The Price Advantage

MICHAEL V. MARN
ERIC V. ROEGNER
CRAIG C. ZAWADA

WILEY

John Wiley & Sons, Inc.

The Price Advantage

Founded in 1807, John Wiley & Sons is the oldest independent publishing company in the United States. With offices in North America, Europe, Australia, and Asia, Wiley is globally committed to developing and marketing print and electronic products and services for our customers' professional and personal knowledge and understanding.

The Wiley Finance series contains books written specifically for finance and investment professionals, sophisticated individual investors and their financial advisors, and senior business executives. Book topics range from portfolio management to e-commerce, risk management, financial engineering, valuation, financial instrument analysis, and pricing strategy, as well as much more.

For a list of available titles, visit our Web site at www.WileyFinance.com.

The Price Advantage

MICHAEL V. MARN
ERIC V. ROEGNER
CRAIG C. ZAWADA

WILEY

John Wiley & Sons, Inc.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey.
Published simultaneously in Canada.

Library of Congress Cataloging-in-Publication Data:

Marn, Michael V.
The price advantage / Michael V. Marn, Eric V. Roegner, Craig C. Zawada.
p. cm.
Includes bibliographical references and index.
ISBN 0-471-46669-7 (CLOTH)
1. Pricing. I. Roegner, Eric V. II. Zawada, Craig C. III. Title.
HF5416.5.M365 2004
658.8'16—dc22
2003017896

Printed in the United States of America.

10 9 8 7 6 5 4 3 2 1

For
Nancy, Kristina, and Gail

Contents

Preface

When we conceived the idea of writing a book on pricing, we asked ourselves—as our readers should too—several basic questions. Why a book on pricing? Why a book by McKinsey & Company on pricing? Why a book on pricing now? Let us begin by addressing these basic questions.

WHY A BOOK ON PRICING?

Pricing, although one of the most critical management functions, remains one of the most misunderstood and undermanaged functions at many companies that are otherwise high performers. Pricing is far and away the most sensitive profit lever that managers can influence. Very small changes in average price translate into huge changes in operating profit.

The universe of pricing concepts and knowledge has advanced significantly over the past several decades, with business and academic journals regularly featuring articles on the topic. That said, few businesses have successfully tapped into the incredible potential that improved pricing holds. Even thoughtful general managers feel helpless to make real progress on the pricing front. They do not even know where to begin to get a handle on identifying—much less capturing—the exciting performance upside that pricing so often holds.

This book is not designed to be an exhaustive review of the considerable body of pricing theory that has accumulated over the years. To the contrary, this book has been written as a practical pricing guide for that thoughtful general manager who has been tempted by the unrealized promise of improved pricing and, perhaps, frustrated by attempts to translate pricing theory into bottom-line impact for his or her business. It is intended to provide a logical and structured approach for identifying where the most precious sources of untapped pricing opportunity reside in a business, along with practical, case-illustrated guidance on how to capture that opportunity.

WHY A BOOK BY McKINSEY ON PRICING?

Over the past 20 years, pricing has become one of the most frequent areas in which we have helped businesses across Europe, the Americas, and the Asia Pacific region to improve their performance. These companies represent a rich and diverse range of industries, including industrial goods, consumer packaged goods, consumer durables, banking, telecommunications, chemicals, retailing, high-tech products, basic materials, insurance, pharmaceuticals, and transportation. To support our service to clients, McKinsey has invested more than $20 million in developing practical knowledge in pricing over the past five years alone. We are credited with having developed and advanced a majority of the most useful contemporary pricing frameworks—the pocket price waterfall and the value map are just two examples.

WHY A BOOK ON PRICING NOW?

Over the past decade, we have published more than 20 full-length journal articles on specific topics in pricing. These articles have often followed our investments in developing fresh knowledge in the pricing space and have covered a range of issues, including transaction price management, price wars, making pricing change happen, postmerger pricing, and pricing strategies for integrated solutions. The breadth of our knowledge in pricing has grown to the point where presenting a holistic and integrated perspective in a single volume seems appropriate and timely.

In addition, conditions may be more favorable than ever for companies that try to create what we call the price advantage. In the early 1990s, many businesses tried to improve pricing performance and capability, but despite the best intentions, most failed to create real pricing improvements. Changes in organizations and information technology (IT) have increased the chances of success for companies trying to create the price advantage.

Based on our experience, less than a third of the major companies around the world had functional departments professionally dedicated to pricing ten years ago. When general managers mounted initiatives to upgrade the discipline and professionalism with which pricing was executed, they were often handicapped by an organization that lacked resident core skills in pricing. Now, however, more than four-fifths of these companies have created or begun to create dedicated pricing departments. Today, more and more companies have the horsepower to drive and execute pricing excellence throughout their organizations.

Also in the early 1990s, many companies simply did not have effective, enterprise-wide information systems that could allow fast access to accurate data on customers, transactions, and markets. Successful pricing is a game of knowledge and information, and such systems are necessary to support effective pricing judgment. Furthermore, well-developed pricing application and decision support software was virtually unavailable. Even businesses with viable enterprise data systems had to write their own pricing decision support and performance reporting software, often adding years to the implementation of thoughtful price improvement programs.

These IT constraints are by and large no longer major obstacles. Most companies now have functioning enterprise information systems that can provide at least the core data required to support pricing excellence. And a robust variety of commercial pricing software applications has been developed in recent years that further ease the development of pricing excellence in organizations.

Beyond these IT and organizational shifts, pricing is also capturing a higher priority on management agendas. It is one of the few performance improvement areas that remain essentially untapped for many companies today. With the easiest cost cutting already accomplished in most businesses and with demand growth slowing in many markets, superior pricing stands out as one of the few powerful and unexploited levers available to managers today.

Given that the intrinsic priority of the pricing function is on the rise and the organizational and IT hurdles are mostly behind us, now may be the best of times for businesses to get serious about improving their pricing capability and performance—and to have at their disposal a practical handbook to help guide that improvement.

STRUCTURE OF THE BOOK

This book is organized into six main sections. Part One describes the price advantage and explains why it is worthwhile for businesses to pursue that rare but valuable advantage. It then lays out our overarching framework for identifying and ultimately capturing pricing opportunity. This framework, the three levels of price management, provides the integrating thread that weaves through the book and is applicable to most business situations. Part Two explores each of these three levels in considerable detail.

Parts Three, Four, and Five address in turn special pricing topics, unique pricing events faced by companies, and themes that open a wider field of pricing opportunities. Part Six is devoted to the practical enablers and constraints to making enduring and positive pricing change happen, including a detailed case study and some final thoughts. In addition, the Appendixes are designed to provide some useful examples of the application of core frameworks discussed in the book and an overview of key points in pricing law.

This book contains a number of disguised cases to illustrate pricing concepts, frameworks, and insights. These cases are rooted in McKinsey's extensive client work in pricing, and client identities are heavily disguised to assure protection of confidential client information and strategies. The location and nature of opportunities identified are consistent with the underlying cases, and the magnitude of improvements shown by these examples is real.

Unless otherwise noted, when we talk about a company's "product," we are referring to that company's comprehensive product, service, and support offering to customers. This convention allows for more economical word usage throughout the book.

Acknowledgments

When you spend more than a year of your life writing and rewriting, planning and drafting, editing and redoing, it is difficult to express your appreciation for those who accompanied you on the journey. But we will do our best to recognize the efforts of those who inspired us, toiled with us, and supported us throughout the writing of this book.

First, we must acknowledge that this book represents the culmination of more than 25 years' experience in pricing. This experience was gained from hundreds of engagements involving hundreds of McKinsey & Company consultants. We want to thank all the clients who allowed us to be a part of their transformation, and all the consultants who contributed to our knowledge over the years.

Next, it is appropriate to recognize the contribution of the "godfathers" of pricing, those who first recognized the power of pricing—Kent B. Monroe, Tom Nagle, Dan Nimer, and Arleigh Walker—and those who supported the development of the pricing discipline within McKinsey: David Court, Tom French, Robert Garda, Philip Hawk, Ralf Leszinski, Andrew Parsons, and Rob Rosiello. They created the foundation on which this book is built and continue to support the continuing evolution of our knowledge.

Once we decided the time had come to commit our knowledge to paper and write this book, there were two people who made the entire journey with us, from blank screen to printed book. Cheri Eyink served as our ever-persistent project manager. Besides managing the schedules and deadlines, she acted as a thought partner on the content of the book, pushing our thinking and challenging us on what our readers want to know. Roger Malone was our trusty editor throughout the process. From the beginning, he guided us through this daunting task, not only acting as our sounding board and editor, but also pushing us to deliver the best of the Firm and ourselves to our readers. We want to thank both of them for their input and support.

In addition, eight people were instrumental in developing key concepts included in this book and sharing that knowledge through the written word. For their contributions in these areas, we would like to thank John Abele (postmerger pricing), Scott Andre and Robert Musslewhite (industry strategy), Walter Baker (value profiling), Daniel G. Doster (solutions pricing), Dieter Kiewell (pricing tools and implementation), John Voyzey (price wars), and Gene Zelek, chair of the Antitrust and Trade Regulation Group at Freeborn & Peters in Chicago (legal issues). There were also a number of people who made significant contributions to the knowledge we present here: Kevin Bright, Hugh Courtney, David Dvorin, Kristine Kelly, Andy Kincheloe, Michal Kisilevitz, Eric Lin, Glenn Mercer, Jamie Moffitt, David Sackin, Mike Sherman, Philippe Stubbe, and Lynda Martin Alegi, head of the Global Antitrust Group at Baker & McKenzie in London.

Additional editorial support was also provided by our colleagues at *The McKinsey Quarterly*, in particular Don Bergh, Stuart Flack, and Allan Gold, and by Bill Falloon and his team at John Wiley & Sons. We are grateful for their involvement.

As everyone knows, projects of this magnitude are not accomplished without the support of professionals who take care of the many details. We would particularly like to thank Mary Turchon for her assistance with organizing meetings, printing manuscripts, and generally taking care of the administrative issues. We would also like to thank Danica Reed for her research assistance. Finally, we would like to recognize Janet Clifford and Mary Ann Brej for their work on the exhibits, formatting and reformatting them to help us get our message across.

To all those identified above and those who supported us over the years, we offer a heartfelt thank you. Although the words do not seem to capture our gratitude, please know they are offered in sincere appreciation and recognition of your contributions.

PART One

Pricing Fundamentals

CHAPTER 1

Introduction

What's your advantage? What capability distinguishes your company from its peers, allows your business to perform better than your competitors, provides the foundation for superior returns to your shareholders? Is it a cost advantage—do you purchase better and manufacture more efficiently than your competition? Is it a distribution advantage—are your products sold through the best wholesalers, retailers, and locations in your markets? Is it a technology advantage or an innovation advantage? Or is yours a brand advantage or a capital structure advantage or a service advantage?

For all of the advantages that businesses pursue, there is one powerful advantage that is accessible to virtually every business, but actually pursued—much less achieved—by very few. That advantage is *the price advantage*.

Setting prices for goods and services is one of the most fundamental of management disciplines. It is unavoidable. Every product and every service sold since the beginning of time has had to have a price assigned to it. And setting that price is among the most crucial, most profit-sensitive decisions that all companies have to make. Ironically, very few companies price well. For a host of reasons, few ever develop anything resembling a superior, businesswide, core capability in pricing. In other words, few companies build pricing into the distinctive business advantage that it can be.

In this book, we will discuss the details of creating and sustaining a price advantage, where pricing excellence generates superior returns to shareholders. But first, let us look at why getting pricing right is so important, and why so few companies realize this advantage.

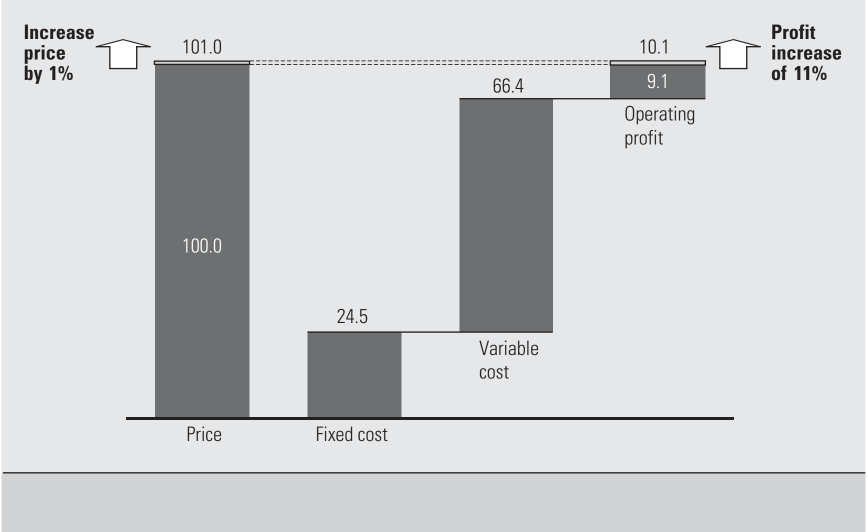
THE POWER OF 1 PERCENT

Why is it so vital to get pricing right? Because pricing right is the fastest and most effective way for companies to grow profits. The right price will boost profits faster than increasing volume; the wrong price can shrink profit just as quickly. As shown in Exhibit 1-1, the power of pricing is dramatic. Using the average income statement of the Global 1200 (an aggregation of 1,200 large, publicly held companies from around the world), the exhibit illustrates just how quickly the right price can create profit.

Starting with price indexed to 100, we see that fixed costs (items like overhead, property, and depreciation that do not vary when volume changes) amount to an indexed average of 24.5 percent of price. Variable costs (expenses like labor and materials that shift in tandem with volume) account for another 66.4 percent. This leaves an average return on sales (ROS) of 9.1 percent.

Now, against these average Global 1200 economics, how much is it worth to improve your price by 1 percent? Assuming volume remains steady, price will rise to 101, fixed costs by definition are unchanged, and, since there is no change in volume, variable costs are also constant.

Exhibit 1-1 Average Economics: Global 1200 (2002)

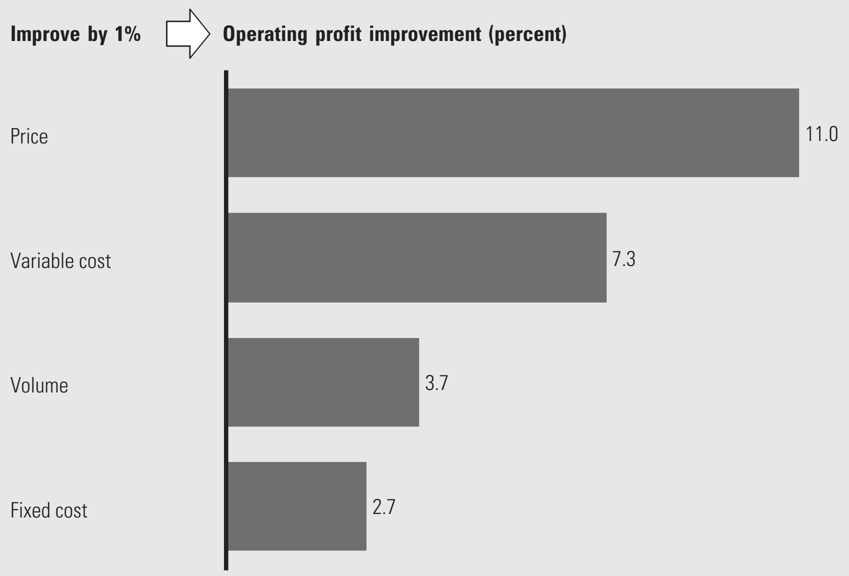


Operating profit, however, rises to 10.1 percent from 9.1, a relative increase of 11 percent.

The clear message is that very small improvements in price translate into huge increases in operating profit. When you talk about creating a pricing advantage, you may have to recalibrate your thinking about the significance of very small change. Pricing initiatives that increase average prices by only a quarter or a half percent are important because they bring disproportional increases in operating profit. A 1 or 2 percent price improvement is a major victory with significant profit implications. Find 3 percent—and many companies can, once they start looking—and operating profit can jump by more than 30 percent, using average Global 1200 economics.

Pricing is far and away the most powerful profit lever that a company can influence. Continuing with average Global 1200 economics, Exhibit 1-2

Exhibit 1-2 Comparison of Profit Levers



Based on Global 1200 average economics (2002).

illustrates what happens to operating profit when each of the other levers is improved by 1 percent, while the other factors stay constant.

A 1 percent decline in variable costs results in a 7.3 percent increase in operating profit. Though not as powerful as a change in price, this is still significant. However, most companies have pushed the variable cost lever quite hard in recent years through purchasing and supply management initiatives, labor productivity improvements, and other measures. Continued improvement in variable cost structure has become increasingly difficult.

Changes in fixed costs have an even smaller effect on operating profit. A 1 percent improvement generates only a 2.7 percent operating profit increase. While making other cost-cutting efforts, companies in the 1990s were also busy trimming these fixed costs, such that, as with variable costs, further improvements are becoming more and more elusive.

The profit sensitivity to a change in volume can be a real surprise to many. A 1 percent increase in unit sales volume, while prices and per-unit costs are held constant, results in a 3.7 percent increase in operating profit. This is about a third of the impact of a 1 percent improvement in pricing. But which lever gets the majority of the attention and energy from marketing and sales people? The volume lever, despite its profit impact being so much lower than improving price.

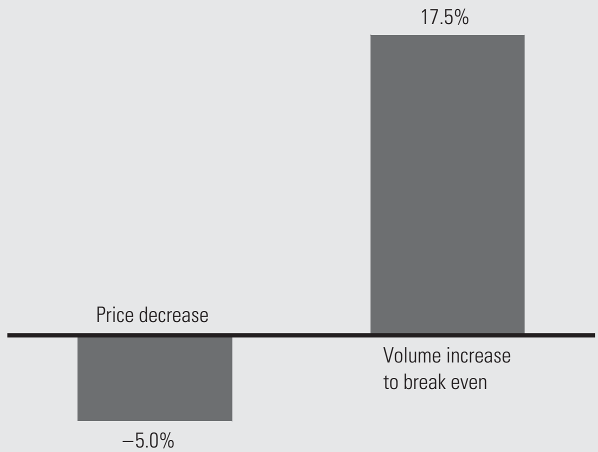
Unfortunately, the pricing lever is a double-edged sword. No lever can increase profits more quickly than raising price a percentage point or two, but at the same time nothing will drop profits through the floor faster than letting price slip down a percentage point or two. If your average price drops just a single percentage point, then assuming your economics are similar to the Global 1200 average, your operating profits decrease by that same 11 percent.

THE PRICE/VOLUME TRADEOFF

This inevitably leads us to the age-old question of the price/volume/profit tradeoff: If I lower my price, can I increase volume enough to generate more operating profit? Exhibit 1-3 explores how that tradeoff works—or, more accurately, does not work. If a business takes steps that effectively reduce average prices by 5 percent, how much of a volume increase would be necessary to break even on an operating profit basis?

With economics similar to the Global 1200 average, a 5 percent price decrease would require a 17.5 percent volume increase, not to increase operating profits but just to break even. Such an increase is highly unlikely. For a 5 percent drop in price to generate a 17.5 percent volume

Exhibit 1-3 Break-Even Price/Volume Tradeoff



Based on Global 1200 average economics.

rise would require a price elasticity of –3.5:1. That is, every percentage point drop in price would have to drive unit volume up by 3.5 percent. Our experience in real markets shows price elasticities commonly reach a maximum of only –1.7:1 or –1.8:1. On rare occasions, usually for consumer items purchased on impulse, it might be as high as –2.5:1. In the real world, –3.5:1 price elasticity is *extremely* rare. Thus, the basic arithmetic of decreasing price to increase volume to increase profits just does not add up. Note that you should do this calculation using the economics of your own business to confirm how the price/volume/profit tradeoff works for you.

So the first reason pricing is so important is that profits are extremely sensitive to even minute changes in prices. Each percentage point of price is a precious nugget of profit that should be held tight to the chest and never given up without a hard fight. Unfortunately, sales reps, propelled by their incentive systems, routinely negotiate away five percentage points at a time through discounts, special offers, and other inducements to complete a contract. Companies with a superior pricing capability—with the price advantage—consistently let fewer of those nuggets slip away.

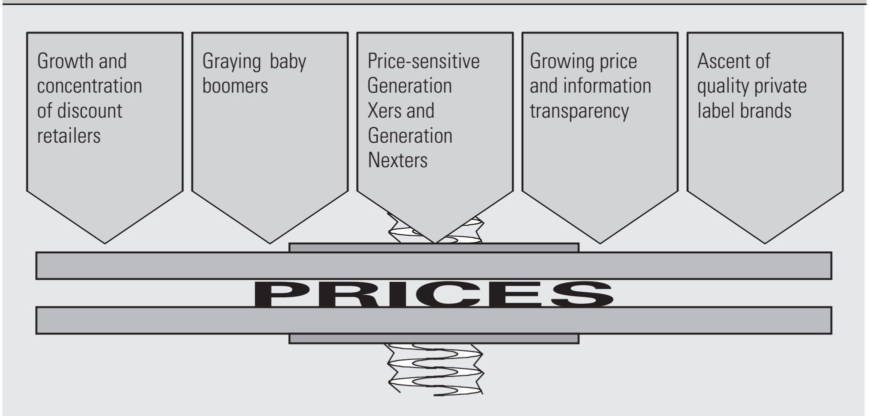
MARKET FORCES ADD PRESSURE

The second reason managing pricing is so important is because even if nothing changes internally, most companies, whether selling to consumers or to businesses, face unprecedented downward pressure on prices. If nothing is done, these external forces will depress prices and erode profits quickly.

Prices in consumer markets are being squeezed by a combination of fundamental changes in the business environment and demographic shifts, as illustrated in Exhibit 1-4. Discount retailers such as Wal-Mart, Home Depot, and Costco are growing larger, and the industry is becoming increasingly concentrated. These giants are using their market power to extract ever lower prices from consumer goods suppliers. The growth of the Internet, as well as increased use of price advertising by these discounters, has made it easier for shoppers to find and compare prices of consumer products. Meanwhile, private-label packaged goods, usually sold under a retailer's brand name, have also witnessed quality improvements that put added pressure on traditional brands in many product categories.

Generational shifts are leaving their mark on the consumer market as well. The baby boomers who fueled much of the rampant consumer spending through the 1990s are throttling back on their purchases now

Exhibit 1-4 Consumer Price Squeeze

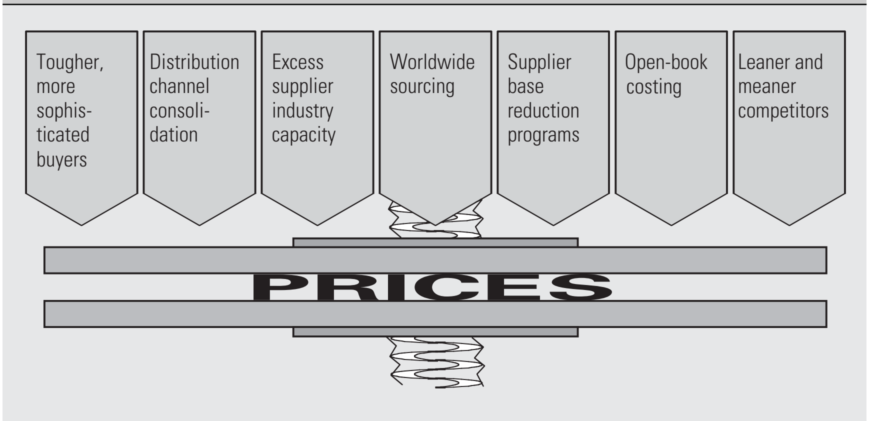


that they are helping children through college, supporting aging parents, preparing for their own retirement, and carrying other new financial burdens. The generations behind the baby boomers have been notably more price sensitive, having grown up surrounded by discount retailers of every stripe.

Business-to-business (B2B) companies are also feeling price pressure from changes in the market environment, as shown in Exhibit 1-5. Buyers are tougher and more skilled than ever in extracting every last penny of price from suppliers. Efficiency programs during the 1990s have unleashed newfound excess capacity into many markets. Supplier base reduction programs tend to concentrate a large volume of a customer's purchases onto a decreasing number of suppliers, thereby raising the stakes and the negotiating power of the customers over the suppliers. Open-book costing, in which powerful buyers insist on knowing the details of a supplier's costs for each component of a product, including individual component materials costs, direct labor, and overhead, has become more common. With this greater visibility into suppliers' costs, buyers gain leverage in negotiating prices.

Furthermore, many industrial suppliers have significantly cut their own costs—have themselves become leaner and meaner—and thus generally feel more confident to compete more aggressively on price to secure business. Also, global companies are increasingly shopping the world for

Exhibit 1-5 B2B Price Squeeze



the best prices, and then insisting on those unified low prices for all their buying locations. And finally, just as in consumer distribution, B2B distribution channels are becoming more concentrated and more powerful relative to suppliers.

The forces that are putting pressure on companies that serve consumers and businesses alike are gathering strength and are not likely to subside in the foreseeable future. A company that neglects pricing, that does not actively develop an enhanced pricing capability and a price advantage to combat this onslaught, will inevitably find prices crumble away under the weight of these prevailing forces.

THE NOBILITY OF PRICING EXCELLENCE

The last reason why building a price advantage in your business is so important goes beyond profit economics or market forces to the spirit, heart, and pride of an organization. There is a genuine nobility to pricing done well. Individuals responsible for setting prices hold a sacred trust. They assure that a business gets fairly rewarded in the marketplace for products and services superior to its competitors—that there is a real payoff for being better.

The price advantage is not about gouging customers or employing tricks to gain undeserved revenues. Quite to the contrary, the real price advantage is a source of organizational pride. The highest compliment a customer can pay a supplier is to knowingly pay more for that company's goods and services. In doing so, the customer is saying, "You are higher priced, but you are worth it; you are superior to my other supplier alternatives." Businesses that, lacking the pricing advantage, fail to have their superiority rewarded with higher prices often lose their drive—and even their ability—to continue to be superior.

WHY THE PRICE ADVANTAGE IS SO RARE

The reasons for pursuing a price advantage are compelling, but very few companies have achieved a level of competence in pricing that could be described as a price advantage. While many may attribute much of the double-digit profit growth that was so common in the 1990s to improved pricing practices, in fact the bulk of this growth can be traced to cost cutting and increased demand. Pricing had little to do with the profit growth during this period and remains a largely untapped opportunity.

A number of factors explain why companies undermanage the opportunities inherent in pricing and why so few businesses have ever developed a pricing advantage.

- Under past buoyant economics brought on by strong demand and sharp cost cutting, many companies sensed little need to develop advanced pricing skills and to pursue pricing as a source of increased profits.
- Companies often did not believe that pricing was manageable. They saw prices as set by the market, by customers, or by unreasonable competitors.
- Data to support pricing decisions was either not available or not current enough to help with real-time pricing decisions.
- Price differentiation and other pricing actions were misperceived as always illegal, and therefore degrees of pricing freedom were internally limited.
- Pricing mistakes and errors were hard for most companies to detect. If your sales representative in Scotland negotiated a price that was 5 percent lower than it could have been, it was unlikely to raise a red flag at headquarters.
- Frontline pricers often had virtually no incentive to stretch for an additional percent in price.
- Senior managers often had little, if any, involvement in pricing.

As we will show in later chapters, the obstacles outlined here are real but can be overcome with some effort. Indeed, these barriers to building pricing capabilities are not trivial, and creating a price advantage is hard work. But the payoff is so large that knocking down these barriers is well worth the effort.

* * *

The price advantage is a powerful advantage worth pursuing and is achievable by each and every business, but fully realized by very few. It deserves pursuit because pricing is such an extremely sensitive profit lever, with small swings in price levels generating huge swings in bottom-line profitability. As we have shown, a 1 percent increase in price can increase your profit by 11 percent or more; a 1 percent slip in price can erode profits by that same 11 percent or more. And rare are the circumstances where decreasing price can generate nearly enough additional sales volume to offset the effects of a price cut and produce incremental profitability.

Furthermore, the price advantage deserves pursuit because of prevailing market forces—both in consumer and business markets—that are putting unprecedented downward pressure on industrywide price levels and showing no signs of subsiding. Failure to take real initiative in pricing today virtually assures that percentage points of price will slip through your hands annually—and that huge chunks of operating profit will drop off your bottom line. Finally, achieving the price advantage can be a source of organizational pride as employees are reassured that their hard work to create superior products and services does not go unrewarded.