Effective pricing in industrial manufacturing - The five building blocks

Pricing product and service offerings effectively is the best way for industrial manufacturers to protect and increase their bottom lines. Period. Unfortunately, most organizations are ill-prepared to do this; pricing improvement just isn't on the agenda. For manufacturers to survive these days, it has to be.

Effective pricing requires institutionalizing five key building blocks:

1. Clear and appropriate customer and product strategies
2. Accurate and available measurement of customer profitability
3. Awareness of marketplace dynamics
4. Well-aligned customer and employees roles and incentives
5. Effective systems

1. Clear and appropriate customer and product strategies

Industrial manufacturers are especially guilty of not spending enough time thinking through product strategies. Competitive bidding situations arise and the first reaction is often to drop the price to avoid losing the deal. These organizations fail to think about how to differentiate their products such that they can obtain more price.

For example, a manufacturer of motor controls was experiencing significant pricing pressure in competitive bid situations because customers were asking for bids base purely on specific performance specifications. After a few months of taking unprofitable deals, it desperately began to explore ways that it could extract more price. A significant amount of research revealed that their motor controls were roughly 80% of the size and weight of competitor's offerings. In many cases, this difference was worth 10-15% more to customers (estimated through conjoint analysis). The company trained its sales force to identify such situations and sell on value, not price.

Similarly, many companies fail to consciously develop strategies for customers. Customers are assets, especially in more commoditized business. There must be approaches for improving the value of these customers. Unfortunately, many companies label certain customers as "strategic" claiming that "we must sell there for strategic reasons". Unfortunately, this often means customers who consistently receive tremendous price breaks without ever delivering to the bottom line either directly or indirectly.

2. Accurate and available measurement of customer profitability

Many manufacturers set prices without having any idea as to how these decisions will impact the bottom line. Proposed prices are established based on what it will take to win deals, not on what will make the customer profitable. Companies that make good deals do five things very well:

1. Measure every deal to understand how it will impact customer profitability
2. View individual deals in the context of the overall customer relationship (i.e., some deals can be unprofitable as long as the relationship is profitable as a whole)
3. Estimate product mix and have a way to enforce it (e.g., rebating)
4. Make customer profitability information known to the appropriate individuals
5. Regularly review customer profitability at a detailed level to understand how it can be improved

3. Awareness of marketplace dynamics

Industrial manufacturers are notorious for looking inward rather than outward and, consequently, fail to understand how the dynamics of the marketplace affect their business.

One of the biggest areas overlooked is elasticity of demand; how sales volumes rise and fall based on price changes (i.e., demand curves). This is especially true for manufacturers of flow goods. What these manufacturers overlook is the opportunity to increase or decrease prices in a precise manner to increase contribution margins, sometimes significantly. In many cases, margins can be increased significantly by changing prices slightly (generally, prices need to be increased. Margins are generally, bit not always, adversely affected by price decreases as the increased volumes do not usually offset the per unit margin decreases).

4. Well-aligned customer and employees roles and incentives

The best pricing intentions will be undermined if the people influencing and setting prices aren't motivated to act in your company's best interest. Many industrial manufacturers have compensation programs that focus sales rep compensation on achieving revenue, not margin. Two reasons are most often cited for this:

1. It's the sales rep's job to *get* business. Marketing will make sure it's profitable.
2. Measuring revenue is easy.

The problem is that your sales rep is usually the closest person to your customer. The rep is the one best positioned to determine what the customer is actually willing to pay. Even if your sales reps don't make the ultimate decisions on pricing, they have a large influence as they know the customer best. Unfortunately, when you pay on revenue, your sales rep is primarily motivated to get a deal done; any deal. Even bad deals for your company result in a commission for them.

5. Effective systems

For many industrial manufacturers, managing pricing can be extremely complex. A proliferation of SKUs combined with individually negotiated deals with specific customers can create hundreds of thousands or millions of individual price points. Such situations can result many problems, including:

- Large, expensive pricing departments
- Lost margin
- Customer confusion and dissatisfaction leading to attrition

Organizations that have learned to manage pricing well tend to share five characteristics:

- Information is maintained in a single "source of truth", not in multiple spreadsheets and databases across the company
- Pricing structures are as hierarchical as possible (i.e., rules can be applied to levels in the customer and product hierarchies rather than only for specific customer / product combinations)
- Pricing maintenance is performed as close to the customer as possible (e.g., by a sales rep)
- Business logic is built into pricing systems (e.g., sales reps cannot exceed established discount levels because systems will not accept) to guarantee valid pricing
- Quotations created for customers can be turned into orders automatically

For example, one manufacturer of specialized computer equipment created a centralized repository of hierarchical pricing information. On top of that, it built a Sales Force Automation (SFA) application updated from the repository that enabled sales reps to create and price complex product configurations on their laptops. The system converted those quotations into orders with the press of a button and submitted them to the company's order entry system. As a result, the company was able to save $3M annually through clerical staff reductions in addition to increasing average margins and overall revenues.

Conclusion

Situations in which companies have been able to implement pricing improvements effectively tend to share similar characteristics:

1. Support - High-level of executive support
2. Commitment - Heavy involvement from pricing decision makers and influencers
3. Patience - Phased approach to improvements

By modeling your pricing improvement program in this manner, you too can build the capabilities to improve your bottom line; one building block at a time.

Bart Schwartz is Managing Principal with Schwartz Consulting, a Elmhurst, IL-based consultancy. He can be reached at 773.580.1091 or bart@schwartzconsult.com.