Executive Insights

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Optimizing B2B Pricing — One of the Greatest Levers on Profitability

Buyers have become increasingly sophisticated and determined in their quest to reduce costs and maintain competitiveness. Their training and methods today are much more sophisticated than only a decade ago. Their use of tenders has become more common, and many purchasers are now armed with comprehensive market information and suppliers' global pricing history.

In this environment, many companies are failing to address the growing challenge, adopting an approach to pricing that focuses on sales volumes at the expense of profitability and that lacks the coordination, discipline, market intelligence and rigor needed to maintain margins.

The good news is that these businesses have a huge economic opportunity in front of them because pricing is one of the most effective levers on profitability. Incremental revenues from better pricing go straight to the bottom line; the flip side is that price cuts have a disproportionate impact on profits and are usually very difficult to reverse.

L.E.K. Consulting believes that a sound pricing strategy should comprise three core elements:

- Value creation — an understanding of what different customer segments value at each point of their buying process
- Compelling choices — offers and pricing choices that lead to more proactive, strategy-led pricing, sustainable differentiation versus competitors, and increased customer retention
- Successful tools and execution — capabilities that enable effective and consistent decisions

To help companies build these elements of their pricing strategy and become more profit-focused in their approach, L.E.K. developed its "Five Pillars" framework. It is an integrated and holistic model for transforming an organization's pricing strategy and delivery processes. Using this approach, clients have seen a significant boost in profits of between 4% and 9%.

The five pillars are value creation, price structure, value communication, discount policy and pricing execution (see Figure 1).

Pillar 1: Value creation

The key to value creation is in understanding what buyers value, and how much. The starting point is the identification of product and service attributes that increase the total value perceived by the customer — in other words, a reference value (often the price of a competitive alternative) and additional value drivers that add up to the total value for the customer. The price will then be set as high as possible between the reference and total values.

To get this right, companies need to know exactly who their customers are, their needs and their purchase drivers, then segment them according to their differences. The nature and importance of additional value drivers will vary by segment.

Optimizing B2B Pricing - One of the Greatest Levers on Profitability was written by **Aubry Pierre** and **Remy Ossmann**, Partners at L.E.K. Consulting. Aubry is based in Paris and London and Remy is based in Paris.

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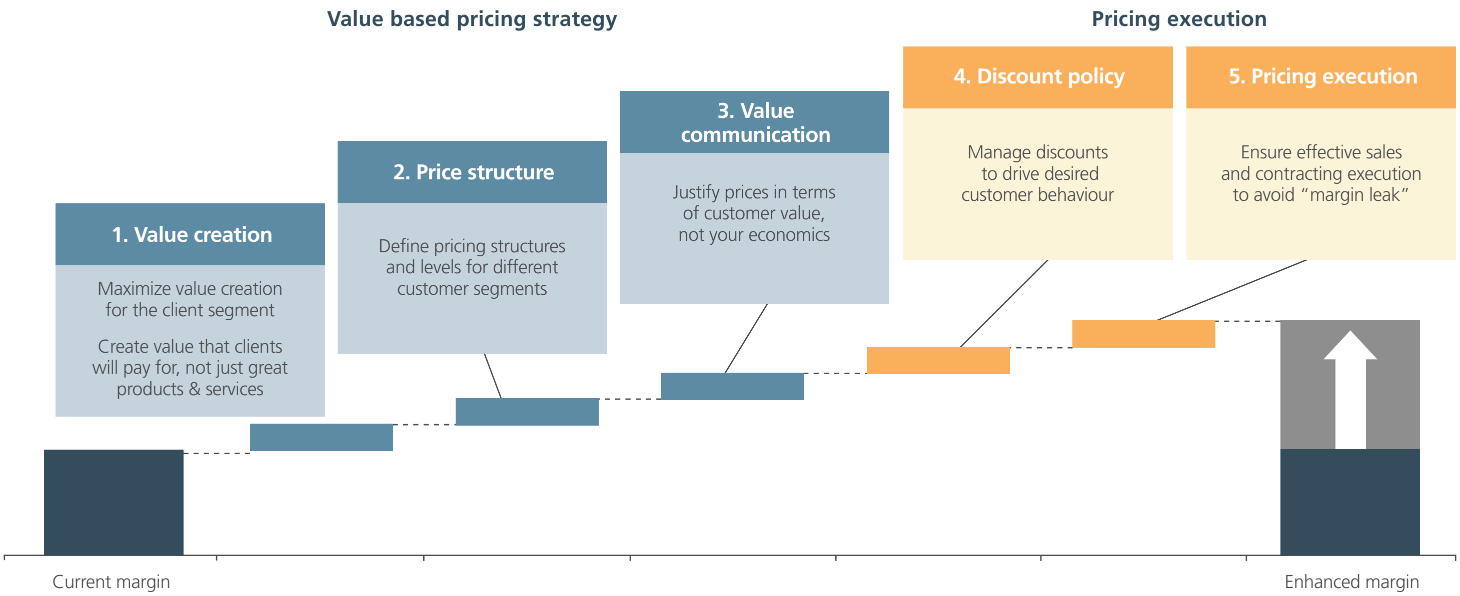
Figure 1
The five pillars of pricing strategy



Source: L.E.K. Analysis

Value drivers can be analytical and emotional. Analytical drivers are about the rational review of the features, benefits and risks of a potential offer versus those of competitive offerings; emotional ones relate to the perception of differential benefits like fairness, CSR or an organization's brand image.

Following this type of value driver analysis, Apple has built a brand that has enabled it to sell at prices that have little correlation with production costs and are typically higher than its competitors'. The value creation process can have a big impact even in highly commoditized industrial sectors. For example, SKF, the world's leading ball-bearing manufacturer, headquartered in Sweden, refined its segmentation strategy to better understand and quantify the economic value of its products to customers. One of the company's key commercial successes resulting from this strategy was a web-based sales tool, Documented Solutions Program, designed to demonstrate to customers the benefits of purchasing its higher-cost ball bearings, such as longer product life, lower cost of failure and inventory savings. The offer is priced differentially by customer segment, depending on the cost of failure in the segment's industrial process. That is value-based pricing.

The key takeaways of value creation:

- Effective pricing requires balancing the price charged with the value generated for the customer
- Businesses and brands must develop differentiated value drivers
- The value of each driver is industry- and segment-specific and must be explored through quantitative and qualitative research
- Pricing is based on the sum of values of each driver for the target segment
- There are specific value drivers in all industries and most segments

Pillar 2: Price structure

Once value creation has been defined, the organization can set the optimal prices of its products and services for each segment. A one-size-fits-all approach to pricing must be avoided, as it reduces the profit potential of some sales categories.

One of the pioneering innovative pricing structures is GE Aviation's "Power by the Hour" for its jet engines, where clients self-segment and pay for what they actually value — flight time. GE's pricing model has transformed a fixed cost into a variable cost for customers and leveraged bespoke telemetry that has made it hard for competitors to copy.

It is important that "redlines" are put around segment-specific offerings in order to minimize revenue leakage by customers choosing the cheaper options not intended for them. This usually calls for the careful inclusion, in each offer, of attributes that are unappealing to adjacent segments, e.g., excessive lead times, lower service and higher unit sales.

The key takeaways of price structure:

- Price structure is as important as price level
- It is segment-specific
- Segments must be "redlined"
- Bundles and packages can help, but can be "unpicked" by competitors

Pillar 3: Value communication

Having developed the price structure, an organization must make sure that its customers clearly understand the value proposition offered and the corresponding price. The company must raise the reference value it is offering and, most importantly, highlight the specific value drivers for the client. One critical point here is that the value drivers must be described in the buyer's, not the seller's, language. For example, describing the longer life of a product is infinitely less powerful than explaining that a 20% reduction in maintenance costs and machine downtime will reduce COGS by €5m p.a.

The key takeaways of value communication:

- Always communicate price and value simultaneously
- Use the buyer's language to communicate the value in his / her terms
- Value drivers are segment-specific
- Value drivers change depending on the point in the customer's buying process
- Value is generated by both analytical and emotional value drivers

Pillar 4: Discount policy

Discounts are a universal feature of any buying process. It is, however, critical to manage discounts separately from price structure (Pillar 2). Indeed, discounts deserve undivided attention and clear steering. The risk of not doing this is financial loss through eager salespeople discounting prematurely or too generously.

Efficient discounting focuses on tying discounts to customer value and reciprocal concessions:

- Customer value: Discounting policy must offer higher discounts to customers that purchase higher volumes or drive more value for the firm. This makes economic sense and is expected by buyers. Reciprocally, however, lower-volume/lower-value customers must receive lower discounts. This is called discount banding, and it is surprisingly rare. In most of our engagements, we find that discounts vary widely and are often not linked to customer value but rather to the salesperson's client management skills.
- Reciprocal concessions: Discounts are not a one-way street. Buyers fully understand that in exchange for a discount, they will be asked for a compromise, for example, longer lead times, simplified logistics or a longer-term commitment. Customers must effectively "earn" the discount. Codifying and quantifying these reciprocal commitments is a source of value creation.

It's important that salespeople do not deviate from the discount policy. A clear escalation policy for customer requests can help. The key is to design a process that makes it easier for the salesforce to negotiate with its customers than with its hierarchy. Deploying this escalation approach, one of our clients reduced the percentage of discounting requests in a year from 70% of proposals to 30%.

The key takeaways of discount policy:

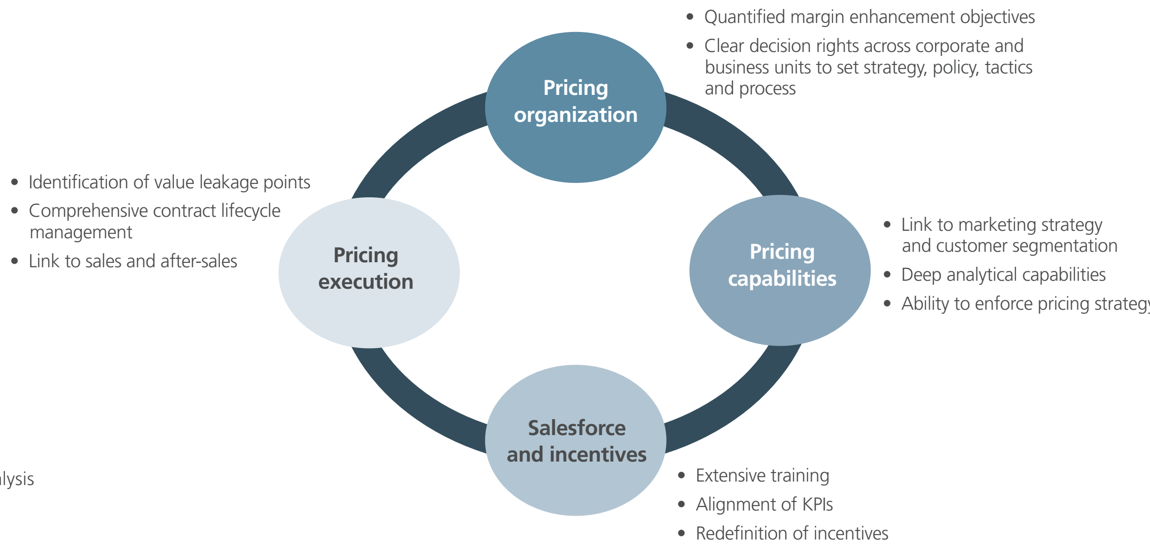
- Set a segment-specific discounting policy
- Encourage customers to value and "earn" discounts
- Create tools to enable the salesforce to understand and model the economic impact of discounting
- Avoid price exceptions and one-off sales

Pillar 5: Pricing execution

Maximizing value through strategic pricing requires organizational change. This applies to two key areas: contract management and pricing management capabilities:

- Contract management: Many companies lose a considerable amount of economic value after pricing has been agreed. This happens through poor discipline such as offering additional free services, not charging for order changes and cancellations, conceding preferential payment terms, or not applying contractual conditions such as price indexation. Lax practices of this nature can easily equate to an erosion of several percentage points from the original price. Companies can prevent this by identifying and quantifying all value leakage points and by putting in place appropriate remedial and contract lifecycle management measures.

Figure 2
The key components of pricing capability



Source: L.E.K. Analysis

- Pricing management capabilities: Ultimately, for many organizations, becoming pricing-driven requires a deep rethink of how they operate (see Figure 2). This includes reviewing the fundamental elements of setting margin enhancement objectives and chains of delivery ownership across the organization, and ensuring that the right capabilities are in place, that the salesforce is well-trained and incentivized with clear KPIs, and that execution is flawless and fully integrated with the rest of the organization.

The key takeaways of pricing execution:

- Create institutional and individual capability
- Coordinate via a common set of insightful pricing choices
- Integrate across the organization (pricing, marketing, sales, customer service, etc.)
- Track meaningful metrics
- Produce actionable and sustainable decisions

Transforming the organization into a price-driven entity and making the five pillars work is not a simple task, but in our experience, those companies that get it right enjoy a long-term transformation in profitability — and a far more engaged and productive workforce.

About the Authors:

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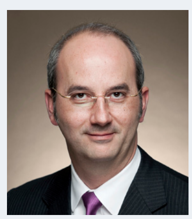

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About L.E.K. Consulting

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