly compare prices across competitors.



Pricing strategy

The best pricing stratgies quantify the intent and the rationale

Over the next year, we plan to increase prices by roughly 6% to 8% because we believe in the following opportunities/challenges in our market:

1. Most consumers will not notice the 5% size reduction of our product weight occurring in 2010, meaning we will realize margin enhancement without major volume loss.
2. Our product innovation can successfully target and penetrate the super premium segment.

These statements take time to prepare. Finding the evidence alone and agreeing on its implications can be a painstaking process. But these statements create clarity around the pricing goals and how they link to corporate objectives. They help you hold your teams accountable.

When we speak with executives the world over, most of them can proudly point to crisply defined sales goals or manufacturing processes. You see them displayed on banners hanging in the lobby, or on posters decorating the hallways on the way to the shop floor. You may see hints about pricing, too, such as The Disney Company talking about “affordability”.

But far less common are the numbers and the commitments for pricing and profit, never mind a definition for success in either area.

"Writing things down" means that each business unit needs to express its profit orientation in numbers (relative or absolute) and define the pricing steps it will take to meet them. This takes the mystery and emotions out of pricing discussions. Over time the mechanics of good pricing become ingrained, even second nature.

As an executive, you need to drill deeper into the overall strategic direction of all business units. In the spirit of what we said earlier, no one expects the executives to do all the pricing work on their own. Rather, they should challenge their direct reports and teams by asking challenging questions and demanding that teams provide the answers and the support for those answers.

If a business unit has done its homework properly, executives can probe with a handful of simple "what if?" situations. The four simplest ones apply to any company in any industry in any part of the world:

- what will happen if we raise prices?
- what will happen if we cut prices?
- how <u>exactly</u> will we respond if our main competitor raises prices?
- how <u>exactly</u> will we respond if our main competitor cuts prices?

The answers should start with numbers, not stories. You can answer all four of these questions with a vast list of variables, but the most relevant ones are revenue, volume, absolute profit, margin, and market share. Everyone involved in these discussions should already have a vested interest in improving those metrics. In many companies that excel in pricing power, the incentive plans – from salespeople all the way up to C-level executives – reward performance against some combination of those five metrics. This makes pricing power even more personal, and not just for the senior executives.

What the business units bring to these discussions depends heavily on your market structure and your position in it. For companies in an oligopoly, having an explicit pricing strategy serves as your touchstone and conscience when you feel the need to act to stabilize prices, prevent price erosion, or defuse a price war. For companies in other markets, it still serves as your conscience, but more as way to remain disciplined and true to your objectives when the temptation arises to use pricing as a convenient means to reach a short-term goal.

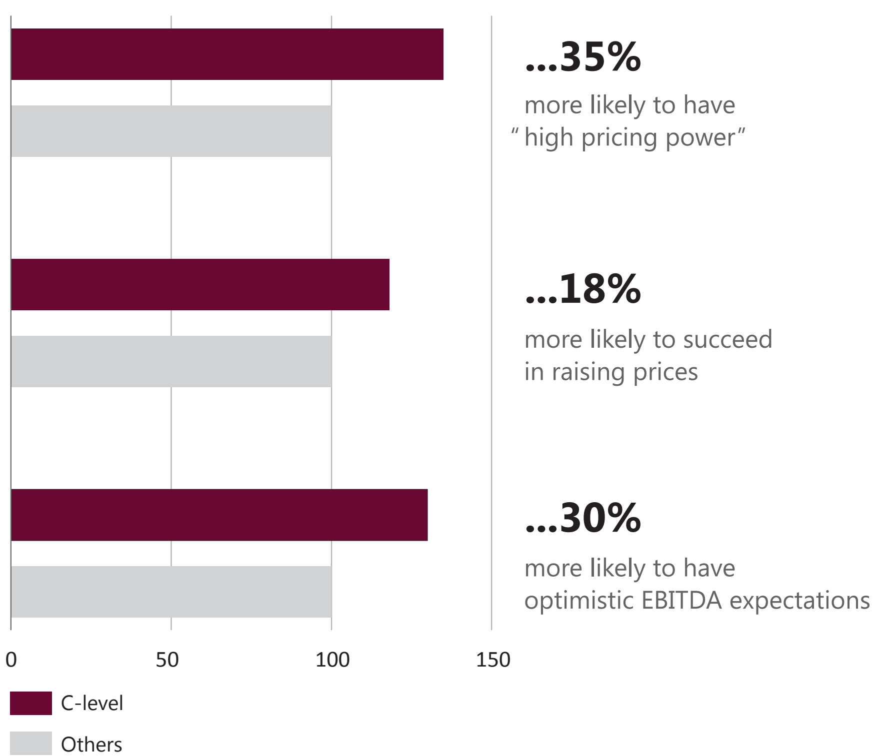
This also presents an opportunity for C-level executives to dig even deeper. We strongly recommend that each executive spend two hours every month examining a specific pricing topic. It could be contract language, negotiating strategies, terms and conditions, selling tactics, or even plans for market research.

The shadow presence of a senior executive can seem ominous for any team. But it brings two very positive benefits to the organization which can help establish proof of concept, build confidence, and further enhance pricing power. First, it creates a sense of discipline and helps foster accountability. The risk of being watched or judged sharpens the team's focus even more.

But with that risk comes reward. Creating the right impression and meeting or exceeding targets under that scrutiny should bring recognition and create an appetite for more, not only for that team but also for others. Whenever possible, you should publicize the positive results internally and express them in money terms. Even small "victories" can have that contagious and positive effect if the senior executives position them properly.

C-level involvement drives pricing performance

Companies with increased C-level involvement in pricing are...



Companies with active C-level involvement in pricing are 18% more likely to put through a successful price increase, according to the study. But more importantly, they are 26% more likely to get higher margins from their price increases than companies without the C-level involvement in pricing. Every point of margin you can get from a price increase is precious in today's tough climate.

Once you have defined your pricing strategies and made your teams accountable for them, you need to make sure you have the right organization so that your company can act on it confidently and effectively.

Having executives devote more of their time and energy to pricing makes a difference. But the impact grows when the executives equip their companies to do the same. That means creating a dedicated pricing organization. The Global Pricing Study 2012 showed that such organizations also have a clear impact on a company's ability to translate pricing power into higher profits.

CHANGE #2

Support the development of a pricing organization with well-defined pricing processes

Your employees may talk about pricing a lot, but they probably do not always talk about it in a structured or efficient way. That is an unfortunate truth in most companies, large and small. It not only hampers a company's ability to deliver an explicit pricing strategy. It makes it harder to generate and harness pricing power.

That fact has something to do with the nature of pricing itself. Pricing complexity is a fact of life. It almost always involves too many people, too many opinions, too many interactions, too much data, and too little time. Pricing is also complex because making pricing decisions – both strategically and tactically – involves taking internal and external information into account. You have to look at customers and competitors as best you can, even if the data are sketchy and you need to make your best assumptions.

Finally, the pricing "process" itself is also a unique animal. Unlike other processes such as manufacturing, a pricing process needs to generate an <u>optimal</u> outcome as its output each time, not an <u>identical</u> outcome.

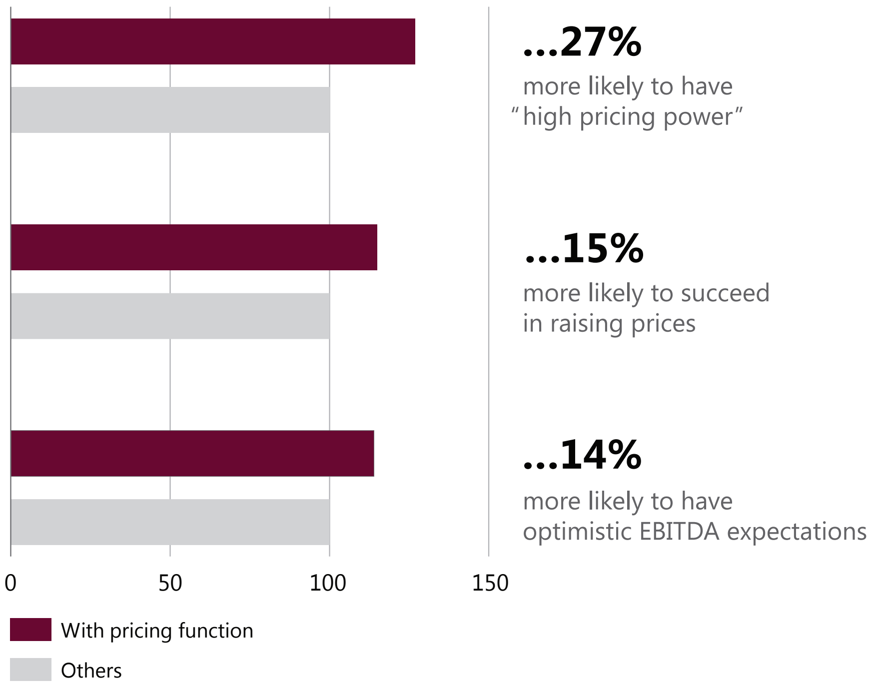
It is naïve to think that transparency and accountability in such a process can arise without the guidance and catalyzing involvement of senior management. Likewise, it is naïve to think that a pricing organization can emerge organically from the general chaos and complexity of day-to-day pricing without senior management support and inspiration, never mind emerge with a credible mandate and the resources to execute it. Pricing is too complicated a process in most organizations to untangle cleanly without authoritative guidance, if not objective voices.

In this area as well, C-level executives need to become active in pricing and make pricing their own personal matter.

Companies with dedicated pricing organizations are 15% more likely to increase prices than companies which lack one. They also pass on 11% more of their planned price increases than companies without a pricing organization.

Pricing organizations make a clear difference

Companies with dedicated pricing organizations



When that phrase "pricing organization" comes up in a discussion with anyone familiar with a company's pricing decisions, it inevitably leads to two questions:

- What functional area should "own" the pricing organization?
- How centralized should the pricing organization be?

There is no single correct answer to either question. The best way to approach these questions is to align the pricing organization with your company's market position, brand strength, and need for regional differentiation. At one extreme you have a company such as Apple, with a well-defined market position, a strong and ubiquitous brand name, and little need for regional customization. Such companies lend themselves much better to a centralized pricing organization. They face a high risk of arbitrage, but the risk of damaging the brand outweighs the arbitrage risks and leads them to exercise firm centralized control.

At the other extreme you have companies such as 3M, which have a large number of heterogeneous business units, from health care to office products. Furthermore, regulations often create not only a need, but also an obligation to make local adjustments properly and quickly. These companies tend to have a decentralized structure, with a division or region serving as the highest level of aggregation.

In between you have companies whose approaches combine central control with some regional autonomy and input. Porsche fits this model. The headquarters issues specific process guidance that applies to all regions (such as not allowing "cash back" incentives), but the regions have some leeway to set the prices locally. In turn, the regions must provide that pricing information and its rationale back to the central organization.

Regardless of the type of organization – and whether it sits in sales or marketing – some elements hold true universally. First, you need to write down who does what, when, and with what kind of data. You need to ensure that all relevant stakeholders from different divisions are included to the right degree and at the right time.

Like many of the recommendations in this eBook, that sounds deceptively simple. But it is very difficult for a company to establish a clean RACI chart (**R**esponsible, **A**ccountable, **C**onsulted, **I**nformed) combined with information flows without direct intervention of senior management.

The study showed clearly that having some form of centralization – in best case, a dedicated pricing organization – also has a correspondingly high impact on a company's pricing power, its ability to implement bigger price increases successfully, and its optimism about future profits. This does not mean that a centralized structure is *the* answer for all companies who establish pricing organizations. We see this instead as the result of CEOs who put pricing on their agenda and who want to get the pricing authority closer to themselves (e.g., more centralized) in the interim. But over time, the best organizational form still depends on a company's market position, brand strength, and need for regional differentiation.

So it is now time for another simple question: does your company have a process for *raising* prices? Process here does not mean the anecdotal "process in people's heads", passed along haphazardly from generation to generation like tribal oral history. It means a process that aligns and defines the task that several functions – primarily marketing, finance, and sales – have to perform. It means a process that has a system behind it, designed to allow the organization to make decisions as efficiently as possible. It means a process that is written down, teachable, and not entirely dependent on the knowledge any individual keeps in his or her head.

The process for exercising pricing power should have as much standardization as possible. The rule of thumb is to start the planning with universal standards, then place the burden of proof for an exception clearly on the business unit, region, or division which feels it requires one. Common sense and experience dictate that you will need to tolerate some exceptions, but they must always have a justifiable basis.

Finally, you need to help your organization get in the habit of ending debates. One global company whose C-level executives play key roles in pricing refers to this as "creating knowns". Revisiting assumptions is necessary for any organization, lest it lapse into a comfort zone. But the revisiting assumptions cannot become a paralyzing, perpetual state of mind.

Even in the extremely dynamic context of e-commerce, some companies have made the choice to define strategic "guardrails" for pricing, supported and vetted by their C-level executives. These guardrails describe their relative positioning to major competitors and how to preserve it, but not at all costs. The managers have clear ceilings on how high they can price their products to consumers – even at times of scarcity or at times of peak demand. Likewise, they have clear pricing floors which they must not breach, so that they can protect margins and prevent price wars.

The right mix of incentives helps, but this in turn depends on having "one set of numbers" that allows you to control and monitor the pricing process. Beyond the five major financial metrics, you can ask for additional key performance indicators (KPI's) to track pricing performance. What percentage of a planned price increase did the business unit achieve on a net basis? How has product mix shifted after a price increase? How has the won-loss rate for deals changed?

A few years ago, Albert M. Baehny, the CEO of Geberit, the European market leader in sanitary technology, summed up his role in pricing nicely.

"Wherever there is active price management, a clearly defined pricing process, explicit rules of price determination and well-defined responsibilities for price implementation and price controlling, margins may be increased significantly and sustainably," he told Germany's *Handelsblatt* newspaper in June 2008. Then he warned: "When pricing is delegated or – if worse comes to worst – left to the market, you will never get beyond mediocrity."

But sometimes, improving these metrics and growing your pricing power requires some imagination. Is there a better way to go to market, in terms of how you price your products and services? Some companies would answer that question for themselves with an emphatic "yes", as the next chapter on revenue models explains.

CHANGE #3

Ensure that your revenue models reflect both the value you deliver and the costs you incur

Management thinker and marketing guru Peter Drucker once said that "customers don't buy products. They buy the benefits that these products and their suppliers offer to them."

The challenge in finding the right revenue model for any business is that it needs to match up with the value you deliver and with the costs you incur. Neither of these remains fixed for long, long periods. Many companies might therefore be working with outdated revenue or price models.

Please think back once again to the circumstances described at the beginning of this eBook, which are findings from the Global Pricing Study 2012. In short:

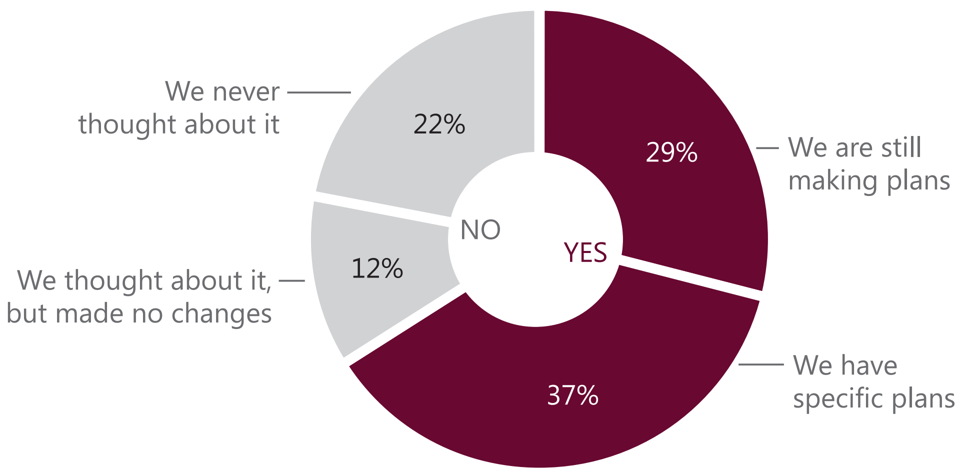
- over 80% of companies have come under increased pricing pressure
- almost 60% of companies are embroiled in a "hot" price war
- the vast majority of companies feel they can't justify a price increase above current levels of inflation
- even when they dare to raise prices at all, they manage to get only half of what they ask for

These circumstances should create enough urgency for you to intervene rather than accept these circumstances as givens. You need to take measures to counteract price pressures and other symptoms of weak pricing power. This includes re-examining your price models and adjusting them to the tougher economic situation or to changes in your market situation. You can also treat this as an opportunity to redefine the nature of competition in your market by focusing more on value to your customers.

Fortunately, some 37% of respondents in the study said their companies have set plans in motion to change their revenue models. An additional 29% indicated that some sort of initiative is underway, but not yet as advanced.

Revenue models

When faced with increasing pricing pressures, most companies re-examined their revenue models



The most obvious change in a price model is to move away from per-unit pricing to price per unit of value. Perhaps the oldest example of such a model is Xerox, which charged its customers on a copy basis rather than saddling them with capital investment in several machines.

Enercon (wind turbines) and General Electric (aircraft engines) take similar approaches with their pricing models. Instead of taking a "build it and forget it" approach to pricing that transfers all the product risk to the customer, Enercon charges a price based on what the wind park yields. The more electricity generated (in KWh), the greater to the value to the customer, and the higher the price that Enercon ultimately receives.

Instead of charging for jet engines on a piece basis, GE decided to price per mile flown. The logic is identical to Enercon's and Xerox's. The benefit to an airline or an aircraft leasing company is not "having engines". The benefit comes from using those engines to fly planes further and longer with less maintenance.

Michelin sees even more benefits from this kind of model, which they use for their tires for industrial vehicles. The default option for a price model for tires is to charge your customer a certain price per tire. But simply having x number of tires is not the benefit a customer wants most. More beneficial to them is performance, in terms of factors such as responsiveness and durability.

Recognizing this benefit, Michelin switched its price model from "price per tire" to "price per kilometer". The idea that a better tire lasts longer is intuitive to a customer. If Michelin's product falls short, Michelin bears the risk. But if the tire outperforms, Michelin shares in the additional benefit it provided the customer.

Now let's say that Michelin comes up with an even better tire, one which lasts 20% longer than previous tires. With the new "price per kilometer" revenue model, they don't need to make any adjustments when they launch it. Customers pay as before and revenue stays stable. But Michelin now needs to supply fewer tires.

They essentially implemented a price premium for the innovation without taking any additional or extraordinary action. Can you imagine the effort required for Michelin to achieve a 20% higher price with the old price-per-tire revenue model?

A good price model provides a number of benefits. Customers understand the link to value intuitively in a good model, which can help increase the chances that they perceive both the model and the resulting prices as fair and also as an easier way to do business. They can also allow a customer to move away from high upfront investments and manage their payments in smaller, but regular installments. In the best cases, they can create enough goodwill to discourage a customer from switching or even considering another supplier.

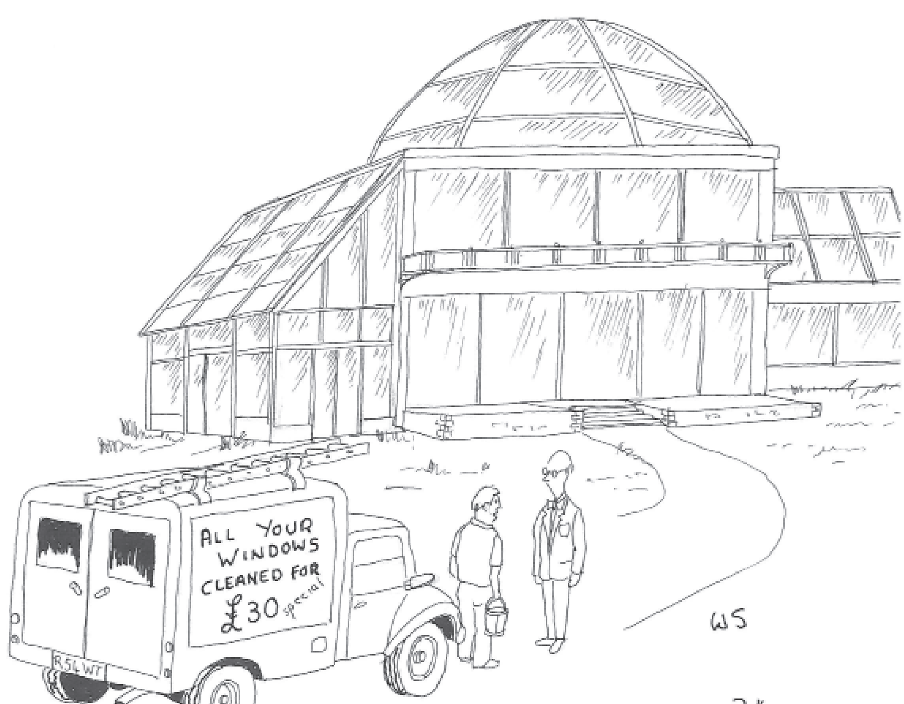
Moving away from these examples, one could imagine prices based on unbundling (such as Ryanair) or on other metrics (per user, per click). Ryanair broke up the industry's all-inclusive bundle (the air fare) into important constituent parts such as food and beverage, baggage fees, fees for airport check-in, and even in-flight smoking. Customers can customize their entire experience as they see fit, knowing two things: the more they want, the more they'll pay. But if they want to simply fly from City A to City B with absolutely no frills whatsoever, they also know that Ryanair will not charge them an artificially high, bundled fare that subsidizes the enjoyment or convenience of other passengers.

Price models and metrics in the software industry have evolved to match needs, but with an element of flexibility (usage-based metrics, storage-based metrics, etc.). This also applies to telecommunications. The Swiss mobile services provider Swisscom had a high price perception, which their former price metric only reinforced. By charging customers for the length of their call (price per minute), they forced callers to look at their watches and constantly wonder how much a longer call may cost.

When the company switched its usage-based metric from price-per-minute to price-per-call, they created something new which made price comparisons difficult. This kind of in-transparency usually favors an expensive incumbent. The new model meant that customers could now focus on their conversation, not their costs. Swisscom capped the length of a call at one hour, but turned this into an advantage by communicating an eye-catching, low "price per hour" for a phone call.

Developing and implementing a new revenue model is truly a strategic exercise, not a mechanical or technical one. You can't simply ask someone "over there" in your organization to model some alternatives. It requires experience and market knowledge, as well as the foresight to understand the indirect benefits from the change. These include the "easy" price increases and lower sales effort (Michelin) or changes to customer perception (Swisscom).

But good price models must respect two dimensions. You have the customer benefit on one side, and the costs on the other. Flat rates are a common example of price models that try to satisfy one dimension (the customer) but neglect the cost side. When AT&T decided to offer iPhone users up to 400 MB per month for $30, the uptake created a spike in AT&T's capital expenditure to keep up with demand. Costs followed usage, but the price model didn't.



"Well, er, could we negotiate?"

It's not senior management's job to create these new models or adapt old ones. But as an executive, you make success more likely when you ask simple questions to make sure the work gets done. The simplest two questions rework and amplify the comment from Mr. Drucker:

- How well does this revenue model reflect the benefits we provide our customers?
- How well does this revenue model align with the costs we incur?

Now you can benefit from the positive side effects of holding your company accountable and from having installed a pricing strategy and organization: First, it keeps the business unit focused on the question of benefits to the customer. You turn your company's attention towards what the customers need and what they value. Even the development of new products or line extensions should have a link to the revenue or price model early in the development process.

We recommend that you encourage a lot of creativity and welcome radical new ideas when it comes to new revenue models, especially when it leads to more thinking around the benefits that your products and services provide your customers. The fact that you also need to consider costs and implementation will provide a "reality check" on the ideas anyway, so it makes sense to cast the net as wide as you can at first.

The modeling of the effects of the change will need to take costs into account. This ensures that you can afford to create the benefits you provide and also that success won't kill you because the revenue you generate does not keep pace with the costs you incur.

But implementation can pose an even trickier challenge. You may hear the standard comment from marketing and sales that "*We have always done it <u>this</u> way*" when a business unit tries to implement a new price or revenue model. Instead of dismissing the comment as a sign of resistance or defensiveness, we suggest at first that you respect the comment and try to understand what it is a symptom of.

If market conditions – customer needs, competitors, technology, costs – have all changed to such a degree that a new model is warranted, you have a strong argument. But the comment may signal a lack of confidence. Or it may mean that a certain segment of customers will legitimately resist the change.

Any new model – be it revolutionary or evolutionary – will not work unless customers accept it. The ultimate challenge may be to prepare your salesforce better to "sell" customers who are used to your old revenue model.

Finally, a change in a revenue model can serve as a strategic coup for companies. If you have enough pricing power in a market, being the first company to change the industry's revenue model may put your competitors at a disadvantage long enough for you to make significant gains in share or profit.

This can also work the other way around. A clever revenue model can allow a new market entrant to establish itself in a way that the incumbents cannot afford to counter. But not every company can redefine the basis of competition in certain market segments in this manner. In the end, success always hinges on customer acceptance.

Communication is an essential part of gaining customer acceptance. That is what we will talk about in the final chapter.

CHANGE #4

Communicate your pricing strategy and pricing identity

C-level executives are a company's best pricing ambassadors. The reach and the power of what they say – or don't say – will set the tone for pricing within the organization and also in the marketplace. Granted, what executives **say** about pricing support must match with what their companies **do** about pricing. Consistency is of paramount importance if you want your communications to maintain credibility and avoid confusion.

The first step is to take a close look at what you say already and how you say it, regardless of whether the word "price" appears explicitly.

Representatives of a company, from a C-level executive down to a junior sales rep, only have a limited amount of time to convey an impression to an audience. Spending too much of time talking about price causes damage in two ways. First, the more someone stresses price, the more they sensitize the audience to price. Second, every expression you make about price is a lost opportunity to talk about value instead.

We would like to reiterate the definition of pricing power used at the outset of this eBook: Pricing power is the ability of a company to get the prices it deserves for the value it delivers to customers.

The most elegant communication from a company with high pricing power should focus consistently on three things, in order of priority: customers, the value the company delivers to them, and the prices the company deserves.

Anything else risks creating a situation in which someone misunderstood or misinterpreted the communication. And amidst confusion in business, competitors will tend to assume the worst motives rather than any noble or innocent ones. Price aggression is often the result. It's no wonder, then, that some companies talk their way into price wars that they think someone else started.

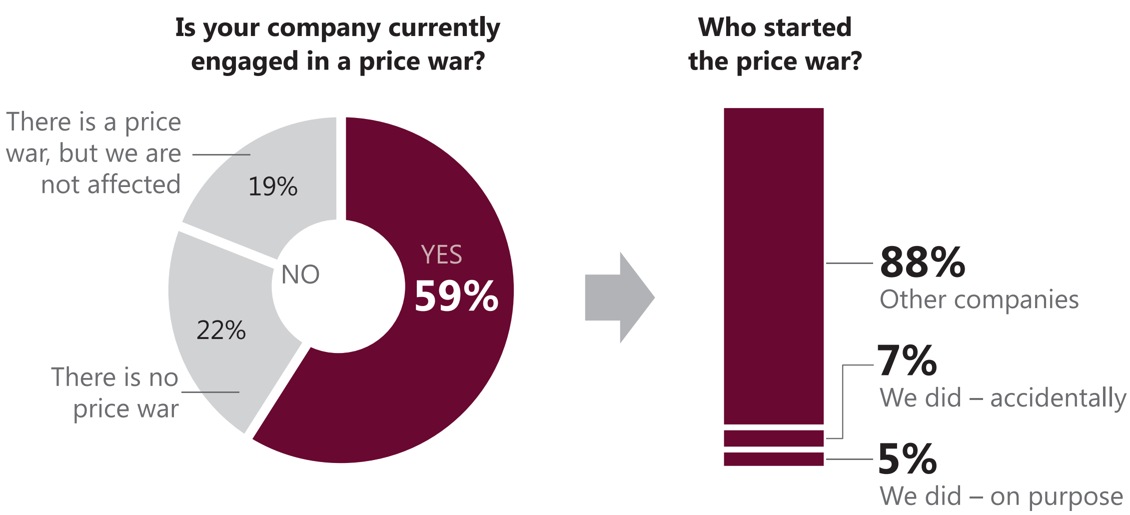
The study's findings revealed that perception rarely matches reality when it comes to discussing price wars. Some 59% of respondents said that their company is currently engaged in a price war. But when asked who started that price war, 88% of respondents said that other companies did it. Of the 12% who took responsibility for the launching the price war, roughly half said the move was accidental, the other half said it was intentional.

Please reflect on that last sentence for a moment. If you take any 20 price wars raging today, on average only 1 of those 20 resulted from a conscious management decision that the company admits to. The others resulted from some misunderstanding, misinterpretation, miscalculation, or were initiated by the competitors.

That is a shame, because more often than not, price wars do little more than drain revenue and profits from a market. Market share gains, even when they appear significant in the short-term, usually dissipate after competitors retaliate. Often the unfortunate cycle repeats itself.

Price wars

The vast majority of companies involved in a price war blamed the competition for starting it



In those situations, companies have a decisive advantage when they know precisely where and when to respond or not respond, and also what levers they should use. A response in a price war or amidst rising price pressures need not always involve changes to prices *per se*. In fact, in the absence of a more refined plan, the best response to have ready if a price war threatens is the word "no".

In other words, you do not react until you have a very thorough understanding of the risks, the potential upside, and the next moves your competitors may take. In many cases, companies heavily overestimate both the impact that their competitors' price changes will have, and the speed with which those impacts might occur.

No reaction is usually better than an impulsive one. You should respond to a price war only after you have fully assessed the risks and consequences. Even then, you should proceed with smaller, very focused or "surgical" countermeasures.

One crucial element in pricing communication is a company's ability to project a pricing identity. Over the four actions in this change mandate, you will have learned a lot about your company's pricing identity. You should be in a position to answer these questions:

- Do you want to be a leader or follower on pricing?
- Do you want your pricing to be simple or complex?
- Do you want to emphasize price or value in your communications?
- Do you want your brand perceived as discount or premium?
- Is your focus more on skimming or on market penetration?

The answers to these questions – which should go hand in hand with the guidance you provide your business units – form the core of your *pricing identity*, the way that parties ranging from investors to customers to competitors will perceive you. Most importantly, the price identity is the translation of a brand's USP and pricing strategy into a pricing proposition understood by the customers, to increase the likelihood that your target customers choose you and stay with you.

Think of Amazon.com and imagine how Jeff Bezos, its customer-centric founder and CEO, might answer those five questions above:

✓ Leader

✓ Slightly complex

✓ Price-driven

✓ Discount

✓ Market penetration

That represents how most people perceive Amazon, because of the company's remarkable consistency in hammering home those messages. The answers make sense for Amazon individually and collectively.

In its latest annual filing with the US Securities and Exchange Commission, Amazon officially described its pricing identity as follows: *"We strive to offer our customers the lowest prices possible through low everyday product pricing and shipping offers, including through membership in Amazon Prime, and to improve our operating efficiencies so that we can continue to lower prices for our customers."*

It is a well-crafted pricing identity, especially because Amazon does not always charge the lowest prices for books. When we undertook a detailed analysis of Amazon's pricing for top-selling print books in the UK in late 2012, we learned that print titles in the Top 20 on Amazon were on average 6% less expensive than all other competitors. But Amazon charged an average premium of 13% on print books in its Top 21-50 and 15% on print books in its Top 51-100 compared to the competitor with the lowest price.

Our comment that Amazon's actual prices do not correspond exactly to pricing identity is a compliment, not a criticism. Because so many book buyers shop for reasons other than price, Amazon's convenience and service – combined with the widespread *perception* of offering the lowest prices – are a formidable marketing combination.

The same applies to Ryanair. The unbundled "pay for what you want" approach and the very low base fare create the impression that Ryanair always has the lowest prices. Depending on how a passenger configures a flight, however, he or she may actually pay more for a Ryanair flight than a flight on a competing airline. But the power of the price image discourages passengers from constantly making comparisons. The element of control and influence that a customer has in planning a flight provides the customer a positive, intangible benefit, as does the confidence that they will pay low prices without investing lots of time in research and comparison shopping.

Your answers to those five questions may differ greatly from those of Mr. Bezos. No matter how you answer the questions, however, your communication needs to reflect those answers. *You* are managing your pricing identity internally and externally. Confusion is a big risk. Consistency is a big asset. You need to provide guidance and establish and enforce accountability in this aspect as well.

Over time, executives can use their pricing power as the basis for creating a profit culture within the company. This extends beyond communication and extends to incentives. Companies with a profit orientation introduce incentives related to profit and pricing performance. They also set standards for price controlling (KPIs, pricing cockpit, including price implementation performance) and elevate "price performance" to a fixture on the agenda of every board meeting.

So... how will you make pricing personal?

The Global Pricing Study 2012 showed that over 80% of companies face intense pricing pressure from competitors and customers, on top of the risk of inflation from volatile commodity prices. This underscores the urgency for C-level executives to intervene now. Staying in a pricing "comfort zone" is no longer an option.

However, this greater emphasis on pricing and the accompanying organizational changes are not merely short-term survival mechanisms. Generating and harnessing pricing power is one thing. Sustaining it is another, and should be a true source of competitive advantage.

Executives should not retreat back into pricing "comfort zones" when economic growth returns to historical levels. As an executive, the attention that you pay right now – and the organizational changes you set in motion – will reward your company even more when growth picks up.

How should you make this commitment? That is where the four-part change mandate comes in, based on findings and insights from the Global Pricing Study 2012 as well as Simon-Kucher & Partners' benchmarks and experience:

- Establish and enforce clear accountability for pricing strategy
- Support the development of a pricing organization with transparent pricing processes
- Ensure that revenue models reflect both the value their business units deliver and the costs they incur
- Communicate their pricing strategy and pricing identity, as the company's pricing ambassadors, internally and externally

You need to focus your attention on all four areas, which all serve to build greater accountability, stronger internal structures and processes, revenue models that reflect the value you deliver, better communication, and ultimately, higher pricing power and correspondingly higher profits.

About the authors

Georg Tacke, Ph.D., is the CEO of Simon-Kucher & Partners, the world's leading pricing consulting firm.

David Vidal is a partner in the firm's Paris office.

Annette Ehrhardt is a senior director in the firm's Zurich office.

www.simon-kucher.com