AlixPartners

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TOP NINE MYTHS OF REVENUE AND GROWTH

Myth six: Why higher prices don't always mean lower volumes

In the **Top Nine Myths of Revenue and Growth,** a nine-part series, AlixPartners spotlights the changing calculus of top-line revenue strategies and suggests ways companies can overcome commonly held revenue and growth myths as they pursue—and achieve—profitable growth.

Pricing challenges have long bedeviled leaders in B2B markets: should they raise prices to lift margins in the short term, or should they hold the line, mindful that a sudden outflow of customers could slow longer-term revenue momentum? The stakes are high because if volume declines, the operational, employee, and investor implications can offset any revenue increases.

Given that risk, should business leaders look elsewhere for margin improvement? Not necessarily. The myth that price increases always come at the expense of volume rests on several misconceptions.

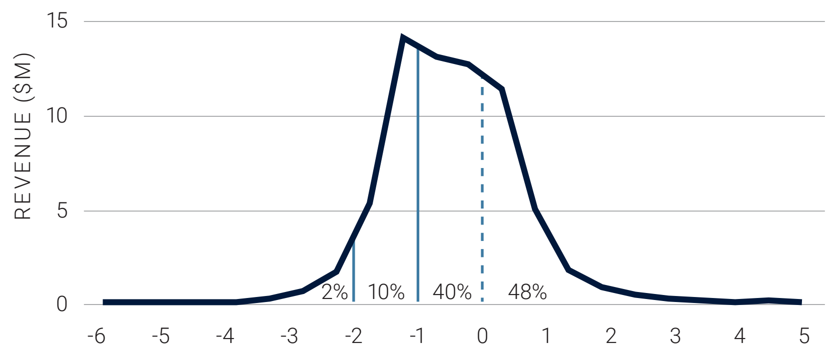
MYTH SIX: WHY HIGHER PRICES DON'T ALWAYS MEAN LOWER VOLUMES

MISCONCEPTION #1 IS THAT ALL PRICES ARE NEGOTIATED WITH THE SAME DEGREE OF SKILL ON BOTH SIDES.

In reality, buyers and sellers bring varying degrees of skill to each negotiation, so prices for the same product and situation can and will vary widely. Consider a company we recently worked with whose prices for a building materials product vary widely across customers in comparable markets, as shown in Figure 1. The customer's skill in securing alternative supplies and the seller's skill in communicating the company's value proposition both affect the outcome of pricing negotiations, of course. But price also varies by how highly the buyer values the seller's offering—the more highly it's valued, the less likely it will be vulnerable to competing propositions, especially if price is the main differentiator.

Sales representatives can more confidently hold or raise prices when they come to the table armed with precise information on what comparable customers are paying, as well as with detailed information on the value that the company's offer creates for a specific customer. That knowledge enables them to realize higher prices more consistently without sacrificing volume. In addition, companies can further encourage thoughtful pricing by linking sales incentives to pricing outcomes rather than volume alone. Companies that we have worked with have achieved pricing improvements (net of volume loss) of 100-300 basis points or more by providing sales reps with fuller customer information and adjusting their incentives.

FIGURE 1: SPREAD ACROSS MEAN FOR RESPECTIVE TIER PRICE



No. of standard deviations from mean price – calculated at SKU-district-transaction type-price tier level

Source: Zilliant data extract, AlixPartners analysis

MISCONCEPTION #2 IS THAT ALL CUSTOMERS FOCUS EQUALLY ON ALL COMPONENTS OF REALIZED SELLING PRICE.

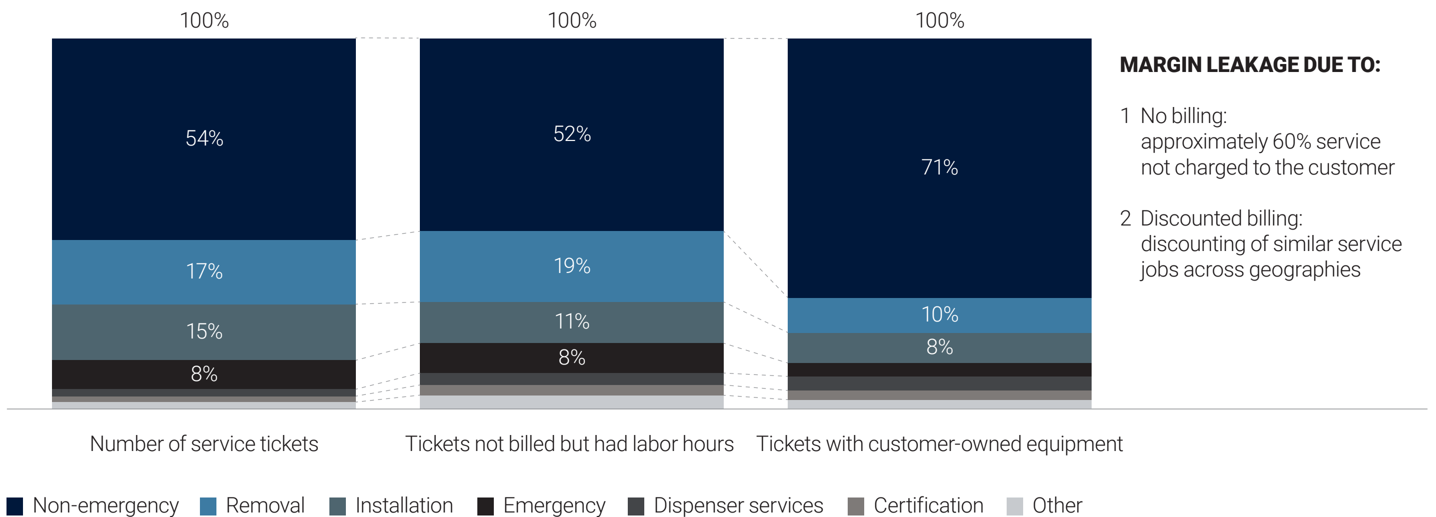
Again, the reality is different. Net price realized from customers can be considered the sum of two principal elements: 1) a negotiated price that includes competitive discounts or rebates; and 2) upcharges or discounts for operational requirements, such as rush orders, that deviate from the negotiated offer. Customers pay the combination of the two elements, but incentives for both purchasing managers and sales teams are typically based on the negotiated price–and that's where both parties direct their focus. Exceptional terms such as delayed payment, small orders, rush orders, special packaging, expedited delivery, and other requirements all cost suppliers real money beyond what was negotiated and must be addressed. Those costs are often recoverable based on contract terms but are never actually invoiced.

Companies with strong pricing systems precisely define their offer in such exceptional conditions and include upcharges for customer deviation from the standard. Failure to include those charges can result in net prices that are 100-200 basis points lower than what the seller envisioned when negotiating an offer. To close the pricing gap, sellers should develop a detailed understanding of the costs of variations from negotiated terms, communicate those costs to customers, and exhibit resolve to negotiate deserved upcharges or take those activities and costs out of their systems.

We recently advised an industrial manufacturer with declining margins to analyze its offer to key customers. The company found that a growing number of rush orders (that is, orders requiring 24-hour turnaround) had the effect of squeezing margins by 150 basis points or more. To address that issue, the company carefully measured the behavior of key customers around rush orders, quantified the cost to itself and the benefit to its customers, and approached key customers with a combination of price increases and behavioral requirements that enabled the company to improve margins by 50-100 basis points.

FIGURE 2: MANY SERVICES ARE NOT BILLED TO THE CUSTOMERS RESULTING IN REVENUE AND GROSS PROFIT LEAKAGE

Service ticket types and those not billed to customers



Source: AlixPartners

MISCONCEPTION #3 IS THAT CHANGES IN INPUT COSTS (SUCH AS THOSE FOR RAW MATERIALS, LOGISTICS, OR LABOR) CANNOT BE RECOVERED PREDICTABLY AND CONSISTENTLY WITHOUT INCURRING OFFSETTING DECLINES IN VOLUME.

Clients find such cost recovery especially challenging in complex environments where numerous combinations of input and output goods complicate the translation of cost increases into product price increases. The challenge can be overcome, however, with well-calibrated measurement systems, precise communications with the sales force, and a clearly articulated explanation of the seller's pricing policy. In many cases, both suppliers and customers could benefit from reducing the price volatility that results from changing input costs, but the two parties never openly discuss how to create win-win agreements that would benefit both sides.

We have recently worked with specialty chemicals and manufacturing companies that have invested in new tools that provide a detailed understanding of the linkages between changes in the prices of input goods and associated output goods. When combined with better supplier-customer communication and smart contract structures, that granular understanding of cost increases that were previously thought to be unrecoverable can generate price improvements of 50-100 basis points.

MISCONCEPTION #4 HOLDS THAT THE LIST PRICE DOESN'T MATTER.

In some businesses, such as those that create or configure a custom product in response to a request for bids, the concept of a list price is of little relevance. But in many other B2B businesses, customers can and do see a published list price. Unless that list price aligns with the company's value proposition and positioning relative to its competitors, the company risks losing potential leads or limiting itself in negotiations. Yet many companies neglect their list prices, updating them infrequently and with insufficient rigor. They assume wrongly that customers don't pay attention to published list prices and that markets drive pricing outcomes through discounting and negotiation.

Carefully considered list prices, adjusted frequently and designed to set a starting point for negotiations in line with the company's value proposition and business model, can be a powerful pricing lever. Companies that effectively perform that price-setting exercise often realize pricing improvements of 50-100 basis points.

BETTER UNDERSTANDING LEADS TO BETTER PRICING.

The misconceptions discussed here all stem from the tendency of companies to arrive at prices one customer at a time, rather than thematically driving improvements in policy, sales capabilities, and sales support. Changing that one-customer-at-a-time mentality is the key to improved price realization. Four critical steps toward change are:

Creating tools and supporting processes that help sellers understand the real value of their products to different customers—and why some customers are less resistant to price increases than others. Tools featuring analytics that identify unnecessary variations in product and customer prices enable sellers to fine-tune their understanding of customers and pinpoint opportunities for value improvement. Application-specific value calculators permit sellers to understand how customers derive value from a product, and understand their relative price sensitivity. Such calculators can be augmented by simple evaluation exercises that help sellers estimate the importance of the seller's offer to customers. Those exercises examine such areas as:

- the trajectory of the customer's spend on a given product;
- the customer's history of putting business out for tender;
- the customer's spend with the seller as a percentage of its overall spend; and
- the professionalism of the customer's purchasing organization.

The value of standard variance and value tools can be enhanced by tools such as customer and product profitability calculators, cost-price translators that model the effect of changing costs on prices and margins, and leakage waterfalls. Together, such sales support tools can not only help companies recover higher costs but also plug price leaks that stem from mispriced or uncharged products and services.

Training salespeople to calculate customer value created by the company's products and services, and articulate that value during price negotiations. Sales representatives typically embrace such training, which gives them newfound confidence to approach customers and realize more complete value for the company's products and services. Improved incentives can help companies reinforce the importance of building pricing capability. Those incentives can include both compensation structures that feature pricing metrics and incremental pricing authority associated with improved pricing performance.

Well-aligned communications strategies can be as helpful as the tools themselves. Salespeople respond to communications that reinforce the company's focus on margin management as a key strategy, just as they do to statements of the company's intent to pass through input costs fairly and equitably. By regularly and clearly addressing the organization, customers, and investors with the specifics of the company's overall margin strategy, companies create an umbrella that protects sellers when they aggressively seek to recover higher costs.

Centralizing management of pricing best practices and key sources of price leakage. A pricing center of excellence can help ensure deployment of pricing best practices tailored to the needs of each business unit or customer segment. They can also provide crucial visibility to price leakage and support sales reps when they're called upon to execute price changes with their customers.

To ensure that the new attitude toward pricing takes root in the organization, leading B2B companies back their programs with center-led pricing war rooms. War rooms help generate the organization-wide institutional momentum that, like water wearing down a stone, gradually changes local mindsets. Information-sharing and clear communication of strategic intent contribute to creating systemwide transparency. In such an environment, positive peer pressure and the free exchange of winning sales strategies and tactics help develop more effective salespeople and a more effective, cohesive sales organization.

By following the action plan we have described and supporting it with a center-led war room, business leaders can finally succeed in their quest for price improvement. The journey starts with senior management's acknowledgement and acceptance that customers are, on the whole, skilled and effective negotiators. With that bedrock assumption in place, senior leaders can turn their attention to what they can actually change and control: the skill and confidence of their salespeople and the competitive environment in which they operate.

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ABOUT US

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These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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