



REBUILDING PROFITS IN THE MANUFACTURING SECTOR

HOW TO MANAGE PROFITS AND PRICING

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Although 2004 is hinting at the promise of economic recovery, market uncertainty and supply/energy cost spikes have created a difficult marketplace for manufacturing firms. Companies are struggling, earnings warnings are increasing, and market growth is stagnant.

Firms are responding in a variety of ways. While cost cutting efforts continue as an essential element of management concern, the effectiveness of these moves is declining – managers are chasing ever smaller reduction opportunities. There's a need to focus on the other side of profit – revenue. While difficult markets make volume increases challenging – probably impossible – the pricing side of revenue offers opportunities for improvement, even in difficult markets. Price leverage on profits is substantial: for many manufacturing firms, a 1% improvement in price can drive as much as a 15% profit improvement. Managers can capture this potential profit opportunity by focusing on two pricing areas:

- Pricing for value.
- Coping with customer price resistance.

Pricing for Value

Key to managing value-based processes is creation and communication of offering differentiation. What do we mean by differentiation? Many manufacturing firms are aggressively adding services or bundling products in an attempt to make their total offering different. This is not differentiation – offerings can be different from competitors but not necessarily differentiated!

Differentiation comes only from differences that create unique economic impact in a customer's business. These economic impacts are the result of benefits the customer receives when they use a supplier's products and services. Economic benefits may result from reducing the customer's costs or increasing the customer's revenue. Manufacturing firms that add services or create new product bundles to make their offerings different may find customers willing to buy more volume but not at higher prices. Adding services or increasing complexity with new product bundles drive higher costs. If higher costs do not drive higher prices, this creates challenging profit problems – the kind of problems that sap profits.

Another approach some manufacturing firms are pursuing is to create “solution offerings.” Solution offerings are intended to create a complete package that solves a specific customer problem. The challenge with solutions is that customers may find solving the problem themselves is cheaper. As a minimum, offering solutions are much more difficult to sell: they require selling at senior management levels (not just purchasing), and have much longer selling cycles. Sales people must be skilled in diagnosing customer needs and fitting solutions to these needs – often a lengthy and expensive process. Manufacturing firms attempting the solution offering approach increasingly are finding the costs high, cash flow slow, and anticipated profits elusive.

There are several reasons why customers may refuse to pay higher prices for added services, product bundles or solution offerings. First, while the services, bundles and solutions may make the offering different, they do not necessarily create differentiation value for customers. Creating differentiation value is the first step in getting higher prices; when customers do not receive more value from a supplier’s services than competitors, they won’t pay for them.

Second, services, bundles and solutions may create value for some customers but not for all. Customers who receive no value from the services won’t pay more for them, and will insist suppliers charge competitive (lower) prices. Even customers who do benefit from the added services will be more price sensitive – less willing to pay – when they know that others are paying less for the same offering. The key to getting paid for services, bundles, or solutions is to tailor offerings to specific customers, and not providing differentiated services to customers who won’t pay for them. This means there will be more offering variations to manage; our experience is that tailoring to provide unique benefits and value often results in price premiums that readily justify the cost of multiple offerings.

Finally, customers will not pay for services, product bundles and solution offerings when they do not understand the benefits and value they receive from them. And they won’t pay for these benefits and value until they are forced to make decisions about not receiving them. The first task for managers in manufacturing firms is to communicate value to target customers in terms the customers can understand. It’s not the customer’s job to understand value; it’s the supplier’s responsibility to quantify and communicate it. Then managers must institute policies to compel customers to acknowledge the value delivered. This is best done by understanding all offering components and forcing customers to give up value creating offering elements in order to get lower prices. For example, start charging for rush orders or requests for order changes beyond what is typically supplied in your market.

Here are some key managerial tasks to implement value-based pricing:

- 1) **Make sure you understand how your target customers use your products and services – how your customers make money in their business.** This is the essence of the sales and marketing functions: to comprehend what drives customer businesses. At the same time, make sure you understand what benefits customers can get from competitors. Avoid adding offering elements that might make you different without adding differentiation.
- 2) **Unbundle differentiated offering elements from your core product offering.** You can provide competitive offers for your core products and services while offering the opportunity to purchase superior offerings at premium prices. For example, if your ability to deliver on rush orders is superior to competition, then be sure to withhold rush service from customers who are beating you up for lower prices. Save your valuable services, product bundles and solutions for those who will pay for it.

3) **Drive market communication that emphasizes your differentiation – the rationale for customers to do business with you and not with competitors.**

Make sure your differentiation story is widely known across your customers' organizations – build allies to help you get your value message out. Market communication includes everything from advertisements to CEO statements to selling scripts to invoices; all must work together to communicate that the business is focused on delivering value to target customers.

Coping with Customer Price Resistance

Customers resist price levels for several reasons:

- They are aware that there are lower market prices available.
- They do not understand the economic impact of using a supplier's offerings.
- They benefit by creating an arena of intense competitive bidding.
- They have never been forced to choose between value delivery and lower prices.

Almost universally, customers are rapidly getting better at negotiations. Purchasing has become a strategic focus for many firms, and it is increasingly being used to drive price concessions from suppliers. Customers insist suppliers provide the best products and services, but at lower prices. At the same time, managers in manufacturing have been reducing their offering line – they have controlled cost by reducing offering variations and system complexity. Of course there are economies of scale available here; if only a limited number of offerings are available, the fixed costs involved in providing these gets spread over larger volumes, resulting in lower unit cost. But there's a problem: not all customers benefit from the offering elements that are now part of a smaller offering set, and they won't pay for them. As word gets out – and it always does – that some customers are paying lower prices, general market price sensitivity goes up; even customers who

benefit and would pay for the offering know there are lower prices available and insist they pay less.

Customers also are price resistant when they don't understand the value they receive from a supplier's offering. Much of the manufacturing sector's advertising and selling scripts remain focused on product features and not economic value. Myopic advertising and selling practices assume customers completely understand why they should buy the product and how they will benefit economically using the product. Our experience is that even when customers really understand the economic benefits of a supplier's offerings, that knowledge rarely enters the purchasing dance. Product myopia makes it easy for customers to see suppliers as delivering commodities, facilitating price negotiations in the purchasing agent's office. When manufacturing firms don't force customers to acknowledge value delivery, the purchasing dance is always price focused.

Customers may resist supplier price positioning because in the past they've been rewarded for creating an atmosphere of intense competitive pricing activity. If purchasing agents who suggest there are better competitive deals available have been able to negotiate lower prices, you can expect them to raise the lower price specter in every sales call – their actions have been rewarded. Even subtle suggestions of competitive activity may work (“you're higher than all the competition” or “I'd like to give you this order, but you'll have to sharpen the pencil”) if you demonstrate you are willing to chase every order. The problem is, of course, if this game is being played on you, you can count on it being played with all of your competitors. Purchasing agents sometimes use the hint of competition to encourage price cutting among suppliers.

Customers are price resistant when they don't have to make value tradeoffs to get lower price. Customers will not accept higher prices if they can get all of what they want at lower prices. Sales policies that are

focused on driving volume often wind up getting sales that deliver large, but unprofitable deals. Customers that are never forced to give up valuable offering components for lower prices are rewarded for their price aggression. Worse, these price aggressive customers become trained to ask for more offering while paying less.

So what can managers do to deal with aggressive customer price resistance? Here are some key managerial tasks:

- 1) **Segment the customer base, understand the unique benefit needs for each customer group, and target segments to which you can offer something uniquely valuable.** Create offerings that are uniquely suited for specific customer groups, and target customer groups where you can deliver differentiation at competitive advantage. Avoid customers where you have no advantage. For example, a manufacturing company with nationwide plants targets nationwide manufacturers to whom it can offer a consistent quality product where there is a high level of need for service support.
- 2) **Refocus market communication and selling scripts so they are benefit-value driven.** All customer communication should be founded on the customer's business and how the customer will benefit economically with your offerings, avoiding "product myopia." Instead of talking about the characteristics of your product, contrast the economic benefits (less waste, improved production processes, ability for the customer to achieve price premiums, etc.) the customer receives from your products with the consequences of using competitive alternatives. Of course, this means you must understand how customers benefit from your products.
- 3) **Carefully negotiate with price aggressive customers.** Make sure you have good intelligence about competitors' prices. Start all

negotiations with a "walk away" point and don't compromise this end point in the heat of negotiations. Be careful about the orders you pursue – the only winner in a price negotiation is the price aggressive customer. For example, your walk away position for aggressive price negotiators should be your "fighter" brand – a stripped down, basic offering that will allow the customer to receive the product at a low price without valuable services (the means for you to control costs).

- 4) **Institute sales policies that force customers to accept lower levels of value delivery in exchange for lower price.** Avoid rewarding customers for price aggression by giving them both lower price and valuable offering elements. This means you must understand the customer's business well enough to determine your economic impact on their business, and you've engaged in thorough market communication about this value delivery. For example, tell a price sensitive customer that you will meet their demand for lower prices if all orders are "must take" deals in car-load quantities with minimum two week order lead times.

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