RULE ONE

Replace the Discounting Habit with a Little Arrogance

Discounting is a habit entrenched in most organizations. Simple analysis can point to where bad discounting leaves money on the table. Like any addiction, the discounting habit is tough to break cold turkey. The best way to dislodge any deep-rooted attitude is to replace it with another. Arrogance, just a little bit, signals the confidence needed to kick the discounting habit.

We learned the danger of unthinking discounting when we started our first professional services business almost 15 years ago. There were only three of us then, and we did all the business development and proposal work ourselves. Then something happened, which led us to the rule: Replace the Discounting Habit with a Little Arrogance.

We got a call from a company that seemed to be interested in our services. So naturally we leapt at the opportunity and wrote a solid proposal with what we felt was fair pricing. The prospective customer responded by asking for a lower price. And when we lowered the price, he asked for a still lower price. After three cycles, we decided to change our approach. We then asked the prospect a question we should have asked in the beginning. "What do you know about us and how confident are you that we can solve your business problem?" His response was honest. "Nothing and not much."

That exchange led to a different conversation and a different proposal. The proposal focused on our understanding of the prospect's business pain, how our services would alleviate that pain, and how the prospect's business would directly benefit from the value our services added. A day later, with no more talk of discounts, the prospect gave us the engagement. From that exchange, we learned a critical lesson. If all you talk about with customers is price, there is no price that is going to be low enough. Price is important, but there are considerations that must come first. We learned to start the conversation with value.

When we started a new business four years ago, we received a call from a senior executive at a large electronics company. She wanted a quote to train and prepare a sales team for a negotiation with a tough price buyer that purchased over $1 billion of product from them. We asked what her budget was. When it was lower than our normal fee for such an activity, we did two things. First, we gave her the name of two consulting firms that could meet her budget, one in her immediate area. The second was to ask her a question. It was an important one: Was she thinking about this exercise as an expense or as an investment? She paused but answered honestly that she was thinking about it as an expense. That gave us a chance to talk about how it should be viewed as an investment and that there would be a probable payback on that investment. We booked the deal and went on to do a number of activities with that company.

Successful managers and salespeople know how they create value for customers and know how to change the discussion to value. The best companies know they have to display a little arrogance about the value they offer in order to send an important signal to potential buyers. That signal is: We are confident in the value we provide and, therefore, the prices we charge.

This attitude replaces the knee-jerk reaction of dropping price with the reaction of "Do you know what we offer?" Companies know that if they have one moment of weakness in the discussion with the customer, they will send the signal that there is a discount to be had. All the customer has to do is push for more. Instead, smart salespeople make trade-offs on the level of value a customer receives as part of the offering, to align with the customer's price. That little bit of arrogance is what gives companies the courage to demand a payback for the value they create for customers.

When your salespeople get asked for a lower price, what is their response? We suggest it *should* be some variation of "What do you know about us and how confident are you that we can solve your business problem?" Salespeople need to step back and ask a few questions about what business pain the customer is experiencing and what the customer is trying to accomplish. How does the business pain impact the customer's financial goals? How does it threaten relationships with their own customers? How does it limit the customer's opportunities? These questions should be asked at the beginning, with the implicit message that your company is in the best position among all other vendors to alleviate the customer's business pain. After that baseline is established, important conversations about pricing can take place. That's what we mean by replacing the discount habit with a little arrogance.

Arrogance, just a little, means that people, especially salespeople, feel confident about what their company offers and why it functions better on behalf of its customers. If they don't feel confident, how can you expect them to price with confidence? You're the victim we talked about in the introduction. If you don't have the arrogance, give up discounting for a while and go out and talk to customers. Talk to those who are using your products and services. Ask them a real simple question. Ask the question that you're afraid to ask because it may appear stupid: Why do you use our products? Listen real well to their answers. If these customers believe in your company, then maybe you had better believe in your company, too.

The starting point in being confident in your price is being confident in your value. That starting point begins at the top of the firm with the leadership and senior managers. If you want to stop any habit, you've got to replace it with something. If you want to replace the discounting habit, we recommend a couple of steps. First, recognize how bad it is. Once you realize how much money you're leaving on the table in your customer negotiations, develop some rules for when you will and won't discount. Start with your smallest, highest-value accounts and write those rules in stone. Notice the results. See, you didn't lose as many customers as you thought you would.

If You Don't Think You Can Control Price Discounting, You're Right

How many times have you felt the need to discount prices to meet your quarter or year-end sales objectives? Come on, be honest. We don't think that any of us can say "never" to the addiction of price discounting. When you have responsibilities to run a business, the pressure to keep the revenue flowing and people working is tremendous. That pressure is sometimes alleviated when markets are growing and customers are plentiful. But when industries slow down, as they inevitably do, the pressure to discount goes up exponentially.

There's nothing wrong with discounting. Sometimes it's the right response. It's the *habit* of discounting—the unthinking and throw-caution-to-the-wind desperation—that's so destructive. It's the addiction to discounting that we're against. The difficulty with discounting is, as with all addictions, that it is very difficult to stop. People get used to discounting. They defend it as "industry practice." Our clients tell us, "We have no choice but to discount because our competitors are nuts." In fact, the competitors just look like they are nuts because they have the same addiction. By the way, we always tell our clients, "Your competitors are saying the same thing about you, and for precisely the same reason."

Discounting never occurs in a vacuum. Companies and managers develop systems and processes that allow discounting to flourish. Discounting occurs despite vigorous attempts to control it.

Many companies have implemented systems that place barriers on salespeople who want to offer discounts. Managers do that because they think it limits the discounting. And it does, at first. Maybe the salesperson must first obtain the approval of a higher-level manager. In rare cases, the president of the company must sign off on discounting requests. But the systems usually fail and for the same reason: The systems are focused on approving and subsequently giving discounts. Everybody learns the game. Customers and salespeople alike play it well.

It's this discounting mindset that gives customers the entry point for obtaining discounts that are often not necessary to close the sale. We don't blame customers for negotiating for discounts. We blame the discounting habit. We've seen discounting justified in every possible way. Some companies justify it by customer. These companies start off by giving discounts to its largest customers "only." These are the big customers, perhaps the marquee opportunities in the industry, and they order lots of products and services. Perhaps the volume of business they transact legitimizes the discount, but perhaps not. But invariably the companies succumb to *discount creep*, the expansion of a project or mission beyond its original goals, often after initial successes. Then the midsized and smaller accounts start getting discounts, too.

Sometimes companies justify discounting by product. In these cases, discounts are offered only for commodity products with lots of competition. Again, discount creep kicks in. Pretty soon, the company's newer technology, innovative high-value offerings start getting discounted, too. Sure, there are some justifications, such as the ability to get the low-value commodity products put on the purchase order as well. But the results are the same. Companies end up leaving money on the table in the negotiating process.

The software industry is rife with examples of discounting run amok. Just before Oracle acquired PeopleSoft, both companies were offering discounts as high as 80 percent to close deals. The problem is that customers quickly figured out that it's in their interests to hold their orders to the very end of the quarter. Subsequently all of the business gets closed at a discount. To make matters worse, Oracle, the winner in the deal, blamed the problem on their customers: "... the tendency of some of our customers to wait until the end of the fiscal quarter or our fiscal year in hope of obtaining more favorable discounts."[1] Can a company's misfortunes in pricing ever be the customer's fault? We don't think so. Oracle simply trained its customers over time to expect large discounts.

Red Hat is a leading distributor of Linux-based software and services. The company recently reported 55 percent growth in revenue but missed the mark expected by analysts by 1.7 percent, causing a slight decline in the stock price. When questioned about this, Red Hat CEO Matt Szulik said, "Red Hat wasn't willing to yield on price just to close a deal at the end of the quarter. Why do something economically foolish to satisfy a near-term metric for Wall Street?"[2] Having set that expectation with customers, Red Hat's company performance continues to be solid. They have confidence in their pricing, and it shows in their growth, profits, and stock performance.

Who Gets and Gives Price Discounts?

Here is the first assignment in this book. Go ask for a plot of all of your customers' pricing. The plot can be for a high-value product or for a low-value one. It doesn't matter. If possible, have the summary reflect total discounts and total volume. For this first step, the goal is to show which customers are getting which discounts for which products. Ideally, the summary will also compare discounts for different sized customers.

Don't ask for data, ask for the plot. It's the graph that is worth a thousand words. Let's look at an example plot (Figure 1.1).

The plot represents the price charged per pound for a commodity product along with the total requirements for each customer. Notice several things about the plot. First, look at the number of customers who pay less than $0.30 per pound. That's 30 percent less than what the larger customers pay. Maybe the coding is wrong and the customer is actually buying a lot more than listed. Maybe it was a

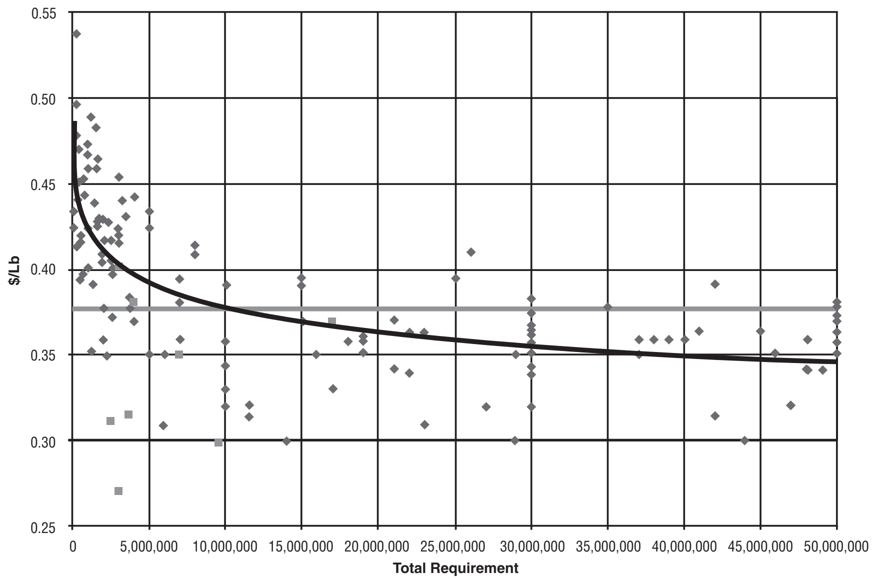

Figure 1.1 Prices Paid by Total Requirements.

sample order in the expectation that a customer was going to buy more in the future. Whatever the excuse, given that it is happening in so many accounts, this is a sure sign of uncontrolled discounting.

It also might be because a customer was given a quotation for a larger volume but is only purchasing a smaller volume at this time. This indicates poor control in executing quotations with customers. Whatever the reason, each of these dots has a story to tell and the story weaves a web of implications around the discounting for the firm. We continue to be amazed at the number of managers who fail to take advantage of the insights from this type of analysis. What gets measured gets done. If you review these plots and start to ask questions about who is getting discounts and why, you are going to find the problems that lead to excessive or just plain ad hoc discounting. Ask for the justifications for the discounts. Ask for the policies that control them. We predict you will not find such policies—that's the point of this exercise.

Take a look at who in the organization is giving the most discounts. Average the discounts for each of your salespeople. You will notice that some don't give lots of discounts. You will also notice that some salespeople and maybe sales managers give lots of them. This is going to be a scary process of discovery. Don't go on the warpath. This is not about apportioning blame. Just recognize that discounts happen because of the lack of training, systems, and controls. Well-meaning business professionals provide discounts because they are compensated, managed, and taught to do just that. When you find the discounts, you've got to determine the root causes of the problem, and those root causes are rarely just the salespeople who dispense them.

If you don't review and manage your discounts, the trend will continue and possibly accelerate. If you begin to look at them and question them, that act alone will help people realize that they've got to at least do a better job of justifying them. If you back that up with needed policies and procedures and put some teeth into implementing them, you are well on your way to kicking the discounting habit.

Be Willing to Fire Unprofitable Customers

Now that you know how bad your discounting is, you can begin to take proactive steps to repair the damage. One of the problems that leads to discounting is salespeople and managers who look for every opportunity to sell something. They don't stop and ask whether any particular customer or order is good or bad for the business. This is one of the root causes that leads to excessive discounting: selling to customers who don't and will never value the things you do as a firm. To make matters worse, these may be the customers who switch vendors, complain about everything, and extract all sorts of extra services that they don't pay for. Why do we continue to serve them? Because we are trained to satisfy the customers, whatever it takes. Whether it's smart—in other words, profitable—to continue to serve individual customers rarely enters the conversation.

We learned this lesson the hard way. Many years ago we started a project with a company that needed help with pricing a new product. Halfway through the project, we got a call from the purchasing agent at the client that he wanted to negotiate our fee down. We started to argue with him that reducing our fee would hurt the project, but he wasn't listening. All he cared about was his number. So we changed tactics. We agreed that we would be willing to renegotiate the scope and price of the project. In the meantime, we proposed that it would be best to shut the project down. The purchasing agent seemed okay with that.

Then we made a call to the senior vice president who had engaged us in the first place. Well, she was not so upbeat about shutting the project down. Within the hour, the purchasing agent was trying to reach us. We took an extra few hours to return his call, but within five minutes we had the project going again and at the price we wanted. The point is that you don't want to fire your customers; you want each one to be profitable. It's the willingness to fire them that makes the point and builds pricing power.

The correct response is to take a step back. Within the global view of possible markets, identify which customers and markets you cannot serve at a profit. If some customers are marginally profitable, but others are significantly more profitable, is your company better off serving the former, or are you better off focusing resources on the more profitable opportunities? It's a matter of defensive strategy. It's simply better for you that unprofitable customers are served by your competitors. It's one less burden for you and one more for them. It's important to determine which doors you do or don't want your salespeople knocking on. If you don't identify these doors, salespeople will waste their time and sell to customers that don't value your offerings. Unfortunately, the track record for business-to-business (BTB) companies in customer targeting and selection is not very good: 79 percent of BTB companies are undiscriminating, responding to all customers.[3] See Figure 1.2.

The 80/20 rule governs this discussion. Also known as the Pareto Curve, the 80/20 rule says that, on average, 80 percent of business

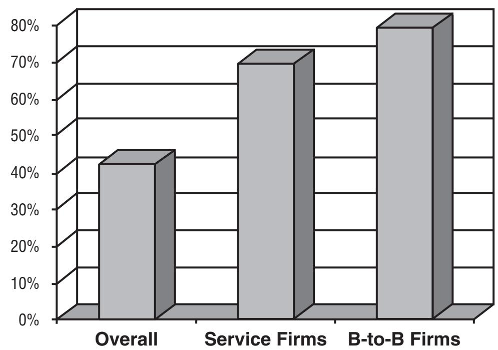

Figure 1.2 Percent of Companies that Respond to All Customers.

will come from 20 percent of customers. As a result, we tend to focus on the big customers who drive most of the business. We let distributors handle the 20 percent. Is this a good strategy? Not always. Research shows that big companies are more than twice as likely to be price buyers.[4] These customers are expert at draining every last drop of price discounts out of their suppliers.

To better highlight the problem, cost accountants have developed what they call the "20-225" rule.[5] Professors Cooper and Kaplan at the Harvard Business School have shown that once the cost of supporting customers is taken into account, only about 20 percent of customers are profitable. In fact, these 20 percent of customers account for 225 percent of the profits. Of course, this means that the other 80 percent of customers *lose* 125 percent of the profits. This principle applies equally to both private-sector and public-sector organizations.

The reality is that serving a large percentage of customers represents a loss for the business. The challenge, of course, is for a company to distinguish between the customers it can serve at a profit and those it cannot.

The first thing to do is select the low-hanging fruit. Make a list of all your customers, from the most profitable to the least. Focus on the 5 or 10 percent of your customers who are least profitable and fire them. These are the customers getting the big discounts but who fail to give you the big volume they invariably promised. These are the high-maintenance customers who the customer service department has on speed dial because they are so demanding. These are the customers who pay late. In other words, these are the customers who cost the company to service and keep on the books.

Firing them will do three things. First, it will increase your profits even though it may cost you some sales revenue at first. Second, it will send the signal to salespeople and customers alike that the company has pricing standards and is willing to stand by them. Your sales and customer service people will love you for it. Finally, it will free up your selling and service resources to pursue more profitable customers, who can add profits and revenue to the firm.

Because they are desperate for business, most managers don't want to fire customers. We don't like to do it either. The goal, of course, is to convert unprofitable customers into profitable ones. Before making a unilateral decision, we recommend that you have a candid conversation with the customers. Tell them why the relationship is not sustainable in its present form and let them know you are prepared to end the relationship. Some percentage of those bottom customers (larger than you may think) will understand and offer to keep doing business with you on some new terms. Only rarely is a customer's interests served by terminating relationships with trusted vendors. Sure, they will push you on price, and they will continue to push until you push back. Once they know they can't get any more concessions, most customers will work with you. And for the few customers willing to push you past the breaking point, let your competitors have the honor of serving them.

How Effective Are Your Price Discounts?

We had a business professor many years ago who said, "The essence of strategy is the efficient allocation of scarce resources so as to achieve maximum return." The point of that statement is that if you are going to do something as a manager, whether it is spending time, money, or both, for the sake of the company, you should have a basic understanding of what that expenditure is going to return in terms of added profits and added sales.

Of course, this is easier said than done. But look at the things you do. For example, you attend meetings to talk about new products or more efficient operations—two important activities designed to increase sales and profits. If you are going to give a price discount, don't you want to be sure that the discount drives added revenue and profits for the company? If you are with a large company, you know that research is conducted to determine market elasticity to changes in price. If markets are elastic, it means that sales are very responsive to changes in price. This can provide guidelines for determining how to get added revenue and profit. The problem is that those guidelines are often wrong.

We were recently contacted by a senior manager of a company to do consulting work. During one meeting, the client asked if we were qualified to do elasticity research. Our answer was "Yes, but elasticity research is not what you need." We could tell the manager wasn't used to being told that what he asked for wasn't really what he needed.

The reason for our position is that for business-to-business markets, elasticity research is rarely effective in driving pricing strategy. Price elasticity research tries to determine a market's responsiveness to changes in price. Elastic markets are quite responsive to changes in price. Inelastic markets are not. Elasticity research tells us when price decreases are going to bring us more revenue. This research also tells us when a price decrease means less revenue.

Now let's consider these layers of complexity when thinking about the use of elasticity research. There are three layers. The first layer is called *derived demand*. Derived demand says that demand for BTB products and services is derived from a downstream demand for your customer's products and services. That is true for original equipment manufactured (OEM) or maintenance, repair, or overhaul

(MRO) products, services, commodities, and high-value products as well. If demand is apportioned to something else, especially the activities in a different company's sales, it is not going to be responsive to changes in price. This makes it, by definition, inelastic. If you give a price discount, unit sales will be relatively fixed and revenue will go down. Profits? They eventually disappear. We talk more about this in Rule Three, "Apply One of Three Simple Pricing Strategies." The second layer is *customer behavior.* Some customers will change suppliers at the drop of a hat. They don't change their volumes—an attribute that elasticity research attempts to capture—but they switch back and forth between suppliers, usually driven by price. We call that *cross-elasticity of demand.* If we measure cross-elasticity of demand, we can determine a market's responsiveness to a company's changes in price, but it *is* unlikely that volume will change. That's because of the derived demand. This means that the elasticity we see isn't going to bring more volume into the market. We talk about this in Rule Four, "Play Better Poker with Customers."

Finally, you need to include *competitive behavior* into the mix. Unless you include competitors' willingness to respond and likelihood of responding, you are missing the most important element of the mix. Even if a market is elastic, when a competitor matches your price decrease, they negate any market effect. If your market is inelastic, as most markets are, you've just wasted a bunch of money on an elasticity study that misses most of the important elements of market dynamics. And you are led to believe that price discounts will work when they won't.

Dell profits are down because its price cuts have failed to spark sales of personal computers. Dell must be the only company in the U.S.–European PC business that thinks they can still do that. Understand that their fall from fame has been a slow affair, but the signal of it came in September 2006 when profits weren't what they expected.

Dell is learning what most other high-tech firms learned in the market downturn of 2000—that price cutting works if you have a cost leadership position in growth phases of market cycles. If you don't have the cost leadership position and/or the market slows down, you need to switch from a penetration prices strategy to a neutral one.

How can you tell? Look at the graph in Figure 1.3, which shows price discounting and gross sales growth. When one line starts heading up (discounting) and the other starts heading down (sales growth), it shouldn't take much more to signal that it's time to at least start thinking about changing your strategy. That's because you are trading profits for sales growth. Here, the leverage is lousy: For every dollar of revenue drop, you lose a dollar of profits. Profits disappear before revenue does. Long before. Dell's excuses are beginning to sound a little too familiar from quarter to quarter. As former Dell CEO, Kevin Rollins, said that Dell is "accelerating price adjustments." We don't know what that means. When companies move to neutral pricing strategy, it is a good idea to let other firms know. Confusing statements not only fail to do that but they actually will increase the price discounting by other companies.

If you don't have the resources of the big company, you still want to make sure it's worthwhile to investigate price effectiveness. Start with a simple plot of average discounts and sales growth on a year-to-year basis for at least four years like the one in Figure 1.3. The four years give you a trend line and the comparison of the two provides a good idea of the overall effectiveness of discounts

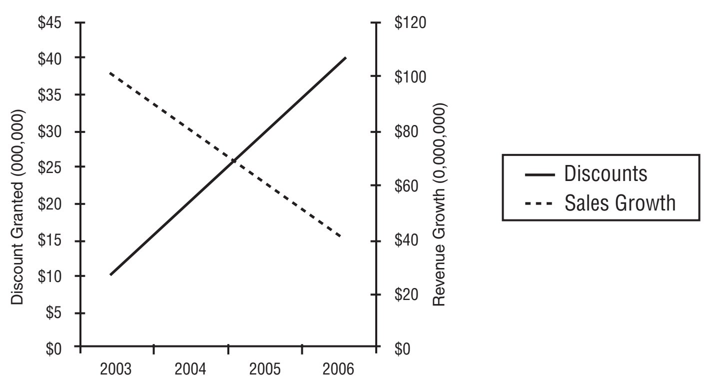

Figure 1.3 Discount Effectiveness, Four-Year Period.

and, perhaps more importantly, how that effectiveness is changing over time.

Notice in Figure 1.3 that discounts are increasing dramatically, yet sales growth is slowing just as dramatically. The price discounts are going up, but they are delivering fewer and fewer incremental sales for the same relative amount of discounts. This represents two things: increased competitiveness in the market and slowing growth of the primary market. It's a clear sign that the effectiveness of price discounting is declining. It's time to look for other ways to support the sale of the product. Promotion and improved sales skills are good areas to consider. There is one other thing clear in this plot. If the company isn't developing new products or technologies, they are going to see decreases in both sales volume *and* profits. More price discounts will not come close to solving that problem. In fact, it's only going to make things worse by sacrificing profits for sales that just aren't there.

Another thing to look at is a plot of revenue and unit sales growth for a product or service line. The graph in Figure 1.4 shows the effectiveness of price decreases to deliver more sales, but it does so by showing the end result of revenue. This equals price times units, that is, the sales volume.

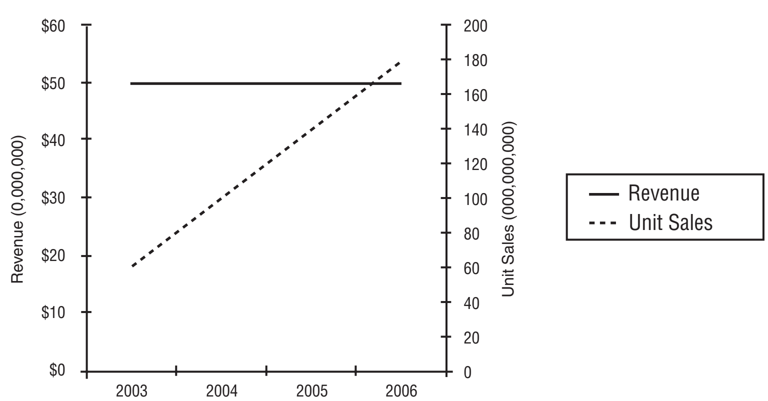

Figure 1.4 Unit Sales Impact on Revenue Growth.

Notice in Figure 1.4 that unit sales are increasing but the revenue is stable. This is indicative of a market that is just on the edge of maturity. Unit sales are still growing due, in part, to decreases in price. But the net effect is that revenue stays the same. Another way to say this is that despite decreases in price, unit volume is not coming up enough to make sales revenue grow. Normally, this would be a sign that it is time to stop giving discounts, but there is one interesting twist on this company's case: The technology was changing. This was actually a computer-based service. Due to increased sophistication in supporting technology to provide this service, costs were declining dramatically, too.

Managers took advantage of this insight by selectively offering price discounts to large customers in return for a long-term and higher share of their business. By doing this quietly, they were able to accomplish several things. First, they limited the likelihood that a competitor could react. Second, they were able to close out the competition with the long-term contracts. Finally, they were able to dramatically increase sales to the point that revenue was up roughly 15 percent and profits increased 35 percent, or roughly $35 million, from this simple insight. Not all discounts are bad—as long as you know where and how to give them. Even on the eve of a mature market, it's possible to use discounting effectively.

Let's look at one more plot (Figure 1.5) that points to the dramatic impact of "periods of desperation" that we talked about in the introduction.

What you see in Figure 1.5 is that every quarter, demand takes a spike. The reason is apparent in the quarterly drop in the average selling price for products. This is a sure sign of end of period desperation. Funny thing was that when we asked the senior executives if this was a problem, they said "No." The lower-level managers knew what was going on, but the senior managers didn't believe them. It was only when they saw this plot that they recognized they had a problem.

What was the fix? They adopted a system that simplified prices so everyone could see what was happening. They trained the

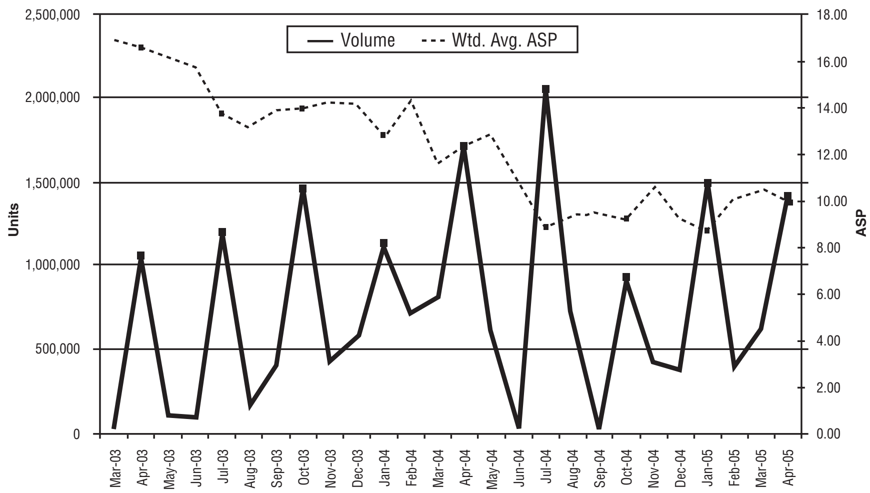

Figure 1.5 Monthly Discount Effectiveness.

salespeople about the value they had for their customers. They did have value—lots of it. They were the leading-edge technology supplier in this business. Sure, there were competitors. But the competitors' technology lagged by six to nine months, which was the window of time needed to have a higher price. The discounting was bad because it just pulled business up from the future month but at a lower price. No incremental business here. It was the graph of the bad behavior that showed the executive team they had an end of period discounting habit that had to be kicked. When they did kick it and were expecting a decline in sales, revenue actually increased 17 percent. Profits went up 37 percent, or roughly $300 million, money grabbed off the table by the right player.

Ask about your discounting practices. But, you've got to do more than just ask. You've got to dig into the responses and look at the graphs of the actual discounts to find out how bad it is. When you look at the graphs, make sure you understand them and begin to ask about the "outliers." This points to desperation pricers, so find out who they are and why they behave that way. There is one more way to see the face of a desperation pricer: Look in the mirror. Set a good example and begin to put some stakes in the ground around where and when to discount and, more importantly, when not to.

Control Discounting with Rules of Engagement

Now you know the depth of your pricing problem. The choices may be hard, but the process is easy. After your review of where and when your salespeople are discounting, you've got to decide when it is clearly a mistake to give discounts. It may be with small customers. It may be with customers who purchase your high-value products and services and where you have little competition. It may be in certain geographic markets. It may be with salespeople who haven't been through your value training program. You've got to identify where you are going to stop giving price discounts.

We call these *rules of engagement.* Simple rules of engagement are set to let salespeople and managers know that you are beginning to limit price discounts. And, you are willing to let some business go. If you have done a good job defining the rules of engagement, it shouldn't cost you much valuable business. By that, we mean you hopefully have identified the customers where it is wrong to be giving discounts. If they decide to leave, it is going to be good for your business. If a competitor takes them, it is great for you and the competitor suffers the deterioration of margins.

The trick to rules of engagement is to start with something easy. It's got to be something that everyone can understand and will agree that it's the next step. And, it's got to be something that you can put some teeth into. For example, consider organizing discounting dollars as a budgeted item. Each sales manager gets a bucket of discount dollars each quarter for his region. He must be careful to make them last for 90 days and that the right customers earn the right to the discounts allocated. Standards must be enforced. If you aren't willing to put teeth into the new rules of engagement, you're wasting your time. Sales managers will just keep asking to get their buckets refilled. Sure, if you feel like blustering about discounts go ahead, but unless you are willing to enforce your new policy, you are better off doing what you were doing before. We know of one company that on a yearly basis fires their most extreme discounters. This kind of "rank-and-yank" strategy has other costs, but it definitely sends a message about what the organization values.

Notes

1. Oracle 10-K, June 25, 2004.
2. Stephen Shankland, "Red Hat Pulls Out a Profit," c/net news.com, December 22, 2004.
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