

# **Pricing in an Economic Downturn**

## **A Pricing Manifesto for CFOs**

by Hermann Simon, Frank Bilstein, Frank Luby, and Drew Conrad

### **Introduction**

Yes, recessions are scary for businesses. But deflation is scarier. Deflation leads to Great Depressions. So now is not the time for companies to engage in price wars. As sales managers across the country threaten to drive down prices in a destructive scramble for declining volume, now is the time for CFOs to show true courage, remove inefficient capacity, enforce pricing discipline, and ensure their companies price for profit.

In fact, history has not been kind to companies that practice predatory pricing in downturns, for they contaminate their future. Those companies find it almost impossible to claw their way back to previous price levels after the economy recovers, and they find themselves saddled with price sensitive, disloyal customers. Successful companies turn crisis to opportunity. They take steps to plug price leaks. They align their pricing more closely to value delivered to customers. They focus on value creation, while others fall victim to creative destruction.

Therefore, for the long term health of our economy, and for the future success of their companies, we encourage CFOs throughout this great land to embrace the following pricing manifesto.

### **Pricing Manifesto**

We the CFOs of the United States, in order to form a more perfect economy, promote the general welfare, and secure the blessings of profit to our companies and our posterity, do ordain and establish the following:

#### Article I.

We will not price to destroy our competitors. We will price for the share we deserve, and we will win on value. A house divided against itself cannot stand, so we will forge a cross-functional consensus on pricing strategy. No rogue product manager or sales manager will upset the map. We will plan each response to competitors. We will give our blood, toil, tears, and sweat so there will be no wars.

Companies do not live by sales alone. They live by profit. We will do our part to balance supply with demand, so industry price levels are not unduly pressured.

To fee or not to fee – there will be no question. We will gladly suffer the slings and arrows from salespeople and customers. We shall no longer sleep, perchance to dream, when quotes are escalated.

## Article II.

We hold these truths to be self-evident, that all companies are not created equal, but they are endowed by their creators with unalienable rights, that among these are the right to charge for the value they deliver.

We will fund pricing research to measure customer willingness-to-pay for our products, relative to competitors. We will fund investments that improve our perceived performance on buying criteria that mean the most to customers, and messaging that focuses on areas where we differentiate.

We recognize the growing need, in these turbulent times, to tailor offerings for customers with different levels of willingness-to-pay. For those most suffering from incredible shrinking wallets, we will strip down our offerings and force tradeoffs for lower price. For others, we will increase service and support, speed and convenience, to defend current prices. We know there will be a growing percentage of customers that prioritize price, but we will never forget those that depend on us to reinforce their value.

We recognize that old truisms and rules of thumb no longer hold. We will examine the way we charge, not just what we charge. For many customers, short term payback will be paramount. Subscription models may suddenly be more appealing. We will expand our menu of price structures so customers of all types may have their fill.

## Article III.

No return is more immediate, no return so certain, as a return on investment in improved pricing processes.

We will squeeze more wine from the same grapes. Policies that have long been undermined or ignored shall now be enforced. We will collect full freight charges. We will put teeth into terms. We will look for breakdowns in systems that cause errors between quote and contract, and between contract and invoice. We will stop giving away discounts that are no longer earned. You can't control what you don't measure, so we will invest in visibility.

When it comes to deal pricing, we will trust, but verify. No one is better placed to gauge customer willingness-to-pay than the salesperson on the front line, but in a down economy, salespeople are even less likely to defend prices. We will give them target prices and price bands to work within and track their performance. We will establish clear criteria for quote escalation and demand documentation. We will conduct post-

mortems on large deals to point out where money was previously left on the table. And will insist on new sales incentives tied to price performance to be our invisible hand.

Though we walk through the shadow of the valley of debt, we fear not fair prices. CFOs of the world unite! You have nothing to lose. You have a world to save.

## **Commentaries**

### Article I.

***Price wars.*** If there was ever an eye-opening moment for us concerning the topic of competitive strategy, then it was this: In the summer of 2003 we presented the CEO of a world-renowned public company with a sophisticated strategy that would secure its path towards profitable growth. She waited with growing impatience for the end of the presentation to crush six months of work with one sentence: “That’s all very well and good. But I want to destroy my competitors!”

Our objections undoubtedly earned a place in the company’s history, but ultimately we failed. Five years have passed since then – five years in which the company has drastically reduced its formerly attractive margins in numerous important markets. And despite strong attacks, the company has not succeeded in ousting even one competitor from its relevant markets.

This experience reflects the mindsets of many established companies. Most still pursue market share over profit, and we fear the economic downturn will only reinforce such wrong-headedness. How is it possible that established companies behave so aggressively and disregard the profit aspect? We have identified four reasons: management education, genes, investors and role models.

***Management education.*** For decades now, business school students have been told that salvation lies in having the highest possible market shares. Well-known strategic planning concepts like the PIMS study or the BCG matrix offer the right tools for this. Research results that refute this market share mantra, like those of renowned Wharton Business School professor Scott Armstrong, have long been ignored.

***Genes.*** Managers want to prevail. This competitive spirit is firmly grounded in our genes and ensures our survival in the corporate shark tank. The company leaders of today have often won their spurs through conquests of new markets and success against competitors. It’s not particularly surprising that managers continue to practice the strategies that took them to the top of the corporate ladder. Too few manage to invest their combative energy into the development of new products instead of battling competitors.

Investors. When research, training, and our own careers keep beating it into us that we have to maintain leadership with aggression, this influences the investors. What's more, market shares are a simple measured value and, especially in growth markets, an indicator for innovative power and customer benefits. For this reason, investors often shun a stock that is losing market share for the first time, because this may be a sign that competition has finally caught up with the leader and the times of attractive margins may be over.

Role Models. Jack Welch, former CEO of General Electric and global management superstar, always insisted that his company would exit any business in which it did not hold the number one or two position. Of all the management beliefs that made Welch famous, this one is probably the most well-known, probably because it sounds so simple and obvious. Since then, the opponents have been gathering strength. *Fortune* ran a cover with the sentence "Sorry Jack!" and proclaimed the new rules of the post-Welch era. Instead of being number one or two, *Fortune* advised: "Find a niche, create something new."

**Fixes.** So how can CFOs lead the fight to stop destructive pricing strategies? We urge CFOs to address the following three areas: mindset, planning, and communication.

Mindset. One way to help shift the mindset of senior managers is to force them to take expected competitive reaction into consideration before making any significant pricing moves. This can be achieved most powerfully through simulated wargaming exercises where some executives play the role of competitors.

Recently we facilitated such an exercise for a supplier to the automotive industry. Prior to the role play, senior executives were planning to aggressively buy share on a particular product line where they had a relatively weak position. After the role play, the executives realized that if they indeed stole share, competitors would inevitably try to refill their plants by striking back at another product line where our client enjoyed value advantages and healthy margins. Our client came to the realization that optimizing product mix was a much better strategy for them than growing market share because it had a far greater impact on total profit dollars. In fact, the client subsequently pulled out of a few other product lines to focus on those where they had the strongest position and highest margins.

It is critical to achieve a cross-functional consensus on pricing strategy. Otherwise, the company will send mixed messages to the market and whipsaw customers with each swing of the pendulum. One way to draw out differences in mindset and drive toward a consensus is to conduct a goal tradeoff exercise with senior managers from different functions.

Here's how it works: First list out the company's major strategic goals – increase new customer acquisition, increase average selling prices, decrease churn rate, increase profits, etc. Then create a number of forced tradeoffs involving these goals (e.g., how strong is your preference for 3% increase in share versus 3% increase in average selling price?). Vary the relative size of the tradeoffs (i.e., also test for how preference shifts as the tradeoff becomes 5% increase in share versus 3% increase in average selling price). How executives individually answer will yield great insight into their mindset and the perceived relative importance of pricing goals. You can even use a research technique called adaptive conjoint analysis to set up and analyze the results from such an exercise.

Once you know where each individual stands on pricing goals, share results and ask each individual to describe why they made the choices they did. What reasoning, past experience, evidence, assumptions, and motives lay behind their preferences? Then hash out a consensus. CFOs can play a big role here in modeling how the different strategic goals would likely impact total profit dollars. We have found that individuals have a far easier time reaching consensus when their thinking has been so clearly exposed and the “math” has been so clearly demonstrated. We recently used a goal tradeoff exercise to achieve internal alignment at a software company which had been plagued by fighting over strategic objectives, to the point of inaction.

In the economic downturn, many executives will be tempted to cut prices to maintain current volumes. CFOs must fight this temptation. They should argue for eliminating inefficient capacity so that the industry reaches a new equilibrium and market price levels are maintained. Shedding capacity is very painful for all affected, but it's the quickest way to improve the microeconomics of industries and surest way to preserve long term profitability. During a recent project for a chemicals company we discovered that our client had been adding capacity to the North American market for five years while all other players had been taking out capacity. Before the engagement, our client believed that competitors were to blame for declining prices and margins in the industry. When we realized our client was greatly contributing to the problem, we were able to convince them to temporarily shut down a facility. Once the client experienced how the market regained equilibrium, and price pressures diminished, they gained confidence to take the capacity out more permanently.

*Planning.* From our experience, one of the best ways to ensure internal alignment on pricing strategy and determine where you should take out capacity is to create a visual guide. We recommend that CFOs create a two dimensional map of the market (e.g., the two dimensions could be product lines and customer segments; or product lines and geographic regions) and then identify spaces on the map where the company deserves the most share. By “deserved”, we mean cases where – from the customer's perspective – the company delivers more value than competitors.

A visual map helps companies plan their pricing moves and counter-moves. The logic is simple: in spaces where you don't deliver more value than competitors, you should not price so low that you gain share. In spaces where you deliver more value than competitors, you should generally pursue price premiums and only selectively use lower prices in self-defense (to let the competition know its aggression will not pay off). It is often helpful to color the spaces on the map according to market attractiveness, considering such criteria as size, profit margins, growth, degree of buyer consolidation, etc. The logic here is: build capabilities to deliver more value than competitors in the most attractive spaces; but don't try to grab more market share in those spaces until you are ready.

The mail-order DVD rental market serves as an instructive example. NetFlix is the pioneer and, with over five million customers, the market leader of mail-order DVD rentals in the USA. No other provider currently offers such a comprehensive DVD selection, such a user-friendly website and such a finely meshed distribution network as NetFlix. NetFlix has clearly earned their market leadership in the USA.

The stationary DVD rental business Blockbuster and the retail giant Wal-Mart attacked NetFlix by offering inferior versions of their service offering at significantly lower prices in order to stay attractive. In reaction, NetFlix drastically reduced its prices to demonstrate who the boss in this business was. And the strategy actually worked, to a certain extent: Wal-Mart realized that it could not successfully serve the market and decided to merge its services with NetFlix. In exchange, NetFlix now refers its DVD customers to Wal-Mart's online offers. But there is a fourth player: Amazon is the potential competitor with the best chances to present a real challenge to NetFlix. Yet Amazon recognizes that the time is not right to attack NetFlix on its home turf. Amazon has yet to earn the leading market position in the USA. Amazon would only be able to compete on this market with a major price drop, making both sides the losers. Instead, Amazon has started a DVD rental business in Germany (where NetFlix is not represented) in order to establish a competitive product step-by-step.

A different kind of map, but no less powerful one for improved pricing, involves stages of the product lifecycle. Companies should generally establish high prices during the early adopter stage, then lower prices through the mass adoption stage, and stabilize or even prices again as the products reach maturity and customers generally strive to avoid high switching costs. We have found many companies, with thousands of products, fail to apply organizing principles like these to their pricing strategy. Recently we have helped several semiconductor clients categorize their products along these lines, resulting in significant pricing improvement and profit gains.

Communication. The new pricing strategy only works if the market understands what you want. Otherwise, employees, customers, competitors and investors could interpret deliberate restraint as a sign of weakness or intentional defense as a full offensive attack

– with fatal results. This clarity can be achieved through consistent actions and continuous, explicit public communication. CFOs should play a lead role here, using their analyst calls and financial filings (10Ks, annual reports, quarterly reports...) to paint a picture of the map and their pricing strategies for different spaces on it.

Companies are repeatedly sending out signals to the public through the media regarding profit orientation. Even some U.S. car companies have publicly communicated restraint. For example, when General Motors supplemented its generous incentive program by adding a loyalty discount of \$1,000 on top of its zero-percent financing and large cash incentives, Ford did not respond with price cuts. Instead Ford decided to "... let them get a short-term boost, and resist giving away the sun, the moon, and the stars...Next month they'll struggle and we'll have the right product at the right price."

## Article II.

***Value measurement.*** Most companies have a sense for how they stack up against the competition on particular features, but they have not quantified their overall value advantage by product or translated this advantage into a deserved price premium. CFOs should push their marketing counterparts to be more quantitative in their assessments, so that pricing is truly aligned with value. CFOs can help further the move from squishy to scientific by funding pricing research with customers. This research should be designed to not only quantify price sensitivity but also segment customers by willingness-to-pay and test for customer acceptance of alternative pricing models.

***Expert judgment.*** A good place to start is using expert judgment to calculate a value index for your company and your main competitors. You can calculate a value index by rating your perceived performance on key buying criteria and weighting the scores by the perceived relative importance of those criteria, in the eyes of customers. You can then compare your company's value index to that of competitors. The bigger the distance between your value index and the index of the next best competitor, the bigger the price premium (or discount) you deserve. If you know competitors' price levels and the relative importance of price to other buying criteria, you can even solve for the deserved price premium, based on your relative value to competitors.

We have successfully used this methodology to set list prices, segment-specific target prices, and specific deal prices for companies across a wide variety of industries. Recently a semiconductor client required its product managers to apply this methodology to nearly 500 existing products and made it part of the business planning process for new products. In roughly 30% of the cases, worth tens of millions of dollars, pricing was not in line with value.

***Primary research.*** Expert judgment may be wrong. We have seen plenty of cases where clients suffered from hubris, and even more where they underestimated their value.

CFOs should fund customer surveys to validate the relative importance of buying criteria and their company's perceived performance on them. Pricing research techniques like discrete choice modeling can also be used to simulate buying situations and measure customer sensitivity to changes in price and features. In current economic conditions, such research is particularly needed to measure changes in customer price sensitivity across different segments of customers.

Statistical research is very helpful, but even qualitative interviews with customers can be enlightening. By asking customers what keeps them up at night, what more they would like you to do and how those improvements would impact their business, you can extract great insight into their willingness-to-pay.

At the beginning of one project, the CEO of a telecommunications infrastructure company told us, "The problem is – our industry is almost completely commoditized. We can't charge a premium anymore. We are priced too high in the marketplace." At the time, the industry was suffering from severe annual price compression. The client was in danger of going out of business, along with some of its competitors. We conducted a handful of interviews with key accounts. After a lengthy discussion with the purchasing manager of one account about the large degree of support our client provided, the respondent abruptly announced, "You know, your client is a 'cheap date' compared to other suppliers". That quote was enough for the CEO to stop lowering prices. Other players soon followed, and the client was pulled back from certain bankruptcy.

Economic value analysis. Yet another way to measure value delivered is to quantify the impact that your product or service has on the customer's business. Some companies do a fairly good job of pointing out how their product reduces total cost of ownership for customers, but most fail to quantify how their product impacts the revenue side of their customers – e.g., how their advantages over competitors help the customer attract more consumers, charge higher prices, increase customer satisfaction ratings, reduce churn, deliver more quickly to their customers, etc.

The trick here is to construct an economic model from the customer's perspective (an ROI model). Get to know your customer's business as well as you can – How do they make money? How do they position themselves in the marketplace? What are the key performance indicators they track? Build assumptions into your model, but then sit down with customers, walk them through the model, and correct the assumptions. Even after their corrections, you will no doubt show that you generate considerable value for your customers. We have used economic value analysis with great success when pricing new software products. For instance, we recently built models for an innovative, new fraud-detection software sold to banks, in order to calculate the labor cost savings and fraud cost savings to banks, as well as the expected impact on customer retention and spending from having safer debit cards. On average, we find that customers will pay for roughly 25%-50% of this documented economic value.

***Segment-specific pricing.*** In this challenging economic climate, it is crucial for companies to tailor solutions and pricing to different customer segments, based on those segments' willingness-to-pay. Analysis of win / loss ratios by segment (i.e., based on transactional data) can help establish differences in price sensitivity. But we have seen the best results come from primary pricing research with customers using tradeoff techniques like adaptive conjoint analysis. These techniques tease out differences between customers in the perceived relative importance of buying criteria like on-time delivery, technical support, product quality, and price. You can then cluster customers with similar preferences into the same segment.

A number of years ago, we conducted a large-scale segmentation study for a client in the packaging industry. Primary research showed there were four clear value-based segments: a "want the best" segment that placed a lot of importance on both product quality and service / support; a "want it now" segment that mostly valued speed of delivery and on-time delivery; a "want no risk" segment that wanted high product quality but was willing to sacrifice service / support for lower prices; and a "want price only" segment that would even sacrifice on product quality for low prices. One additional insight from this study was that the customer's own business strategy largely drove what it looked for from suppliers. For example, the strategy of customers in the "want the best" segment was to serve high-end customers with high quality products and provide exceptional service and technical support. The strategy of "want it now" customers was to minimize turnaround for their customers.

Based on these findings, we worked with the client to create a priority logistics package for the "want it now" segment, including guaranteed next-day delivery, paid freight on late and short orders, prioritized supply / allocation in event of capacity issues, and logistics consulting services. For the "want the best" segment, we created a support plus package with prioritized customer support on technical questions and testing, visits from custom product engineers, and consulting / training on product and process-related problem solving. From the pricing research, we knew roughly how much customers were willing to pay for these packages. Salespeople were instructed to offer the priority logistics solution at a 3% premium and the support plus solution at a 5% premium to the stripped-down base offering designed for more price-sensitive customers. Salespeople loved having the options; it allowed them to force tradeoffs on customers. In the first year of roll-out, operating income increased by 30%.

Since then, we have conducted many similar segmentation studies in other industries, and similar patterns have emerged. We almost always find these basic segments: high touch service / support; speed / convenience; product quality / features; and price. CFOs can play a role here by encouraging their marketing and sales counterparts to think beyond traditional segmentation schemes (e.g., based purely on market segment) to segmentation based on willingness-to-pay.

***Price structures.*** Over the last few years, during the run-up in commodity prices, many of our clients were interested in exploring new pricing models tied to indices (e.g., chemicals companies and transportation companies tying their pricing to indices for oil and gas). Over the next few years, we expect companies to spend more time exploring alternative pricing models that shift payment from upfront charges to ongoing fees, tie pricing more closely to usage and value delivered, and pay out discounts only when they are truly earned.

***Multi-dimensional pricing structures.*** Customers will have smaller budgets in the near term. But that doesn't mean you have to charge less for your products and services. Look for ways to extend payment schedules, and charge extra for the risk and the cost of money. We expect to see an accelerated shift in the software industry from upfront user-based licenses to subscription models, term licenses, hosting, and on-demand pricing, where customers pay for usage. Similarly, we expect financial services firms to generally reduce upfront fees for services and increase transaction fees. Best practice companies will give their salespeople the tools to present multiple financing options (e.g., higher upfront and lower ongoing fees; or lower upfront and higher ongoing fees) when quotes are requested and train salespeople on using these options to force tradeoffs on customers when pushed for lower prices.

***Value-based pricing structures.*** During the downturn, companies may be able to establish a competitive advantage by introducing pricing models that more directly tie pricing to value delivered. For example, a firm selling fraud detection software to banks might tier its pricing by the current level of fraud rather than the size of the bank. In some cases, the overall spend per customer might not be any different, but the pricing model itself will better communicate your value advantages and attract new customers. CFOs should provide the resources to model the financial impact of switching to alternative pricing models, for both their companies and key customers.

***Earned discounts and rebates.*** This is a good time to revisit volume discounts. Salespeople will be tempted to provide historical discount levels to customers even though customers are unlikely to place orders at historical volume levels, and even less likely to comply with stated volumes. CFOs should enforce discount policies and – for those customers guilty of chronic non-compliance in volume – encourage salespeople to shift from pre-paid discounts to post-paid rebates. Consider using rebate programs that reward customers for giving you desired product mix, rather than overall volume.

### **Article III.**

***Pricing execution.*** CFOs should play a lead role in reforming the execution of pricing. It is their responsibility to plug the price leaks, to reduce the waterfalls from list price to true net price that plague most companies.

Systems. It sounds too simple to be true, but don't ignore it: Pick 20-30 invoices at random and trace them back through your systems to contract. You will likely find numerous surprises. One of our clients found that their systems could not generate invoices with more than 20 line items, yet 10% or more of their contracts had more than 20. Invoices had been sent for years with just the first 20 items, while additional products and services had been delivered for free. In other cases, we find decimals being truncated, freight charges not properly applied...

Make sure your systems give you visibility into price performance, on at least a monthly basis. Set key performance indicators for pricing (KPIs), and track these as you track margins and other financial metrics.

Escalations. Measure the percentage of escalated quotes that are simply approved, without any modification to prices requested by the field. We frequently find that 80%-90% are approved. Then ask yourself if an 80%-90% approval rate is truly justified. We often discover that there are no standard escalation criteria, no documentation and scant information provided, and no competitive pricing databases to establish the veracity of a claim from the field. In the absence of good intelligence that could help them determine whether a price concession is indeed necessary (e.g., intelligence on perceived importance of buying criteria and perceived relative performance on these criteria), those with responsibility for approvals tend to approve all that they see.

Yet one example should demonstrate the money that is left on the table from taking this undisciplined approach. A customer marketing manager at a semiconductor client of ours decided to run an experiment. For one month, he systematically rejected every 10<sup>th</sup> quote escalation that came across his desk; all 9 others he approved. At the end of the month, he reviewed the differences in win-loss rates. He found no difference in win rates for those he had rejected.

Key account negotiations. Select 6-8 recent deals with key accounts and reconstruct the pricing process. Interview the parties involved (e.g., sales team, product managers...) and review the e-mail trail and paper trail, from deal origination to final decision, including multiple versions of offers and contracts. Look for breakdowns in the pricing process and identify where money was left on the table.

How much pricing guidance did the field receive? How well did the sales team assess your firm's competitive strength and bargaining power? How well did they force tradeoffs on customers when pushed for lower prices? Good negotiation is 90% preparation, 10% tactics; but we typically find that clients give short shrift to preparation. Make a checklist and sign-off forms to ensure proper preparation. Make sure the field is planning out tit-for-tat concessions ahead of time and taking the lead on contract structure. Run mock negotiations, using your own purchasing people as mock customers.

Try to have a finance representative at live deals to play the role of “cool head,” pulling the sales team back when they get too emotional and risk giving away the store.

Key accounts often make up 80% of the company’s sales. Make sure Sales knows you are watching their price performance.

*Sales incentives.* Give the field an extra incentive to defend higher prices. These incentives can take multiple forms. One way is to apply an adjustment factor to sales, based on performance versus target price. For example, if the salesperson prices at target, multiply the sales by 1.10 and pay out commission on the adjusted sales figure. Sales can be adjusted down for selling significantly below target prices.

Another way to encourage better price performance is to institute peer pricing incentives. In this case, assign salespeople to tiers based on how they price relative to their peers. The 20% of salespeople who perform better than the remaining 80% receive a bonus. Those in the bottom 20% may be penalized. Note that salespeople are not simply coin-operated machines. They are highly competitive, and appeals to their pride can be highly effective. Sometimes it can be enough to simply provide all salespeople with visibility into their price performance versus peers.

*Budgets.* Since CFOs have budgetary power, one good way to drive better pricing through the organization is to use the budget process. We have seen CFOs successfully incorporate average selling price and other pricing KPIs into the budget, down to very low levels of the company. For example, district sales managers were asked to come up with budgeted average selling prices for their territory. They had to sign off on these pricing figures as they signed off on financial figures like revenues. By going through this process, the field put a lot of effort into thinking about what was possible and were then held accountable for their projections.

## **Conclusion**

CFOs often shrink from involvement in the pricing process. Now is not the time to be bashful. Now is the time to print out a copy of the Pricing Manifesto, nail it to your wall, and lead your company to better pricing.

*Hermann Simon, Frank Bilstein, and Frank Luby co-wrote the book Manage for Profit, Not for Market Share: A Guide to Greater Profits in Highly Contested Markets. Hermann Simon is the chairman of Simon-Kucher & Partners, the world’s largest pricing consultancy. Frank Bilstein is an Executive Director with the firm. Frank Luby is a partner in the firm’s Boston office. Drew Conrad is a partner in the firm’s San Francisco office.*

Drew Conrad  
Partner, Simon-Kucher & Partners  
100 View Street, Mountain View, CA 94041