PRICING WITH CONFIDENCE

10 WAYS TO STOP LEAVING MONEY ON THE TABLE

REED K. HOLDEN
MARK R. BURTON

John Wiley & Sons, Inc.

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Dedicated to:

Carolyn Holden
Co-Founder and President

Who made this book a reality

and

John A. Burton

Wish you could be here

The essence of strategy is the efficient allocation of scarce resources so as to maximize their return to the organization.

—David C.D. Rogers

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INTRODUCTION

Why Pricing Is So Hard and Why Most Companies Mess It Up

You're the Salesperson

Imagine you are a salesperson trying to sell a product for $10,000. The customer's purchasing agent responds that a competing supplier is selling a similar product for $8,000.

What would you do?

Let's look at your options. If you have pricing authority, you can choose to match the price of the lower offer. If you can't control price, you go back to your manager or pricing department and ask them for the authority to match the competitor's price. If you get it, maybe you'll be lucky: The customer will sign with you for $8,000, and you'll earn your commission. But most salespeople in this situation know the outcome will be different.

Salespeople know the situation will typically play out as follows: The purchasing agent won't be content with a $2,000 discount. The buyer will go back to the losing supplier and get them to lower their price even further, starting a back-and-forth process that we call the *pricing death spiral.* This process, where smart buyers try to squeeze every last penny out of their vendors, is good only for the buyers. With a pricing death spiral, there are no winners. Only survivors.

Pricing with confidence—the subject of this book—allows you to avoid the pricing death spiral. The approach outlined in this book will help you close the deal without leaving discount dollars on the table. The approach is not difficult, but it requires preparation; a detailed knowledge of your offering, your competitors' offering, and the competitive landscape; as well as a deep awareness of the customer's real objectives and requirements.

With pricing confidence, when the purchasing agent mentions the bid from one of your competitors, your response will be different. "The throughput of the competing machine is half of ours," you will say to the purchasing agent. "Your engineers told us they needed the throughput of our product to increase your product yield. But if you don't think the throughput of our product is really required, we're pleased to offer you a machine that gives you 60 percent of the throughput for $7,900. Which do you prefer?"

Now the purchasing agent is on the defensive. If the purchasing agent insists on a lower price, he can get it but will have to accept a lower-value product. If, as is more likely the case, the increased throughput is essential, the purchasing agent must acknowledge that fact and be prepared to pay the higher price that reflects the increased value your product delivers. Whether the customer buys the lower-value product (whose price beats the competition) or the higher-value product (whose performance beats the competition), you come out ahead. That's confidence in pricing, and that's what this book is all about.

10 Rules of Engagement

Pricing with confidence requires an understanding of 10 rules of engagement. Each rule is a general reminder to all members of the firm of what is needed to grow both profits and revenue in increasingly competitive and price-oriented markets. Here, in brief, are the 10 rules to pricing confidence.

Rule One: Replace the Discounting Habit with a Little Arrogance

The best way to dislodge any deep-rooted habit is to replace it with another.

> *Price discounting is entrenched in most organizations. As with 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, feeling good about your products and services, provides the confidence needed to kick the discounting habit. Simple analysis can point to where bad discounting leaves money on the table.*

Rule Two: Understand the Value You Offer to Your Customer

How can customers be expected to understand your value if you don't?

> *You can't have confidence in your pricing until you have confidence in the financial value that your offerings create for customers. Even though many managers are convinced they can't get this information, the reality is that most of your customers are eager to tell you. All it takes is asking the right questions and being willing to listen.*

Rule Three: Apply One of Three Simple Pricing Strategies

When to price high, when to price low, and a strategy for everything in between.

> *Strategies can and should be simple and agreed to by everyone in the firm. Without this, you can't have confidence in your prices.*

Rule Four: Play Better Poker with Customers

Learn to love your price buyers but play better poker with your poker players.

> *Most customers say that value is what they most want, but many are bluffing when they ask for a discount. Some customers are motivated by price alone. Others want—and are willing to pay for—value. It's the poker players you've got to control. Adjust your offering and selling approach to optimize your advantage for each. Know the difference, so the difference can work for you. You might even learn to love your price buyers.*

Rule Five: Price to Increase Profits

The only effective thing that better pricing should accomplish for companies is to increase profits.

It's a myth that if you discount price to increase sales, you will see increased profits. Profits result when an organization does many things right, including pricing. Efficiency, controlling costs, better profit metrics—all are required for pricing success.

Rule Six: Add New Products and Services that Give You Negotiating Flexibility and Growth

When your products are regarded as commodities, add services to differentiate products and prop up prices.

Provide your salespeople with the gives and gets that are so important in negotiating. When products are regarded as commodities, add services to differentiate products and prop up prices. This strategy is undermined when valuable services are given away. To gain more confidence in negotiating, you can price incremental services to reflect their true value to customers. An effective strategy for market dominance is to develop a dual offering that covers both the high- and low-end customer needs. Flanking offerings grow both the revenue and the global footprint of the firm. If customers want a lower price, subtract features and services.

Rule Seven: Force Your Competitor to React to Your Pricing

Smart players know they don't have to participate in a competitive pricing death spiral.

Every player enjoys one or more value advantages. The trick is to use your value to stop leaving money on the table. Smart players know they don't have to participate in a competitive pricing death spiral. They map their markets. They define where they do and do not have a value advantage over their competitors. They know where and how to compete on price. Most important, they know where and how not to.

Rule Eight: Build Your Selling Backbone

The best pricing strategy will fail unless salespeople and managers have backbone in the selling process and the ability to defend it.

Confidence in negotiation requires confidence in pricing. Confidence in pricing comes from knowing the value of your products or services. It also comes from knowing your customer. Backbone comes from knowing the tricks your customers use to get you to drop price and how to deal with them.

Rule Nine: Take Simple Steps to Move from Cost-Plus to Value-Based Pricing

There is nothing wrong with cost-plus pricing as long as it does a good job of leveraging the financial value you create for customers.

> *Value-based pricing is an ideal. It requires sophisticated internal skills and systems. The trick to value-based pricing is to evolve pricing as the discipline and skills of your people improve. Start gradually. There is nothing wrong with cost-plus pricing as long as it does a good job of leveraging the financial value you create for customers. Once you learn those skills, moving forward to real value-based pricing is a snap.*

Rule Ten: Price with Confidence: Remember Who You Are

Shift the negotiation to how you provide concrete results for your customers.

> *Customers buy results, not rhetoric. Moving beyond the rhetoric of value will enable you to prove those results to customers. By applying these 10 actionable rules, you can have confidence in your pricing decisions. You can move the negotiation to a discussion of how you provide concrete results for your customers. Your firm will earn more profits and revenue by capturing the money you're currently leaving on the table.*

What Is Your Pricing Purpose?

What are you trying to accomplish when you set prices?

Sure, it seems like a simple question. Business 101 tells us that price is one of the four major elements of the marketing mix. Price is one of the Four Ps, the others being Product, Promotion, and Place. Business 101 tells us that the right price should meet the requirement of the buyer and seller. If you hit the optimum price, the theory suggests, your customers will be happier, your profits will be higher, and your bottom line will be healthier.

In reality, pricing is far from simple. Setting the optimum price is one of the most difficult decisions managers ever make. Most companies are so bad at it that they leave money on the table. Lots of it. This book will help you optimize the pricing of your business-to-business products and services so that the money goes in your pocket.

Pricing is about more than setting prices. Pricing represents a strategy to increase sales volume at a profit while incorporating and communicating critical messages about the value the offering delivers to the customer. In general, most organizations fail to use pricing in such a disciplined fashion. Something else happens, of course, but many organizations don't figure this out until it's too late.

There are four pricing strategies that organizations typically employ. Let's take a look at each of these.

1. *Price to Cover Costs:* Here, you set prices based on your costs and add a reasonable margin. It makes sense to do this because if you always price to provide a profit over your costs, you'll make money. 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.
2. *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 strategy a lot and on the surface it sounds good. After all, we know that the market alone sets 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. They ask for a lower price, and we give it to them. In the end, market-based pricing is just lowering price to close a deal.

3. *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. After all, if we can't price to close a deal, what good is pricing? The process should work to provide us with a profit, right? 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.
4. *Pricing to Gain Market Share:* In this strategy, prices are set low to gain share against a competitor. Again, this sounds like a good 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. Most likely, the market leader will simply match your price. Lower prices eat into profits of both companies. Customers love a price war.

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

Yes, but We Need to Meet the Numbers

As business managers, we learn to set financial objectives and then drive the people in the business to meet those numbers. That's what our bosses expect. That's what the analysts expect. There are a number of problems associated with driving employees to meet financial or other objectives, especially if meeting short-term goals is

allowed to eclipse long-term objectives. But that's the subject for another book.

This is a book on pricing, so let's look at the problems of using price to meet specific objectives. In almost all cases, we are talking about applying price discounts to meet short-term sales objectives. Unfortunately, the results of this strategy are almost always unsatisfactory. It's not hard to see why. Discounting simply trains customers to hold off placing their orders in anticipation of even deeper discounts. But there's a bigger problem than leaving money on the table. Rather than selling your products and services because customers derive value from them, you end up selling them just to meet your numbers. It's never sustainable to exchange short-term opportunism for long-term customer development. You may get a high from the adrenalin rush of the end-of-quarter madness, but you end up leaving so much money on the table, you might get asked to leave the game.

It's a game that almost all businesses play. Every year, managers make projections—a fancy name for setting goals—for the organization to meet. And by managers, we include everyone from the executive suite to team leaders and project managers. These projections get reported down the chain of command, workers get their marching orders, and everyone waits for the results to be reported up the chain of command. If it turns out that the company has hit its projections, satisfaction abounds. It's a sign that management understands the market and is in control of the business. It's considered satisfactory if the company outperforms the projections. It's taken as evidence of particularly talented managers. No one asks why the particularly talented managers missed their projections by setting the targets too low.

Cycles of Desperation

What happens if the results start coming up short of projections? Let's back up a step. When goals are set for the corporation, they trickle

down to the divisions, business units, and regions. These projections are based on guesswork. Managers prefer the term *assumptions.* The assumptions take the form of forward-looking estimates about interest rates, prices of raw materials, energy costs, manufacturing capacity, and distribution logistics. The assumptions also factor in the likely behavior of competitors. All these numbers are crunched, and the resulting spreadsheets are quite impressive. But managers can't have much confidence in assumptions driven by variables that are, by definition, uncontrollable and unpredictable. Then the managers consider the one resource that they can control: their sales force. Many business forecasts are driven by assumptions about the sales force's ability to deliver the numbers the managers promise. There are two critical problems with this reality. First, most managers typically overestimate their ability to get salespeople to deliver specific outcomes. But, the second problem is even more destructive. The business loses sight of what should be its main goal: delivering long-term value for its customers. Instead, its focus shifts to meeting numbers to keep managers and investors happy.

Take a look at the situation from the point of view of the sales force. When salespeople get their objectives for the year, they base their ability to deliver results on a number of assumptions of their own. Assumptions such as having the right product mix, delivering products on time, and getting a feel for what competitors do. This is where the wheels begin to fall off the wagon. Nothing ever happens as projected. Interest rates go up. Currency exchange becomes unfavorable. Product delivery is interrupted. Competitors drop prices (imagine that). Customers *seem* to get more price-sensitive. When things don't go as expected, it leads to what we call *cycles of desperation.*

Suppose that the salespeople have been trained to negotiate well. Or perhaps they have a limit to what price they can drop to. In either case, the results are the same. Salespeople do the best they can to hold the line. Do they get rewarded for that? Nope. What happens is that at the end of the period—month, quarter, or year—the organization is short of the projections. Managers finally get off their collective behinds and go out to do what is necessary to close the gap. That

means closing business with customers, whatever it takes. There's an old business adage that says that if the only tool you have is a hammer, all problems look like nails. So it is with managers who need to make the numbers. They have a problem, and the only tool they have is price.

The White Horse Syndrome

We call it the White Horse Syndrome in honor of television shows in which a complicated problem of long duration is resolved when a hero such as the Lone Ranger rides into town in a cloud of dust on a white horse to save the day. Then, as quickly as he arrives, the hero departs, saving everyone the unpleasant task of asking awkward questions such as "How did we get into this mess?" Today's managers also want to be regarded as heroes, saving the day, avoiding awkward questions. Instead what they usually do is drop prices. And in so doing, they shoot themselves and their company in the foot.

This is because customers learn to focus their negotiations on discounts. When we are in the market for a new car, most of us have learned to shop on the last day of the month, when salespeople, desperate to make their sales quotas for the month, are most willing to discount.

We know of one manager who refused to play this no-win game until the division president got desperate. It was a business downturn, and his bonus was at risk if the company did not deliver the numbers. The executive's reaction was predictable. He authorized an end-of-month discount to distributors who would buy forward. The results in the first month were great: The company made its numbers that month.

The next month was different, of course. Customers had placed that month's order the prior month to obtain the generous discount. What did the executive do? This time he offered another discount for buyers who would buy before the end of the month. Did the company make its numbers? No. Remember, they were in a business

downturn. The company needed to adjust its expectations, not use price to make unreasonable numbers.

The company stopped its lunacy in the third month and decided to face the music. In the last week of the third month, the distributors were clearly holding their orders, waiting for another price cut. When the additional price cuts didn't materialize, customers started calling, asking when the discounts would be coming. When they heard that there were no more discounts, they started placing their orders as they had done in the past. Using price as the primary competitive weapon in most markets doesn't buy any additional business; it just gets customers to focus more on price and less on value. The executive missed his numbers and had to forfeit his bonus. But worse, the company lost hundreds of thousands of dollars in profits by offering discounts they didn't have to.

How about the effect of the White Horse Syndrome on the sales force? The salespeople quickly learn that if the managers are going to focus on price, they should, too. As a consequence, they stop focusing on value. They worry less about being good negotiators. When a customer asks for a lower price, they either give it to them or say they have to check with their manager. In either case, the customer knows they have won. Salespeople begin to have less regard for what is in the long-term interests of the company. They stop listening to the value rhetoric coming out of senior executives' mouths.

To make matters worse, the firms that buy into the White Horse Syndrome begin to develop systems that formalize the dysfunctional process. Forms and policies are created to dictate who can control price. Whole departments spring up to support the process. Price exception requests accumulate. Everyone learns how to play the game. Smart salespeople learn how to be the squeaky wheel that demands and obtains the lower price for their customers. Uncontrollable discounting becomes part of the corporate culture, embedded in the corporate DNA, unexamined and unexaminable. Confidence in any pricing strategy goes out the window.

Then the gross rationalization starts. Executives start feeling sorry for themselves, mistaking the difficult conditions they have