

CHAPTER 1

Rule One

Price for Profit

Inflation complicates every aspect of pricing. Rule One is about using price to increase profits. Profits result when an organization understands how their products and services create value for their customers. Higher levels of profit come when a firm sets a fair price based on that value and executes those prices through a salesforce that is prepared to capture, not discount the set prices with customers.

For the first time in decades, persistent inflation has become an urgent short-term consideration for companies around the world. Our view is that while inflation certainly complicates every aspect of pricing, it also represents an ideal opportunity to make long-overdue changes to pricing practices. For that reason, struggling with short-term inflation may have some long-term benefits.

Inflation has propelled the issue of pricing from the back-room to the boardroom. For all the pain it imposes, inflation actually has an unseen benefit. It's that the attention of C-suite business executives will never be more focused on pricing than it is right now. C-Suite leaders are acutely attentive to the unavoidable fact that inflation has an unforgiving impact on the profits of companies that fail to manage it with agility. When input costs rise drastically, an enterprise's profits will take a dive unless

it can quickly pass along price increases, and when it comes to inflation, nimbleness is the imperative.

Most analysts agree on two things. One, that the rate of inflation growth—and the related pain of supply chain volatility—is the highest it has been in more than four decades. Two, that inflation is persistent and that it represents a long-term systemic challenge to businesses large and small. While the Consumer Price Index (CPI) as reported by The Commerce Department recently topped 8.5%—the highest since 1981—we are actually more focused on the less well-known U.S. Producer Price Index. That index, measuring inflation for processed goods for intermediate demand, rose by 24.4% in 2021, the index’s largest calendar-year increase since 1974. The International Monetary Fund’s All Commodity Price Index increased by 49% in the same 12 months. The bottom line is that inflation-driven supply chain volatility, compounded by the COVID-19 pandemic labor shortages, intensifies the pricing pressures on businesses in every sector and those pressures will not soon recede.

When the Tide Goes Out

The persistent global inflation we are experiencing today exposes a limitation of most B2B pricing practices. “You only find out who is swimming naked when the tide goes out,” is a nugget of wisdom attributed to Warren Buffett, the most successful investor in American history. What the Oracle of Omaha means by this observation is that you really can’t tell whose investing strategy works or appreciate the risks that businesses are taking when markets are performing well. Only when markets are challenged by adverse conditions can we discriminate between those who are smart and those who are just lucky.

While Buffet’s aphorism chiefly applies to investors, it is relevant to the general pricing practices of businesses large and

small. It's no secret that virtually every business tolerates legacy pricing practices they know to be sub-optimal. In a stable and flourishing market, these inefficiencies were mostly tolerated. But when confronted by rapidly rising input costs combined with supply chain volatility, the limitations of legacy pricing practices suddenly can no longer be ignored.

C-suite leaders around the world are seeing that inflation is forcing the tide to recede. Many are rightly concerned about what their stakeholders will see. When inflationary pressures cause costs to increase at the same time that supply chain disruptions soften demand, certain pricing practices turn out to be too slow, too lax, and too undifferentiated.

All is not lost. The practices prescribed by this book will help you modernize your firm's pricing practices to best leverage the challenges of persistent inflation. Inflation gives you opportunities to raise prices. No customer welcomes price increases, but end-users tend to be receptive to pricing upticks backed by a well-articulated and robust rationale. For now, remember that the more your price increase can accurately reflect value and the true cost increases of your products and services, the better you will protect the profits of the firm.

Costs Are Going Up

The best signal that you're in inflationary times is that your costs are going up. Maybe you can see those increases coming from reading the trade and business press. Those costs can rise due to supply shortage, production problems, or random shocks to the delivery chain from weather, for example. The trick is to have a system in place to recognize that inflation is coming, and you will need to pass those costs on to your customers. Delaying that sequence will cut into and possibly eliminate your profits.

Since most companies have a wide range of products, cost increases can have varying impacts on the need to increase prices. Many firms try to average out those cost increases with a uniform price increase across all products. The problem with doing that is when you have a competitor that increases prices on specific products or product groups to more accurately reflect their true cost increase, you will be at a competitive disadvantage with your prices. That's because the products that have a higher cost increase than the price increase will sell more and the products that have a lower cost increase than the price increase will sell less, thus undermining the profits of the firm and providing sales opportunities to those competitors.

Managers around the world worry more about revenue than profits. Many incentive systems are still based on growing revenue. These models assume that a combination of reductions in costs and efficiencies in operations will boost profits. In the best of circumstances, these promised reductions and efficiencies make an impact only once. Eventually, cost declines level out, and efficiencies reach their limit. The inevitable result is that profits decline.

Pricing executives are often the protector of profits for the firm. We all know that this is easier said than done. It takes strength, persistence, and a lot of thought to protect profits in a sales ecosystem that often works counter to those needs. In this chapter, we'll talk about a more successful pricing structure and the steps necessary to make it sustainable.

Three Necessary Adjustments

The businesses that will thrive in inflationary conditions will adjust their pricing strategies in three fundamental ways to cultivate the necessary speed, agility, and discipline to respond quickly to an endlessly volatile environment.

- **Rapid Response.** In order to avoid margin decreases, businesses need to be able to adjust their prices quickly when costs rise. Commercial teams must be able to quickly set new prices as conditions change and roll them out with discipline.
- **Enforce Discipline.** Businesses often tolerate lax enforcement of discount policies when economic conditions are favorable. Strategic exceptions (what we call discounting concessions) are never the optimal practice, but a certain permissiveness is forgivable. Inflation is unforgiving of such practices. The only bulwark against resistance to price increases is the ability to demonstrate how the product or service in question delivers market-ready value.
- **Systematize Pricing.** Inflation-responsive pricing requires businesses to increase the cadence of price changes. We've seen companies roll out systems to reprice quarterly, monthly, or even daily. The price changes must be nuanced, as well. That means avoiding simplistic, across-the-board price increases. Rather, businesses must be able to deploy a spectrum of differentiated increases tailored by the value each product delivers to each customer situation on a timely basis.

Problems with a Revenue Focus

One of the most destructive myths of business, simply stated, is “If you worry about the sales, profits will take care of themselves.” The myth encourages managers to lower prices for the sake of increasing sales. The problem is that this myth will eventually lead to consequences precisely the opposite of what they promise.

What renders this a business myth is the unstated assumption behind it. The assumption is that product or service delivery teams will benefit with increased volume. This mistaken perception causes managers to initiate pricing decisions (usually a discount) to increase revenue that eventually leads to the decline of

profits and, in the cases of mature markets, loss of market share and revenue.

Salespeople usually honor this myth by their zeal to close. Their incentives are carefully designed to drive them to close an order, even if that means giving up some or even all the profit. Senior managers add to the problem with their short-term focus on monthly or quarterly revenue numbers and their willingness to sacrifice profits through lower prices to achieve quota. The problem isn't with the people, it's with the incentive and management culture that encourages them to discount.

The myth exposes pricing in the trenches, the moment when a deal seems to be in jeopardy because of price. In the trenches, it's difficult to have confidence and hold the line on your prices, or to know when to confidently walk away from a sale. It's so difficult that many managers make decisions that may or may not increase sales while still undermining profits.

Navigate Inflation's Challenges

How can B2B business leaders help their commercial teams navigate through the challenges of inflation and supply chain volatility? The automatic response—that the CEO's actions must primarily protect profits—is not complete. While inflation certainly has implications for profitability, business leaders must contend with a wide range of stakeholders to think in much wider terms. This chapter begins a process that leads business leaders to answer that question. Like the formulation of any strategy, the process starts by asking questions:

- What price increases will customers accept?
- How should we represent and implement price increases in an inflationary environment?

- In what places will end-users perceive our value in this new environment?
- How can we create partnerships and strategic mindsets that see inflation as a common concern?
- Where can we help procurement leaders change the conversation away from price?
- How can we present our products, services, and experiences to deliver this value?
- What capabilities will we need to increase the company's resilience and control costs?
- What is the fastest way to reinforce stretched and fractured supply chains?
- How can we establish a vision, set priorities, and organize to direct all this activity?

The CEO is an organization's ultimate integrator. Our experience into the behaviors and mindsets of excellent CEOs shows the pivotal role that chief executives play in setting a clear direction, aligning the organization, managing stakeholders, and serving as "motivator in chief."

The best CEOs act boldly, of course, but also operate from core mindsets that often belie the classic image of the hard-charging executive: they approach important decisions by listening first, treat "soft" culture topics as a hard material advantage, empower employees, and ask questions constantly. Pricing for profits is the ultimate objective. The challenge is that many leaders underestimate the deep level of cross-organizational change needed to make this approach stick.

Consider the benefits to a business when managers get enthusiastic about value and start an initiative to move to profit-based pricing. Their early results attract the notice of other leaders, and

the initiative is distributed across the organization. The goal of profit-based pricing becomes institutionalized.

Competitive Disadvantage in Your Costs

When managers average costs, it puts them at a competitive disadvantage when making pricing moves against those competitors that don't. This is because some business opportunities look less profitable than they in actuality are. The companies that look at incremental costs will have a much truer picture of the profit coming from any piece of potential business.

The ability to measure and manage incremental costs is especially important for professional services companies such as consulting firms, accounting firms, software companies, and law practices. Let's look at an example of the problem of averaging costs and how they play out in a decentralized corporation with a number of large divisions.

At Division A, the decision was to calculate incremental costs; at Division B, the decision was to fully allocate costs. Over time, this company began shifting most production to Division A, the incrementally costed facility, because their costs appeared lower. The problem was that Division B had extensive fixed investments in plant and equipment. Once Division A began producing products costed incrementally, it actually caused more sales orders to move to their division and led to the dramatic underutilization and losses in Division B. The net result was the demise of the entire firm!

The capacity costs of people and/or of fixed facilities for service companies such as professional services firms tend to be a larger portion of their cost structure than corresponding costs for manufacturing companies. Those costs tend to be fixed over the short-term, especially if people are not going to be separated when utilization is low. Furthermore, unused human capacity

is volatile. Just like the value of an unfilled airline seat goes to zero the instant the airplane door closes, the value of a lost day of untapped human capacity to drive revenue and profits evaporates forever.

Costing systems will either help you or hurt you if your pricing purpose is to increase profits. They do that by either preventing or allowing you to accept business that increases the overall profits of the company. Many managers are aware of this approach and its importance but avoid it because they worry that salespeople may start discounting deals down to the level of the incremental costs and all of their business will migrate there. Their concerns are justified.

Fortunately, there is a solution for this concern. The insight to the solution comes from looking at how the airlines manage pricing. Considering the current financial state of many airlines, you might think they are not doing a good job with pricing. But if you understand and apply the premise of how seats are priced you will gather a few good nuggets. We'll discuss this more in Rule Ten.

Have a Better View of Costs

Many firms set prices based on a product or service's cost. That's a reasonable thing to do given that if you can sell above your cost you'll earn a profit. It sounds logical and it works for many. There are two issues that complicate that vision.

First, costs have nothing to do with the value those products and services create for your customers. In many cases, the financial value is much higher than costs. We'll talk more about this in Rule Four: Know Your Value. Recognize that in those cases, you are leaving money on the table and often, lots of it. Costs are an internal look at a business. Value is the external view that is much more reflective of how you can really price to increase profits.

There are a few situations where cost-plus pricing works during inflationary times. In some cases, like distribution, the cost-plus pricing model works well because the increases from manufacturers automatically flow through. Especially if every competitor employs cost-plus within a channel, then the volatility of the market flows right through to the end-customer. If the demand is still strong at the end-customer, then they should be able to absorb the up-lift in price. Some of the issues with this strategy are as follows:

- Competitors tend to be undisciplined, so there is a tendency to price low to gain market share.
- The prices will flow through as long as the demand is strong. If the demand weakens, then you could be left holding a lot of inventory that can't be moved. Your ability to predict demand relative to supply becomes critical with this strategy.
- With a cost-plus strategy, you are assuming that the manufacturer is actually increasing their pricing in a disciplined manner. If they aren't, then you have overinflated pricing that's going to your customers and that is not sustainable.

Common Tactics That Lead to Problems

Pricing is about more than setting prices. Pricing represents a strategy to increase sales volume at a profit while incorporating and communicating critical signals about the value the offering delivers to the customer. In general, most organizations fail to use pricing in such a disciplined fashion.

There are four pricing approaches that organizations still employ:

Pricing to Cover Costs: Here, you set prices based on your costs and add a reasonable margin. It makes sense to do this because if your pricing strategy is to recover costs plus a little

extra, you'll always come away with a profit. Right? Not necessarily. There are two problems with Price to Cover Costs. First, your customers don't care about your costs. They care only about the value you deliver. By ignoring the value that you create for customers, cost-based pricing can keep prices lower than they should be, thus leaving money on the table and reducing profits. On the flip side, pricing to cover costs can actually keep prices higher than optimum, thus reducing sales. The second problem with cost-based pricing is that it allocates overhead and/or fixed plant costs into pricing calculations. Sounds reasonable until you consider that often those costs appear to be variable when they aren't. If you have low utilizations, your allocations are going to be high, preventing you from dropping the price to increase sales and subsequently the utilization. Again, you either forfeit profits or sales. Sometimes both.

Pricing to Gain Market Share: In this strategy, prices are set low to gain share against a competitor. Again, this sounds like a clever idea. We all learned that increasing market share leads to increases in profits. The reality is not that clear-cut. If you already enjoy high market share, it's true you're going to be more profitable. But it's more likely that you are not the market share leader. In that case, using lower prices to go after market share is risky. You can't expect to catch your competitors by surprise. Even if you do, the advantage will be temporary. The market leader will simply match your price. Lower prices eat into profits of both companies. It's a race to the bottom for the competitors while customers watch gleefully. Customers love a price war.

Pricing to Meet the Market: If you know that your costing systems inflate the true costs, maybe you use market-based pricing. Here, organizations let the market set the price. We hear about this approach a lot, and on the surface it sounds good. We know that the efficient market hypothesis has factored in every contribution to costs and prices. Here's the

problem with Pricing to Meet the Market: We don't sell to markets. We sell to customers. And customers, being unique, often surprise us by behaving differently than markets predict they will. Often, they demand lower prices, and—efficient market hypothesis be damned—we often give it to them. In the end, market-based pricing is just lowering price to close a deal or to meet the price of the lowest cost competitor, which, in a global market, represents a sub-optimum pricing strategy or, in less formal terms, is just dumb.

Pricing to Close a Deal: Now we're on to something. Pricing to close a deal is what business and pricing should be all about. If we can't price to close a deal, what good is pricing, right? The process should work to provide us with a profit. Well, not really. When you price to close a deal, it provides customers with every incentive to negotiate for lower prices. These customers put salespeople through a meat grinder of price negotiations. The process, in turn, gives salespeople every incentive to respond with lower prices. It undermines their confidence in prices and leaves money on the table. We make matters worse by paying our commercial teams to do that when the incentives we provide reward them for producing gross revenue instead of profits.

The problem is that these strategies are often in place at the same company. Often, each department uses a different strategy. These approaches are not only in conflict with each other, but they also fail to effectively provide profitable sales. Instead, they can undermine revenue and profits.

Moving to a Profit-Based Approach

Profit-based pricing is a path to a more confident pricing strategy that does not leave money on the table. If you have clearly

defined benefits that give you an advantage over your competitors, you should price based on the value you offer customers. In other words, a profit-based approach depends on the strength of the impact that can be demonstrated to customers.

This is a journey that takes time to implement effectively. The profit-based approach offers a road map to get there, breaking down the steps to the ultimate objective of profit-based pricing. We favor an incremental approach, rather than radical as full-speed-ahead transformation effort, a steady progression will lead to confidence in pricing that is internalized throughout your organization and resistant to the pressures that tend to erode selling backbone.

Organizations that price with confidence see the effort as a team sport. They recognize that improving their pricing capabilities requires the understanding and support of every major department and leader in the organization. It is one thing to say that your people should understand their value to customers and that your offerings, sales strategies, and pricing should be defined by this value. It is quite another to execute with this kind of commercial alignment throughout the firm.

Slow and Steady Wins the Race

If you try to move too quickly, efforts can backfire. Customers will rightly be confused and concerned. As a consequence, they will negotiate even harder or, worse, abandon you. Competitors may see your efforts to price differently as an opening to take market share. They'll start undercutting you on deals and put enormous pressure on your sales teams to react. And without the proper training and tools, your sales teams will be defenseless and frustrated by new pricing approaches that don't make any sense to them. Leaders must anticipate and manage these forces to achieve pricing leadership.

One services firm that we work with started its pricing journey well. The CEO took the lead in announcing to the world and the investment community that “rational” pricing was a priority and that the firm would be dedicating significant resources to it. The CEO established dedicated pricing departments in each major line of business. The company also created a new function that collected and analyzed costing, operations, and competitor pricing data. It put a lot of impressive intellectual effort into creating pricing models that considered value delivered to customers, not just traditional time, and materials measures. But the changes were too much for the organization to absorb quickly. It soon became clear to us that the effort was more than the organization could bite off at once.

Fortunately, the same management team saw this as well. The company took some deliberate steps. The first step was to assess what was realistic to accomplish, given existing resources and time frames. From this assessment, they learned what they were doing right and where renewed effort would be required. They further concluded that some key systems were not ready to undertake such a large-scale upgrade. Moreover, they concluded that their company lacked critical data in such areas as their own costs and competitor pricing.

Pricing Maturity Model

In the end, the company kept its long-term vision but eased up enough to allow the organization time to catch up to the vision. To keep things moving with a focus on more attainable goals, the company developed a pricing maturity model that reflected current, anticipated future capabilities, and related them to specific approaches to pricing. That process represented a reasonable set of attainable goals over time.

The maturity progression focused on improvements in three key areas. The first was continued progress on efforts to define and standardize key service lines so they could innovate to grow more tightly. The second was greater data and insight from additional analyses of costs to serve customers. A third insight was that valuable data could be gathered from failed projects, or projects that did not produce the results the client wanted.

These same projects typically exceeded their scope or budget. By analyzing what drove these shortcomings, the firm began to understand the root causes of service failures. This realization allowed the company to improve service value while focusing on controlling costs. These actions helped the company improve the capabilities of the sales organization to define, measure, and sell value, thus putting backbone in the selling process.

The leadership team determined that it could make three changes within four years. In the first year, the focus was on improving internal data, making informed assumptions about the value of the services, and getting the right people in place. While it built these critical pieces, the company tweaked its current cost-plus pricing models to reflect its steadily improving knowledge of costs to better leverage their high-value differentiators. In year two, the team set target costs and published detailed pricing guidance for the majority of the solutions. For years three and four, the company's objective was to collaborate much more closely with clients to understand value and roll out profit-based pricing models for those services where clients could see measurable evidence of value.

Results were very encouraging. By year two of the process, the value of signed contracts increased 32% and earnings jumped by \$320 million. These impressive results arose from two key insights. The first insight was that it isn't necessary to achieve

some elusive ideal state in pricing to see big improvements in financial performance. In fact, that's the beauty of tackling pricing. Small steps forward can produce big results.

The second insight was counterintuitive. Successful initiatives to improve price are rarely pricing-driven. This team understood that their vision of improving pricing was going to be enabled by better offering definition, cost management, sales skills, and data analysis. The firm continues to show improvements in revenues and profits. This has been possible because management is honest with itself about what the organization was capable of achieving.

The Two Levels of Pricing

Pricing occurs at two levels: strategic and tactical. The strategic level involves, first, setting pricing and offering strategies and, second, establishing the price model, price level, and metric. They also decide on approach price to value, cost-plus pricing, market-driven pricing, or a combination.

At the tactical level of pricing, managers focus on transaction prices and the rules of engagement for price negotiations. At this level it is important to make sure that customers fairly earn discounts and street prices are consistent with long-term strategic objectives. If discounting occurs, it should be for a legitimate reason, such as the guarantee for a longer contract time frame. As shown in Figure 1.1, both strategic and tactical pricing combine the activities that are at the root of pricing with confidence.

The Pricing Leadership Framework (Figure 1.1) offers three important insights. First, adjustments at the tactical level can generate incremental revenues (that drop straight to the bottom line) in a relatively brief period of time. Second, changes at the strategic level involve processes that are more involved with more effort to change. Third, change at the tactical level at some point

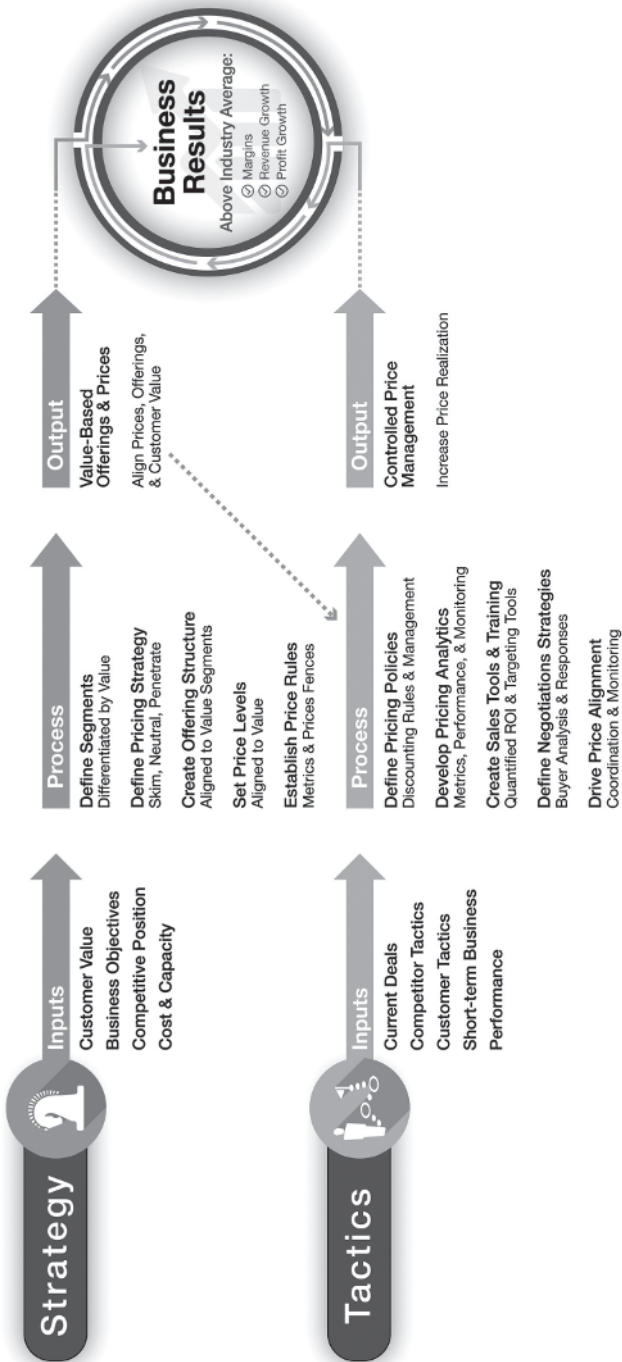


FIGURE 1.1 The Pricing Leadership Framework

needs to be supported at the strategic level (Rule Five: Strategy Sets the Direction); meaningful action is taken at the strategic level. The challenge is how to move forward at both levels by setting short-term goals that can be reached while continuously moving toward a long-term vision of pricing to value.

It is well accepted that a 1% improvement in price results in an 11% boost in net profits, according to research conducted by Mike Marn and others at McKinsey. If we go a step further and get tactical pricing processes under control to eliminate unnecessary discounts, we find that typical gains in net profit can exceed 20% profit improvement. This often causes companies to work at the tactical level and be quite satisfied with the results. For those companies that decide to work at both the strategic and tactical levels, improvements can exceed 40% in profit improvement.

Consider the case of a \$3 billion semiconductor company that implemented tighter controls on discount management and deal evaluation. To ensure these controls had impact, they also implemented a globally integrated revenue and pricing plan. At the same time, the firm had been investing heavily in innovative technologies to bring truly new products to market. This combination of tactical discipline and a newly invigorated product line paid handsome dividends. Within 12 months of the roll-out, profits increased by over \$400 million. The interesting part of this story is that at the time of this turnaround, this company was still in the pilot stages of transforming its pricing capabilities. Let's look at some ways of starting the process.

Criteria for a Confidence-Building Pricing Process

Key to building pricing confidence is the knowledge that it will stand up in the field with sales and customers. Improving your tactical pricing rules and processes is an essential element of

that building process. Even if you don't have a formal pricing department in place, you can boost revenues by just tightening up discounting. We recommend that the pricing transformation journey starts with limiting discounts. Given the returns, getting control of transaction pricing should be a top priority.

Most companies have common complaints that include too much discounting; a lack of consistency in how discounts are awarded; and slow, unresponsive price quotations processes. The challenge with this litany of pain points is there isn't good criteria for a new process that will set them on the right path. Without agreement on what a fair price management process should look like, and the implications of inflation, companies are not able to nimbly prepare price changes.

Final Thoughts

The key to improving pricing confidence is to pick a path that the organization can follow. Rare is the organization that can quickly make the move to a value-based approach. Even capable companies face customers and competitors that are not accommodating. Start with the low-hanging fruit.

The good news is you can increase profitability just by improving your discounting controls (Rule Three: Kick the Discounting Habit). Start by refining your discounting controls and build up to become better at setting prices and defining your coordinated pricing strategy. The full evolution may take years. But at each step, you are sharpening your organization's sense of its value to its customers and driving improvements in results that will make your company more profitable, more competitive, and more confident.

There is nothing like persistent inflation to concentrate the minds of business leaders. Our hope is that as the nation's senior business leaders develop strategies for inflation, best practices in

price strategy will likewise be incorporated. When pricing strategy gets the attention of senior executives, enterprises have an unprecedented opportunity to introduce long-overdue adjustments that will bring their pricing models in line with best practices and help them respond to volatility—whether it comes in the form of inflation or something else—now and in the future.