

Profitability management in a downturn-
Setting up a baseline for long term
success

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Preface

In present economic scenario, many companies are forced to evaluate the internals of the business with the motive of reducing costs. Markets are down, costs are up, and consumers are playing it safe. Widespread layoffs are possible. In these impending situations, companies need to think, a little harder, to make profits and sustain them. How does a business make money under present circumstances, sustain those, and be better than competition in times of recession? Diffident companies tend to start looking at reducing their manufacturing costs, developing distribution advantage, reduce the manpower, or other typical ways of reducing costs. What many companies overlook is the power of pricing right. A company which fully leverages the pricing power of its products can have a larger cash buffer than its competition and better capability to manage the business affected by market forces in the present recessionary period.

Pricing should be considered at strategic, product and transactional level. Companies have traditionally looked at strategic pricing as a primary outlook for pricing the product. Correlating the product price to the industry demand and supply and the manufacturing costs incurred have been the standard information base on which many organizations price their products. Mapping the price's "tone and feel" through different pricing methods like cost plus, volume pricing, or supply and demand gap, companies have tried to price the product. Product specific positioning and competitor factored pricing emerged, where companies involved external competitive aspects of pricing. Product positioning, market driven pricing, competitive pricing fared well in this realm. So did the competition, to stay ahead of competition, companies need to adopt a new pricing focus, including strategic and product pricing, a discipline of transactional pricing. Transactional pricing is pricing management method which is focused on "exacting" price for each transaction. This is the foundational bulwark of pricing for long term profitability.

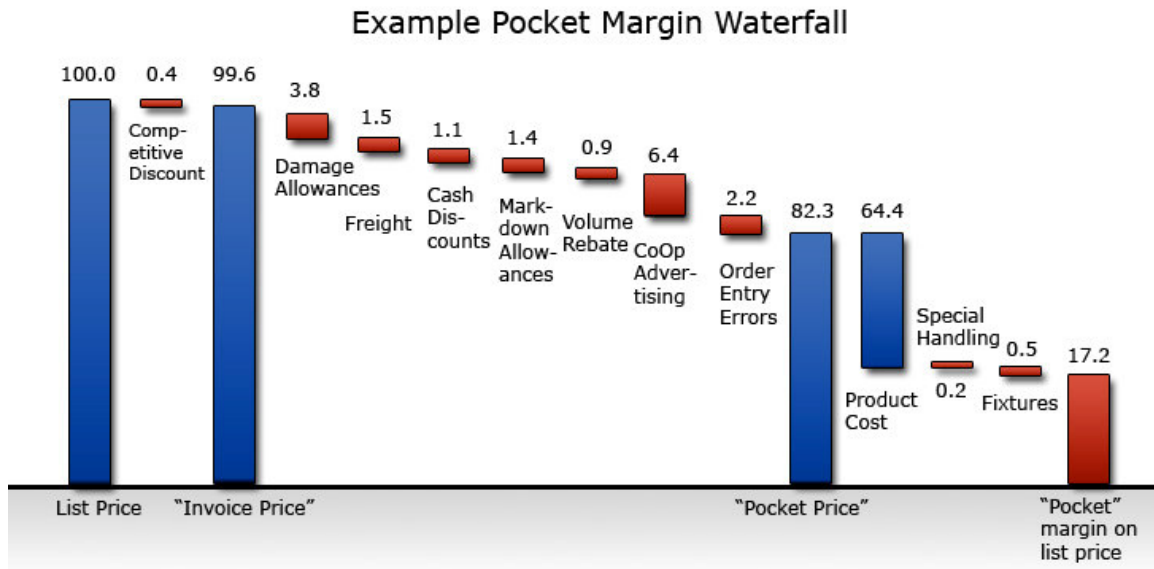
As goes the age old saying "set your pennies right, the dollars will take care of itself" transactional pricing is the method, whose tools when applied strictly in a transactional business set up would bring short term profits and sustain the business with long term competitive benefits. Many organizations possessing a robust costing structure and clear information on price abrading components of price waterfall do not implement the discipline and its tools and processes. Reasons are many for this, lack of systems to support, infrastructure to capture transactional details, detailed work, appreciation of the power of transactional pricing or the reasons may be multifarious and diverse. If applied with rigor and spirit, transactional pricing would deliver concrete results for the company's bottom line. And implementing during the time of recession, organizations would be able to reap long term benefits in the downturn and be better equipped to profit fully from the next upturn.

Here we discuss some of the approaches for braving the present economic downturn. The pertinence and implementability of these approaches are subject to the company and industry specific factors.

Pocket The Maximum- Do Not Let Your Profitability Erode:

Price waterfall model is a significant addition to the management knowledge to understand how the company's profitability is driven and affected by different components in its "costs incurred in reaching the buyer's acceptance price" chain. It provides valuable insights of customer, product, sales personnel capabilities and business unit performance. The most beneficial value of price waterfall model is the mapping of how margins are eroded by different components of transaction. An

example is depicted in the figure below. The erosion is mapped from list price to pocket margin with respective price leaks and abrasions. Companies overlooking the transactional pricing opportunity are focusing on improving its core competency, reducing its costs or any other methods of managing the effects of recession.



Transactional pricing discipline is the bottom most structured detailed level of pricing in the pricing hierarchy. It involves the buyer and his sensitivities upfront. The key to any business success is knowledge about the one who pays the price and his price sensitivity map. Understanding and capitalizing on the buyer's sensitivity and requirements is critical for any business. As specific to a particular buyer is it, so beneficial is it for any company. Businesses have traditionally captured the variability of buyer's behavior in broad segments segregated in liberal parameters for mapping. Every buyer is unique and has specific needs and sensitivity towards the price. Combining the pricing sensitivity in broader segments muddles and creates haziness in the pricing power of the companies. In reality, it is in these broader segments lie smaller but considerable sub-segments where different behaviors separating each sub-segment exist. The pricing managers, with the limitation of their professional profiles, numbers and position disadvantages find difficulty in capturing, appreciating and understanding these sub-segments. Companies who have understood these sub-segments well have utilized specific tools for making the most of the variability available in these segments, by targeting right product or service or the combination of both, at the "right" price to make quicker and faster buck. Indeed to say, these businesses have served both the selling and buying parties in the business deal right. There by making the most in the available situation. A proactive approach in pricing is required with clear and strong focus on pocket price. The margin leakages in price water fall model may occur at each price point i.e. from the list price to the pocket price/margin. The margin leakages and

their sizes are specific to the industry and company. And the leakages are directly related to the competitiveness of the market and the bargaining power of the buyer. Some of the margin eroders are competitive discounts, damage allowances, freight, cash discounts, volume rebates, merchandising costs and unbilled transporting costs.

Specific tools like price bands, customer contribution, product contribution, segment performance, sub-segment buyer behavior, or training on transaction dynamics would help in realizing the right price per buyer. These tools help in evaluating customer sub-segments on different criteria, like profitability, sensitivity, deal dynamics, expectations, how best can we serve and best negotiation practices. Specific other tools if implemented would help the companies to be nimbly responsive to market dynamics.

Manage it “Right”:

Companies feeling the punch of recession, typically react by cost reduction. And this intervention is not the only best reaction to downturn pressures. Many other opportunities exist to deal with recession. Companies can look at how to maximize the profits and profitability by product, segment, sub-segment and customer first.

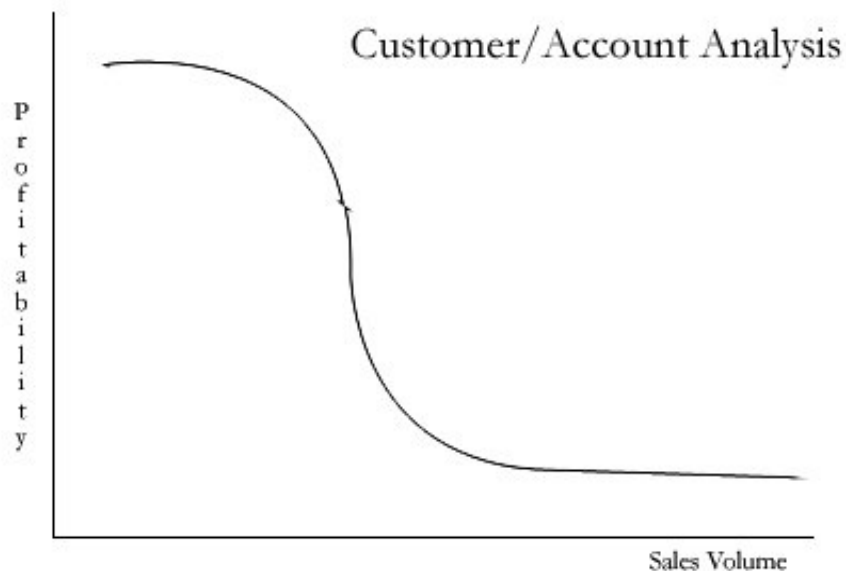
Companies focus on cost cutting during industrial downturn as a flex tendon reaction, as this comes to be immediate controllable in profitability equation. In reality, revenue can be managed and maximized, the fact which many companies over look. “Pricing right” comes to the rescue of such organizations, which want to increase the revenue and alongside their focus on reduction in costs already offers its benefits. Price management and profitability analysis should be applied rigorously along with cost reduction. Once the right pricing processes, organization and tools are in place, the company will find itself at a better position to handle the recession effects. And cost reduction would come handy to offset any possible risks due to other costs on profitability of the business in future. A strong focus on profitability analysis of each customer derives critical business insights for maximizing the profits. Deriving insights from these analyses the organization can align the profitability strategy to the organizational imperatives. Making the most out of highly profitable accounts and relaxing the focus on volume driven sales drives profitability up or allowing the customer to pick up from the storage area to reduce costs incurred by the seller and likewise tactics would drive the pocket price up. At the same time production schedules and product movements across value chain has to be managed to drive up the profitability of total business set up.

To appreciate the costs incurred in reaching the buyer’s acceptance price, the costs assessed through the balance sheets or financial statements provides a limited view. The real and appropriate costs are measured through transactional cost details. Analyzing the cost incurred in the price waterfall captures the utility of each component of the fall, and more importantly discerns the value of the organizational cost

components involved. Before dropping the axe on the organizational cost components or the human resource to deal with recession, it is better to manage the business right.

Motivate the most effective buyer's interface-The sales team:

The present recession period offers the right time, for action and setting direction for transactional price management. Sales force's reaction during the recession period of motivation and rigor to drive sales up to save their jobs and positions. This sentiment can be used to drive profitability up. A structured approach and motivation to sales force to drive profitability up will take the sales process to next level. It is the right time to drive the nail through for profitability maximization and inculcate profitability culture into the sales team. Analysis of price water fall components and most importantly the pocket price indicates and deduces solutions and actionables to manage the profitability right. Wide variations in pocket price realization and price water fall analysis, provides insights in which components are not helping in realizing the value of costs incurred or which ones are dead costs. Some of the frequent insights are derived about competitive situations and customers served. Variations in pocket price band communicate relational insights among margins per sale; customer and competitive situations. A wide variation in pocket price shows, either the negotiating power of certain customers is high or they are able to get better prices for other reasons. It may also be that the sales personnel are driving volumes than profitability. To understand what exactly is the situation, the pocket price gap analysis and sales volume-price map comes handy. Managers facing situation as depicted in figure below can focus on driving the top end profitability sales, while dropping the low end ones thereby giving a strong boost to the overall profitability.



Other considerations of revising incentive plans, or compensation plans, or motivating the sales forces, can also be utilized. In these situations, customer wise, volume wise and possible earning loss wise (w.r.t list price) analysis would yield directions for driving the nail of profitability through the sales team's minds. And when focus on profitability is made into a sales culture, it would position the company for a long term stronger growth once the economic situations improve.

Price Personalities:

Every customer is unique. And unique is his price sensitivity and behavior. Economic analysis has shown in many businesses that a good chunk of customer base behaves in the same way and has similar sensitivities. Although, there are certain differentiating factor(s) or methods in groups in value capturing of product or benefits, these are rarely capitalized on or understood. Instead, these groups are treated more or less in same way when it comes to pricing the product. These groups can be clubbed in sub-segments of price sensitivities. These segments may be insensitive to prices in the zone of equivalence. As, it happens in industrial buying behavior, the customer evaluates the product based on conjoint analysis. Even the retail customer's behavior changes are inducing the trend of conjoint analysis in product buying. Development in customer's behavior, market dynamics, changing lifestyle, and buying patterns has shown a marked change in the B2C customer's price determination methodology. Some customers pay a larger sum of money for the same quality of product in a retail chain than a grocery store. Some others pay a larger sum for non availability of product in the vicinity, and time costs. In certain industries, these behaviors can be mapped with underlying buyer's price personality with respect to the prices they paid previously. For mention, a customer may not be sensitive to product price in a small range (zone of equivalence) for benefits like: saving transaction time, easy availability of product, faster service, easy processing, door delivery, relationship, credit facility, attention received and ambience. These criteria are specific to each industry, business and more importantly to each buyer. Sales force should proactively seek such information during interaction with buyer. Pricing manager's sitting in offices or ground level sales managers find difficulty in capturing this face of the buyer, in detail, which we call "price personality". It involves a structured approach in mapping the behavioral, communication, need and personality aspect. Capturing them using right parameters and their incorporation in pricing decisions at transactional level, provides a significant opportunity for improving profitability. Implementation of such solution is subject to type of industries, behavior, price sensitivities of customer segments, segmentation, regulatory constraints, location, market, competition and information available to the buyer and seller. A disciplined approach to selectively incorporate the margin eroders in price water fall, at different risk points in the sales and negotiation process, while dealing with customers is critical to maximize the profitability. To institutionalize this approach sales team needs to systematically value the customer's benefits and customer loss or switching costs before making the decision on the price point at which the product or service is sold. This would mean influencing the buyer's acceptance price to maximize the profitability.

Mapping and training of such details would enhance the knowledge of the sales staff to rightly price the product, and make most out of the pricing power in their hands and taking the company at a new level of success.

Short Term view:

Falling back on short term strategies like samples, coupons, cash refund, premium gifts, free trials, discounts and volume discounts to deal with recessionary challenges may yield short term sales, but on longer run would hamper the product's profit realization capability. These potential savable margin components, if not selectively and prudently utilized cuts a major chunk in the price water fall, resulting in the thinning of realized pocket margin. And, also such trends would disable the long term product's pricing power. The number of such components in a particular sale affects the pocket price drastically. Alongside the market behavior of correlating to your product to such discounts would seriously injure the future profit realization capability of your product. It is important for businesses to prudently utilize the facilities, tools and benefits of transactional pricing for increasing the profits and grow the business in different geographies with counter cyclical demand or currency fluctuations or significant behavior change in the customer.

In the end, it is all about focusing on maximizing the margin, getting the best out of a sale, with clear focus on profitability of the business. It has never been so opportune a time to use the transactional price management, than now.

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Protomind Consulting is a strategy and management consulting firm. We provide strategy and management consulting and outsourcing advisory services. For more information you may contact: contact@protomindconsulting.com or browse www.protomindconsulting.com