Turning pricing power into profit

Companies often overlook pricing as a driver of earnings growth, instead defaulting to cost cutting and other measures. Here are five steps to growth through pricing.

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An international provider of technical gases had a problem. With a large, highly fragmented product portfolio of more than 500 SKUs, customers in a range of industries, and a broad segmentation of customers by size, prices varied widely even for the same product. And while managers believed there was room to increase prices overall, they had no rational basis from which to challenge current pricing practices. The solution? An analytical tool to pinpoint new price drivers, redraw customer segments, and recommend updated prices. After piloting, the tool was rolled out in seven diverse markets. The company supported this new approach with intensive sales-force training and eventually reset up to 100,000 prices for 150 SKUs per country—resulting in an increase in return on sales of three to five percentage points, without significant changes in volume. The whole program took just three months.

At a time when companies across all B2B sectors are finding it hard to maintain—let alone increase—profitability, the systematic improvement of pricing capabilities can have a lasting positive impact. In fact, our data, which cover more than 1,000 pricing-excellence and performance-improvement initiatives in a range of industries, clearly show that such efforts typically translate into an increase in return on sales of two to seven percentage points, depending on the sector. However, only companies that increase their level of analytical rigor and practical know-how will unlock pricing's full potential to drive both the top and bottom lines. We believe five steps are essential for turning pricing into a profit engine.

1. Provide meaningful transparency into pricing data

Pricing managers often lack a clear understanding of how profitability varies among regions and product lines, and they know even less about how it can vary among individual customers or transactions. Yet these all have an important influence on pricing and sales decisions. To take one example: volatile raw-material prices have caused headaches for companies selling products on contract periods longer than the company's own purchase contracts. When raw-material prices rise, sales reps don't know which prices should go up, by how much, and how quickly. Without that knowledge, profit opportunities evaporate. The front line needs meaningful transparency into price levels, discounts, and other leakages at different levels of granularity and over multiple time periods.

The key word is *meaningful*. The increased data availability and computing power provided by advanced analytics mean that, in theory at least, sales reps can make much better pricing decisions. But the very proliferation and complexity of data have more often than not overwhelmed rather than helped. As a consequence, advanced pricing analytics are often ignored in favor of pricing decisions based on gut feeling, a one-size-fits-all model, past experience, or outdated analysis. The result is that either companies price too low and leave money on the table, or they price too high and lose customers.

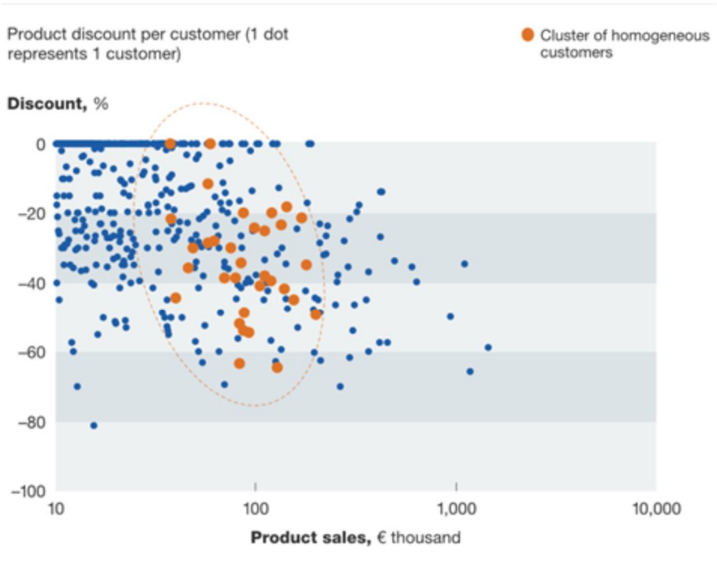
In B2B companies, existing analytics capabilities are often not sophisticated enough to create the right kind of pricing-opportunity algorithms to cope with the large amounts of data available. We often see managers make broad pricing decisions (such as proportional price increases) armed with little more than an Excel spreadsheet. About 75 percent of a typical company's revenue comes from its standard products, which often number in the thousands. Time-consuming, manual practices for setting prices make it virtually impossible to see the pricing patterns that can unlock value. It's simply too overwhelming for large companies to get granular and manage the complexity of these pricing variables, which change constantly, for thousands of products. At its core, this is a big data issue.

A European steel producer, for example, lacked a system to collect relevant data at the level that sales reps cared about—that is, at the level of their individual customers. To address this, the manufacturer decided to combine financial data from several internal IT systems: sales reps' systems, where orders were entered and invoices processed; the production teams' systems, which allowed them to plan capacity, typically at the machine level; and the finance department's systems, which aggregated all these data into financial reports, but typically at higher levels, such as at the level of a plant or a product line. It then set up dashboards to analyze the combined data on a weekly basis. The new system helped identify fresh and critical insights, such as customers who were frequently unprofitable but too small to be noticed.

The best pricing-analytics tools can help test and calibrate pricing drivers for each individual product-customer combination, as well as dig into customer-revenue profiles at the product-volume, industry, and sales-channel levels to unearth new pricing options. They can also derive pricing recommendations based on complex calculations of what drives price differences among customer segments (exhibit). Companies with good analytics capabilities can use the data and teams already in place to find significant growth in a matter of months.

Exhibit

Analysis can identify opportunities for differentiated pricing based on a customer's willingness to pay.



Source: Multinational energy company (disguised example); McKinsey analysis

2. Understand what customers really value

For all the sophistication provided by advanced analytics to master a complex array of prices, the price of a product or service ultimately depends on how much a customer thinks it's worth—that is, "value pricing." The best companies augment pricing analytics with detailed customer insights to identify all the key buying factors that determine how much a product is worth to a given customer, understand how those factors compare with competitors' offers, and quantify the value created for the customer.

At one company, a team of pricing and sales managers was asked to list the factors it thought determined the prices that customers were paying. It then tested and refined these hypotheses. The analysis revealed 14 significant drivers of pricing sensitivity that the sales reps had not identified, many of them counterintuitive. In one case, for instance, it was the quality of the packaging rather than the quality of the product that was the single most important driver for customers' willingness to pay a premium.

While analytics can certainly help in determining value, developing insights often requires "softer" and more traditional skills, such as talking with customers and observing their operations. One manufacturer of specialty tools, for example, was about to launch a series of products with much higher performance than its existing ones and those of its competitors. By first interviewing distributors and then launching targeted market research, the company linked the entire set of key buying factors to what buyers would be willing to pay for, which enabled it to set a price point far higher than marketers had expected.

A pragmatic approach to value pricing is "next-best-alternative pricing." This method involves researching what alternatives customers have to the company's product or service. Best-practice companies go further and make the next-best-alternative approach a mandatory team practice. Teams discuss the cases and role-play negotiations. Creating a database of next-best-alternative cases can also help disseminate the new pricing knowledge.

3. Move from sales reps to 'value negotiators'

Determining the best price means nothing if sales reps can't convince customers to accept it. For this reason, it's critical that sales reps have important pricing capabilities, such as sound judgment to manage time, negotiate thoughtfully, and adjust pricing guidelines in order to maximize value and minimize the risk of customers defecting.

Building negotiating skills is particularly critical. In practice, this often requires spending time understanding how price recommendations are made and what reasoning underpins them so that reps are confident the price makes sense and is defensible. Sales reps—often with the help of managers—also should develop a set of arguments to support the price, with a particular focus on those elements that customers value most. An important part of preparing for negotiation is identifying concessions, understanding starting and walk-away points, and practicing to anticipate behavioral biases and develop sound skills. As one rep who took part in a pricing-excellence transformation explained, "It had become increasingly challenging to defend overall price increases to customers. After this program, it was much easier to understand and communicate the increases and to actually succeed in the negotiations."

4. Provide on-the-job training to build confidence

While most companies understand it's important to build the pricing skills of their people, few move beyond basic training in classes or online. Successful companies, however, use adult-learning techniques, such as experiential learning, to embed the new skills in the front line. The most effective programs rely on a mixed model of education and implementation known as "field and forum."

Forums consist of two- or three-day workshops. Participants learn theory and frameworks by reviewing case studies and using more interactive formats. After each forum, there is a "field" stage, in which participants apply their knowledge to real-life situations, accompanied by experts or senior managers who can provide feedback and guidance. This not only sustainably upgrades the company's pricing capabilities but also delivers sizable bottom-line impact throughout the program. With one or two successful price negotiations, reps develop confidence in the new approach and often become advocates for it with their colleagues.

One company used coaches to help each person on the sales force understand the new pricing process, including how to get the most from the pricing tool. This one-on-one support was intensive, but it was also crucial in ensuring pricing insights translated into higher prices—and higher profit. "This is the first time we can truly benchmark and understand the performance of our sales force," said the company's national sales manager. To reinforce the importance of building capabilities, employees need to see facts, not just anecdotes, about how ineffective pricing hurts the bottom line.

A global petrochemical company, for example, rolled out a pricing-excellence transformation program that included several intense training sessions on how to use the new system, as well as group coaching sessions to analyze each sales manager's portfolio with the new tool kit. In roughly five months, sales managers in the pilot division identified more than 400 transactional-pricing opportunities, contributing to a total bottom-line potential increase of €10 million.

5. Change the culture

In our experience, even the best pricing programs will fail in the long term without a deliberate commitment to overcome the entrenched habits and shifting priorities that doom most change programs. Ingraining pricing success over the long term requires putting in place an "influence model" that includes role modeling, fostering understanding and conviction, developing talent and skills, and implementing reinforcement mechanisms.

While all aspects of the influence model are important, pricing leaders should pay particular attention to developing talent and skills by coaching their people. The other aspect to focus on is the reinforcement mechanism: key performance indicators across all commercial activities. While these performance-management systems can be detailed, the best ones automatically consolidate results into a single reporting system that allows management to monitor overall pricing performance, as well as individual sales reps' performance against targets.

A pricing transformation that delivers the most impact is tightly integrated with a broader set of initiatives that improves commercial performance for the business overall. But at its core, pricing excellence is about combining effective analytics with relevant capabilities. Get that right, and pricing power can truly become a growth engine.

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