L.E.K.

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Take a Stand Against Margin Pressure: How Consumer-Value Pricing Can Deliver Immediate Bottom-Line Results

In the retail industry, pricing is the engine that drives profitability. Pricing generates more leverage than any other component of the marketing mix: small improvements in pricing deliver big improvements in profitability. Rising costs have forced many in the industry to consider increased price points. Yet retailers are wary of following through due to the concern that raising prices means sacrificing both customers and sales.

There is a way to generate greater profits without endangering customer loyalty. Using a straightforward price sensitivity framework driven by the value customers see in each product offering, L.E.K. works with senior retail executives to determine which products customers are willing to pay more for. This framework can either be applied alongside existing pricing models to enhance product margins or used on its own. Companies that have adopted L.E.K.'s approach have demonstrated that between 50 and 150 basis points can be added to the gross margin without eroding their core customer base. For a $1 billion company, this can mean an additional $5–$15 million in gross profit.

Take a Stand Against Margin Pressure was written by **Andrew Rees**, Vice President and Retail & Consumer Products Practice Leader in L.E.K.'s Boston office. Please contact L.E.K. at retail@lek.com for additional information.

Shrinking Margins Demand A New Approach to Pricing

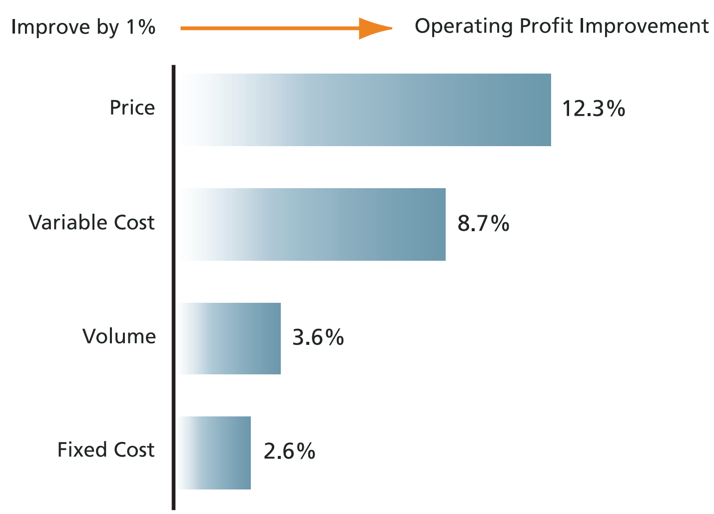
The current global business environment has retailers facing significant cost pressures all along the supply chain: raw materials, manufacturing, transportation, wages and more. Between rising cost-of-goods-sold at one end and aggressive tactics by non-traditional competitors at the other, many retailers are experiencing significant margin pressure.

Of all the variables that impact an organization's performance, L.E.K. has found that price typically has the greatest effect on profit improvement. As illustrated in Figure 1, a one percent increase in price typically results in a 12.5 to 13 percent benefit to the bottom line. Inversely, setting prices non-strategically and ineffectively has the equal and disastrously opposite effect.

Despite the fact that price is a high-leverage strategic tool, L.E.K. has

Figure 1

Comparison of Profit Levers



found that some retailers treat pricing either as an esoteric art (causing them to miss key opportunities) or as a technical algorithm (letting computers pick prices based on imperfect analog patterns). There is another way. By developing a pricing strategy that reflects the value consumers place on each purchase occasion, retailers can optimize margin opportunities while retaining customer loyalty.

The Importance of the Purchase Occasion

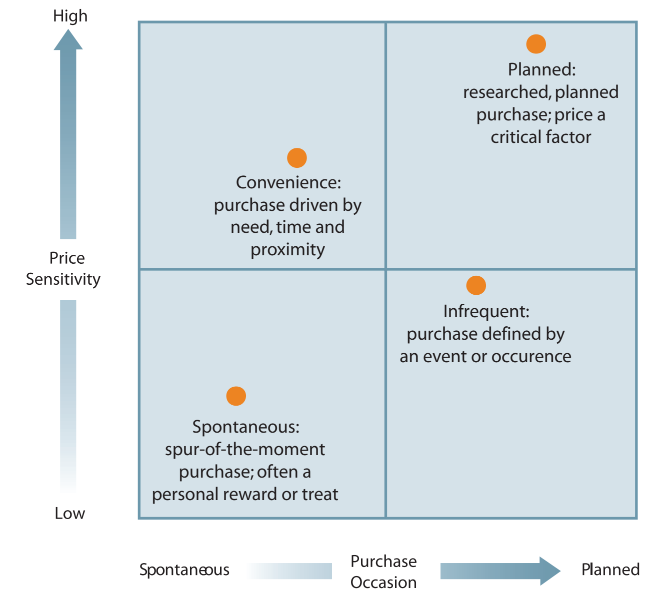
The first step in constructing a Consumer-Value Pricing strategy is to understand the variety of purchase occasions and their value to the consumer. Each purchase occasion – mapped out in Figure 2 by customer sensitivity to price against the degree of required pre-trip planning – implies a thought process for purchasing and a rationalization for how much the consumer is willing to pay.

Typical categories of purchase occasions include Planned, Convenience, Spontaneous and Infrequent:

- **Planned:** A planned purchase occasion is characterized by the willingness of a customer to arrange a trip to a specific store to get the best price.
- **Convenience:** Moderately price-sensitive and minimally planned, a convenience purchase occasion is based on need, proximity and time available to shop.
- **Spontaneous:** A spontaneous purchase is neither planned for nor budgeted. This purchase occasion is not based on need, but is a last-minute personal reward, treat or gift.

Figure 2

Purchase Occasion/Price Sensitivity Matrix



- **Infrequent:** More planned and less price-sensitive than a convenience purchase, an infrequent purchase is driven by an event or occurrence, is apt to be seasonal, and may be a trigger for the consumer visit to the store.

Each individual retailer will want to evaluate their own customer base to assess these and other purchase occasions that are applicable to their specific product offering. A pricing approach that accounts for consumer purchase occasions plays a critical role in maximizing retailer profits. Just as one size does not fit all, rarely does one pricing strategy effectively optimize multiple purchase occasions. The majority of store environments serve multiple purchase occasions – and the consumer will accept differential pricing based on the value of each occasion. As illustrated in Table 1, retail outlets that serve multiple purchase occasions have the most frequent opportunity to enhance margins using differential pricing.

Table 1

Number of Purchase Occasions Served

Single (homogeneous) ⟷ Multiple (heterogeneous)

Purchase Occasion	Convenience Store (e.g., 7-11)	Apparel Specialty Store (e.g., The GAP)	Big Box Retailer (e.g., Lowe's)	Drug Store (e.g., Walgreen's)	Grocery Store (e.g., Albertson's)
Planned			●	●	●
Convenience	●	●		●	●
Spontaneous			●	●	●
Infrequent		●	●		●

Once retailers learn to identify the purchase occasions they serve and the value the consumer attaches to each, the opportunity to enhance margins without losing customers comes that much closer to reality.

Optimum Pricing Yields Maximum Profit

L.E.K.'s approach is straightforward: leverage the price differential consumers will accept across purchase occasions and build this into a comprehensive pricing strategy that can be easily understood and implemented across the organization.

The development of a Consumer-Value Pricing strategy draws on four primary analytical techniques:

- **Customer Purchase Segmentation –** Understand the various roles products play in the minds of consumers and categorize SKUs into groups based on their purchase occasion.
- **Price Elasticity** – Quantify the observed price elasticity by customer purchase segment.
- **Shopping Alternatives** – Identify competitors within each purchase occasion and set a competitive floor and ceiling within which to establish pricing rules.
- **Pricing Rules** – Establish a set of pricing rules that can be easily understood and applied across the organization.

Customer Purchase Segmentation – Customer purchase segmentation is based on understanding the roles products play in the minds of consumers, and categorizing SKUs into pricing groups based on the purchase occasion.

Segmenting customer purchases as Planned, Convenience, Spontaneous or Infrequent, as illustrated in Table 2, enables retailers to price differentially across segments. Not only does this permit retailers to increase prices where customers perceive the most value, but it also allows retailers to signal planned "best price" offerings, thereby driving volume into the store; identify product gaps where the customer can be better served; and physically optimize the merchandise format, managing displays and showcasing Convenience and Spontaneous items to maximize profit.

Price Elasticity – Price elasticity analysis examines the impact of price changes and groups products with similar characteristics into pricing clusters based on consumer purchase occasion. Using historical data combined with consumer research and employee intuition, a competent retailer can predict how price manipulation will impact a week's sales and margin numbers. Through the lens of customer purchase segmentation, however, price

Table 2

Purchase Occasion	Description	Purchase Examples
Planned	• Trip driver – purchasing the product at a certain price point drives the customer to the store • High price awareness • High purchase frequency • High category share – products are typically category leaders	• Automobiles • Tires • Appliances • Audio equipment • Laundry soap • Dog food • Diapers
Convenience	• Trip driver – items convenient to buy • Relatively urgent purchase: purchase is based on limited time and maximum convenience • Relatively high price awareness – consumer is willing to pay a higher price in return for not having to make a special trip elsewhere • Relatively high purchase frequency • Generally low price-point items	• Snack foods • Beverages • Coffee • Gas • Beer & wine • Milk • OTC medicines
Spontaneous	• Low price awareness • Low price sensitivity • Products typically have a reward attribute, purchase not based on need • Low price frequency • Purchase occasion is "spur of the moment"	• Candy • Magazines • Batteries • Videos • CDs • Gift items
Infrequent	• Products that are seasonal, unique/high value or non-standard in format • Products have a reward attribute • Low price awareness • Lowest price sensitivity – customer has little idea of relative price • Generally higher price points	• Cigars • Umbrellas • Seasonal products • Decorative home items • Vacuum cleaner bags • Holiday gifts

elasticity analysis can provide clear direction as to which products should be positioned to drive sales and which products should be positioned to drive margin.

As illustrated in Figure 3, the less elastic the pricing cluster, the less the impact a price change will have on the quantity purchased. L.E.K. has found that consumers will accept a greater degree of price movement in products that are infrequently shopped and (more often than not) event-driven. The Infrequent price, however, is where many retailers are reluctant to make as big a price increase as they potentially could. Interestingly, infrequently shopped items typically have much lower price sensitivity than believed and present the most significant opportunity to increase margins.

Items in the Planned pricing cluster, where price is the driving force behind the consumer purchase occasion, have the least room to move on price without eroding the customer base. These highly elastic products can be successfully positioned as best-price offerings to drive traffic into the store. The elasticity of Convenience and Spontaneous items can likewise be examined to determine the appropriate pricing cluster for each individual retailer's location and demographic.

Shopping Alternatives – Identifying shopping alternatives for each pricing cluster is a precursor to establishing pricing rules for the individual SKUs in that cluster. Looking at the Convenience pricing cluster, for example, we can hypothesize that a Wal-Mart would establish the floor price for snack foods, beverages, OTC medicines and similar items, while a Mobil Mini-Mart would establish the ceiling price. Similarly, in the Planned pricing cluster, Costco may set the floor price for dog food, diapers and so forth, while a neighborhood grocery may set the ceiling price.

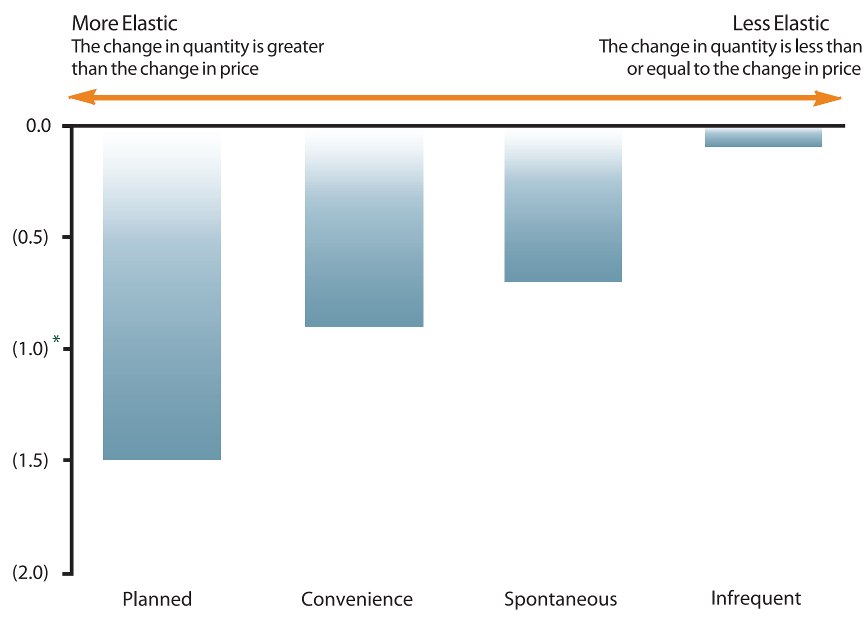
Based on the analysis of shopping alternatives, a zone can be identified from which to establish pricing rules for both the Convenience pricing cluster (for example, more than Wal-Mart but less than Mobil Mini-Mart) as well as the Planned pricing cluster (for example, match or beat Costco's price). This same assessment can be extrapolated to identify floor and ceiling shopping alternatives for Spontaneous and Infrequent pricing clusters and to develop specific and strategically oriented pricing rules for each.

Pricing Rules – Pricing rules provide straightforward pricing guidance that can be understood and applied across the organization to enhance profitability. Working within a floor-to-ceiling price zone as established by analyzing shopping alternatives, Consumer-Value Pricing uses a category leader benchmark to set individual SKU price points.

Establishing rules, such as the variance around a competitor benchmark and/or the type of merchandise offered, as illustrated in Figure 4, provides a disciplined, structured approach for merchants to follow and serves to align managers around a standard model and required actions.

Figure 3

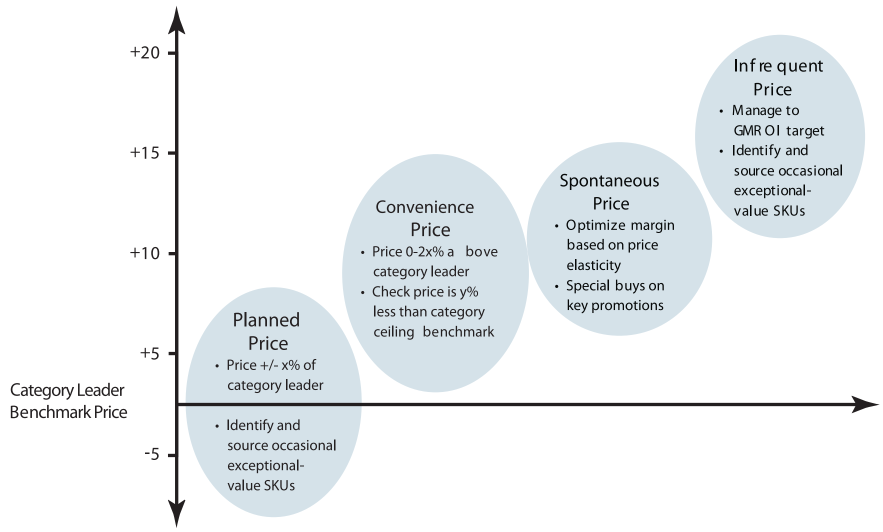
Median Elasticity by Pricing by Cluster



* The change in quantity is equal to the change in price

Figure 4

Sample Consumer-Value Pricing Rules



The analytical capacity now available to retailers makes this the opportune time to leverage pricing to maximum effect. The Consumer-Value approach to pricing explores the differences in consumer purchase occasions and identifies how consumers value different products. The ability to leverage consumer acceptance of differential pricing will lead to the creation of robust, flexible and direct-to-the-bottom-line pricing strategy. The results are greater long-term profits to the retailer, enhanced shareholder value and retained customer loyalty.

Organizational commitment to frequent and consistent benchmarking of the competition is critical to the development of effective Consumer-Value Pricing rules. Through benchmarking analysis, an organization can develop a good understanding of who the competition is (and who it is not), their pricing strategy, how it is executed, and how it impacts the organization's product offering. Benchmarking enables a more accurate understanding of how consumers value each product purchased, which feeds back into the optimization of Consumer-Value Pricing rules.

Toward a More Profitable Pricing Strategy

The main benefit of a Consumer-Value Pricing Strategy is immediate, positive improvement to the corporate bottom line. Companies that have adopted L.E.K.'s approach have demonstrated that between 50 and 150 basis points can be added to gross margin without eroding their core customer base. For a $1 billion company, this translates into a $5–$15 million increase to gross profit. Other powerful advantages of adopting a Consumer-Value Pricing Strategy include:

- Customer retention
- Identification of product gaps
- Guidance for store merchandising and format

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