



# HOW TO REGAIN YOUR MARKETPLACE POWER BY INVESTING IN PRICING STRATEGY, STRUCTURE AND SYSTEMS

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## **Pricing: Rising to the Top of the Corporate Agenda**

There is a new reality in Fortune 1000 companies today. More than ever before, companies are struggling with serious issues regarding how they set and manage prices. The challenges are so great that the issue has finally made it into the executive suite. In a recent survey by the McKinsey Quarterly, pricing strategy was rated as the #1 business issue facing senior executives. So why is pricing so critical today? Let's look at some of the marketplace issues driving the need:

- *Competing Against Procurement Guerillas:* For over a decade, procurement organizations have mastered the art of driving prices down. Executives are finally realizing they need a way to compete against these profit-draining powerhouses.
- *Selling to Global Customers:* As companies operate more globally, suppliers are frequently being asked hard questions like, "why did you charge us 40% more for the same product in Australia than in America?" Executives are being pushed to coordinate policies for cross-border pricing even though they often lack global pricing systems or policies.

- *The China Factor:* China has now assumed a leadership role in the global economy. High quality, low cost products (for virtually every industry) are flying out of China and creating intense price competition. Many domestic industries have been turned upside down and executives are scrambling for ways to compete.
- *Lightning-fast Innovation:* A decade of investment into new product development processes has reduced the cycle time in most industries by 50%. The result is that marketers have less time to extract the value these new products bring to customers before it has been eroded by competitors.

The mixture of these market factors has created a toxic cocktail for companies struggling to maintain their pricing power. In this environment, each vulnerability in your pricing process cuts into profits through reduced price realization. There is simply no room for error in today's market place – yet most firms have not paid enough attention to creating a pricing capability that can succeed against aggressive customers and competitors.

Unfortunately, most Fortune 1000 organizations are not well equipped to handle the volume, complexity and cross-

functional nature of today's pricing issues. Pricing lies at the intersection of Marketing, Finance, and Sales, with each functional area contributing its perspective to pricing decisions. Instead of these contributions adding up to a sound pricing strategy that maximizes profitability, in most companies, pricing options are limited because each area imposes constraints on the pricing decision. In the process, viable strategic options come off the table and pricing becomes a political football with ultimate decisions being made by the functional area with the most power. The result is an unbalanced pricing strategy with too much emphasis on costs, customers, or competition depending on who's making the decision.

A recent example illustrates this point. The company, a multi billion dollar technology firm, had developed a superior new product but the management team couldn't agree how to price it. Marketing conducted customer research and recommended a moderate price point based on the customers' "willingness-to-pay." Finance suggested a high price point to recoup the product's significant R&D expenditures. Sales lobbied for a low price point to convince customers to switch. The debate raged for months. Finally, senior management threw up their hands and picked a moderate price, virtually out of thin air. Not surprisingly, the sales force complained that they had a difficult time explaining and defending the price to customers who were quick to point to the lower prices offered by foreign competitors. Management then concluded that the product didn't create the expected value for customers and they opted to increase discounts in order to drive sales. Although several managers felt that this was the wrong strategy, none would take a stand to defend the price point because they didn't have sufficient information to make their case. In the end, the product failed to hit its volume and profit targets and was written off as a mediocre product.

This demonstrates how one company's failure to establish an effective pricing capability reduced their pricing power and prevented them from getting paid for the

value created for their customers. Unfortunately, this story is not unique – it is repeated across the globe on a daily basis. To be successful, companies must invest in the process, people, and technology to build a pricing capability that can manage cross-functional complexity while going head-to-head with powerful procurement groups and sophisticated competitors. After years of neglect, it is time to invest in pricing. As a guide to those investment decisions, we offer the following four recommendations.

### **1. Create a Disciplined Pricing Organization**

Most Fortune 1000 companies have fairly complex multi-divisional, multi-product businesses that require a pricing approach that combines elements of both centralization and decentralization. While there is no perfect organizational structure, we do recommend a centralized (or coordinating) pricing function that sets and manages macro pricing issues such as overall pricing strategies and policies for operating groups to follow. These policies should outline goals and targets for price integrity and price realization. The central group should also be responsible for measurement systems and controls that drive pricing consistency, rigor, and discipline throughout an organization. With these skills in place, decentralized units can focus on pricing decisions closer to customers and markets - issues such as value creation, offering design, price setting and negotiation tactics. With this approach, it is critical to address pricing complexity upstream. We often see clients build a pricing organization combining centralized control with decentralized execution, yet they fail to achieve the intended results because they push too much complexity to the field. Complexity needs to be strategically planned and coordinated from the center. For this model to work, downstream decision making processes must be simple and timely.

Furthermore, this pricing organization needs to have some teeth. Pricing organizations need the status to help shape strategy and the credibility and power to enforce pricing policies, the degree to which depends on

your organization's culture and your ultimate objective. The pricing organization of one of our clients didn't dictate policy to business units, but it did, however, publish a monthly scorecard on how business units were performing against pricing objectives. And since the scorecard was highly visible and supported by the CEO, it wasn't long before divisional managers changed their behavior to avoid public embarrassment.

## **2. Align Strategic Goals with Individual Incentives**

An issue we frequently come across is the misalignment of a company's overall strategic goals and the pricing performance metrics that drive individual behavior. This is best illustrated at a recent client where the sales force was incented on order volume, with no tie to actual revenue. Our client developed this incentive structure because there was a significant lag between orders and the actual delivery of the product. Management worried that sales didn't have sufficient motivation to close deals. Unfortunately, this compensation scheme led to many phantom bookings, where sales booked a deal, pocketed their commission, and then quietly cancelled (or significantly reduced) the order six months later.

While this may be an extreme example, we see countless ways in which companies incent individuals to make decisions that undercut profitability. For example, Marketing is often incented to drive market share leading to promotional blitzes that drive volume at unprofitable levels. Finance is incented to impose minimum margin requirements on new products, which often precludes Marketing from pursuing lower margin opportunities that could drive capacity utilization and profits.

We believe profitable growth is the key performance measure upon which both companies and individuals should be aligned. Measurement systems that only focus on volume or market share are insufficient and can drive unhealthy behavior. While we're not suggesting eliminating volume or market share measures, they must be complimented with profitability metrics to ensure both

company and individuals are working in concert.

## **3. Invest in Your Analytical Capability**

Few would argue with the old adage "you can't make good decisions with bad information." Nevertheless, most companies make pricing decisions with inadequate information about customer value, competitor pricing, sales trends, and profitability. This was an understandable situation in the past when there simply weren't many options for doing pricing analytics. Today, there is no excuse. Technology vendors have developed excellent software programs to support strategic pricing decisions. There are at least a dozen software vendors who have entered this arena whose systems support three basic functions: pricing analytics, price optimization, and deal management.

But don't make the mistake of thinking that software alone will lead to more effective pricing. Analytical tools are vital to making timely decisions and helping integrate a pricing process into organizations. However, great care must be taken to ensure systems are not implemented before the right process and organization is in place. Consider the example of a CMO at a large industrial manufacturer. He joined the organization about a year ago when their pricing was in disarray. The company had a cumbersome, paper based, overly complex pricing structure that resulted in a price book over 100 pages long. Because customers were complaining and the company was losing deals due to slow response times, the CMO believed he needed to act quickly. He bought and implemented the full suite of pricing software from one of the leading vendors. But because he didn't have a sound strategy and process in place and lacked the necessary organizational pricing skills, the software they implemented simply caused them to make bad decision even faster. The pricing software was not at fault – software can only do what it's programmed to do. Companies need a sound strategy before they can expect software to deliver increased profits.

#### 4. Develop Pricing Leadership

Today, many Fortune 1000 companies are actively recruiting for pricing talent, both at the junior and senior levels, including several executive searches of which we are aware for the role of Chief Pricing Officer. However, since pricing skills are a relatively new corporate discipline, finding expertise can be challenging. Most companies will need to build their capabilities internally and train individuals on the key pricing concepts such as waterfall analysis, price banding, economic value estimation<sup>®</sup>, value assessments, and price segmentation. We find that the most effective pricing organizations recruit individuals who have credibility across all functional areas and are capable of working up and down the organizational hierarchy.

However, the critical mistake made by many firms is assuming that simply developing these skills is enough. To be effective, senior leadership must be willing to change some of its own behaviors as they relate to pricing strategy. We've seen many senior executives unravel years of pricing integrity by agreeing to a highly unprofitable deal just to make a quarterly revenue target. We've witnessed countless organizations muddle through critical decisions because senior leadership couldn't decide (or sent mixed messages) about whether they wanted more market share or greater profits. In the end, senior leadership needs to educate themselves on the executive's role in setting and managing price. For many executives, pricing strategy is a blind spot that they need to correct to insure they are positioned to lead on this very important issue.

#### C o n c l u s i o n

There is no one-size-fits-all approach to building a pricing capability that can regain your pricing power in the marketplace. The best-in-class pricing companies view pricing as an important strategic function of the firm. And with the growing number of complex pricing issues affecting Fortune 1000 companies, the need for an effective pricing capability has become critical. To be effective, pricing needs to work at the crossroads of your Marketing, Sales and Finance organizations. Pricing must be

directly linked to the strategy-setting function within a company, and at the same time, linked to a "local-level" understanding of customers and the economics that drive their businesses. We believe pricing organizations will grow in importance much the way strategic sourcing has grown over the past decade. It's time to start building your pricing muscle today. If designed and managed effectively, this capability will be a significant driver of revenue growth and profit for years to come.

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