McKinsey&Company

THE HIDDEN POWER *of* PRICING

How B2B Companies Can Unlock Profit

McKinsey on Marketing & Sales

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The Hidden Power of Pricing: How B2B Companies Can Unlock Profit

Pricing has the power to lift or lower margins quickly. And yet for many executives today, pricing remains an enigma. How to be proactive and not reactive? How to be a price setter, not a price taker? How to set the right price and actually get it?

Complicating executives' efforts to answer these questions is an abundance of data, a dizzying array of analytics capabilities, and greater pricing transparency that has increased purchasing's prowess when it comes to negotiating.

Many executives are feeling overmatched. In a recent McKinsey Quarterly survey, more than half of the executives who responded felt their companies didn't have a reliable method for compiling pricing intelligence. A third thought their companies didn't systematically use competitive intelligence to review prices and develop offers.

Pricing, however, can be a significant source of above-market growth. We have found that those companies that get the most from pricing both nail the basics (e.g., price setting, discounting, and tracking) and build expertise in an array of relevant areas from analytics to face-to-face negotiations.

This selection of articles brings together both our and others' insights into what it takes to make pricing a strength. We hope it sparks deeper conversations about the possibilities of pricing.

Kevin Chan   Jay Jubas   Dieter Kiewell

ARTICLE

Price to profit: Five steps to above-market growth

by Kevin Chan, Philipp Hillenbrand, Jay Jubas, Dieter Kiewell, Jorge Postigo, Georg Winkler

An international provider of technical gases had a large, highly fragmented product portfolio of more than 500 SKUs, customers in a range of industries, and a broad segmentation of customers by size. As a result, its prices varied widely even for the same product. Managers felt that there was room to increase prices overall, but had no rational basis from which to challenge current pricing practices.

The company decided to completely revamp how it set prices and started with a pilot project. The centerpiece of this effort was the development of an analytical tool that pinpointed new price drivers, redrew customer segments, and recommended new prices. The tool enabled the salesforce to assess the impact of price changes on customer relationships and make any necessary adjustments. More importantly, the company supported the new approach with an intensive salesforce training program.

The pilot was so successful that the company rolled out the approach across seven diverse markets. In one, the analytic tool enabled decision makers to scan company records for 1.3 million transactions. Other markets used the tool to help develop value-pricing methods (systematically identifying the incremental value of a product to a given customer) and create transactional pricing analyses (the systematic analysis of price variances across products, regions, and customers). Overall, the company reset 100,000 prices for 150 SKUs-and saw return on sales (RoS) increase by 3-5 percentage points without significant changes in volume. The whole program took just three months.

Our experience shows that systematic improvement of a business' pricing capabilities can have a lasting positive impact on profitability.

This example of a well-implemented advanced analytics program to turn pricing power into profit comes at a time when companies across all B2B sectors are finding it hard to maintain, let alone improve, profitability. Low-cost entrants have emerged, buyers are more sophisticated, and price transparency has increased to such an extent that global suppliers often compete in the same markets. At the same time, procurement departments are improving their capabilities to negotiate better deals.

Companies can fight back in various ways, cost -cutting included. But our experience shows that systematic improvement of a business's pricing capabilities can have a lasting positive impact on profitability. Our data, which cover more than 1,000 pricing-excellence and performance-improvement initiatives across a range of industries, clearly show that such initiatives typically translate into an uplift of RoS of 2-7 percentage points, depending on the sector.

Pricing is an important source of revenue and profits, but only companies that increase their level of analytical rigor and practical know-how will unlock its full value. From our extensive experience, we believe companies need to do five things to turn pricing into a profit engine:

1. Provide meaningful transparency into pricing data

Pricing managers often negotiate or set prices with one arm tied behind their back. They may lack a clear understanding of how profitability varies between regions and product lines, and know even less about how it can vary among individual customers or transactions. Yet these are all important influences on pricing and sales decisions.

To take one example: Volatile raw material prices have caused headaches for companies selling products on contract periods longer than the company's own purchase contracts. When raw material prices rise, their sales reps don't know which prices should go up, by how much, and how quickly. Without that knowledge, profit opportunities evaporate. The front line needs meaningful transparency into price levels, discounts, and other leakages at different levels of granularity and over multiple time periods.

The key word is "meaningful." The increased data availability and computing power provided by advanced analytics mean that, in theory at least, sales reps can make much better pricing decisions. But the very proliferation and complexity of data has more often than not overwhelmed rather than helped. In consequence, advanced pricing analytics are often ignored in favor of pricing decisions based on gut feeling, a one-size-fits-all model, past experience, or outdated analysis. The result is that companies either price too low and leave money on the table, or too high and lose customers.

In B2B companies, existing analytics capabilities are often not sophisticated enough to create the right kind of pricing opportunity algorithms to cope with the large amounts of data available. Too often, we see managers make broad pricing decisions (e.g. proportional price increases) armed with little more than an Excel spreadsheet.

Companies with good analytics capabilities can use the data and teams already in place to find significant growth in a matter of months.

A European steel producer, for example, lacked a system to collect relevant data at the level that sales reps cared aboutthat is, at the level of their individual customers. To address this, the manufacturer decided to combine financial data from several internal IT systems: sales reps' systems, where orders were entered and invoices processed; the production teams' systems, which allowed them to plan capacity, typically at machine level; and finance's systems, which aggregated all this data into financial reports, but typically at higher levels, such as a plant or a product line. It then set up dashboards to analyze the combined data on a weekly basis. The new system helped identify new and critical insights, such as customers who were frequently unprofitable but too small to be noticed.

While there is a surfeit of pricing analytics tools available, the best ones can help test and calibrate pricing drivers for each individual product -customer combination, as well as dig into customer revenue profiles at the product -volume, industry, and sales-channel levels to unearth new pricing options. They can also derive pricing recommendations based on complex calculations of what drives price differences between customer segments. In our experience, companies with good analytics capabilities can use the data and teams already in place to find significant growth in a matter of months.

2. Understand what customers really value

For all the sophistication provided by advanced analytics to master a complex array of prices, the price of a product or service ultimately depends on how much a customer thinks it's worth, i.e., value. The best companies augment their pricing analytics with detailed customer insights. Value pricing requires identifying all the key buying factors that determine how much a product is worth to a given customer, understanding how those factors compare with competitors' offers, and being able to quantify the value created for the customer.

The best companies augment their pricing analytics with detailed customer insights.

At one company, a team of pricing and sales managers was asked to list the factors they thought determined the prices their customers were paying. It then tested and refined these hypotheses. The analysis revealed 14 significant drivers of pricing sensitivity that the sales reps had not identified. Many of the results were counterintuitive. In one case, it was the quality of the packaging rather than the quality of the product that was the single most important driver for customers' willingness to pay a premium.

While analytics can certainly help in determining value, developing insights often requires "softer" and more traditional skills, such as talking with customers and observing their operations.

One manufacturer of specialty tools, for example, was about to launch a series of products with much higher performance than either its own existing ones or their competitors'. By first interviewing distributors and then launching targeted market research, the company linked the entire set of key buying factors to what buyers would be willing to pay for, which enabled it to set a price point far higher than the marketers had anticipated.

A pragmatic approach to value pricing is "next-best alternative pricing." This method involves researching what alternatives customers have to the company's product or service.
Best-practice companies go further and make the "next-best alternative" approach a mandatory team effort. Teams discuss the cases and role play negotiations. Creating a database of the next -best alternative cases also helps disseminate the new pricing knowledge.

3. Move from "sales reps" to "value negotiators"

Determining the best price means nothing if the sales rep can't convince the customer to accept it. For this reason, it's critical that price setters sharpen their business skills. They need to use sound judgment to manage time, negotiate thoughtfully, and adjust pricing guidelines in order to maximize value and minimize the risk of customers defecting.

Determining the best price means nothing if the sales rep can't convince the customer to accept it.

Focusing on building negotiating skills is critical. In practice, this often requires a three-step process. In the first step, the sales rep spends time understanding how the price recommendations are made and what the reasons for them are. This understanding provides him or her with confidence that the price makes sense and is defensible. In the second step, the sales rep-often with a manager's help-develops a set of arguments to support the price. This will include communicating the true cost of each element of a given service or product, with particular focus on those items that the customer values most. The third step is about preparing the actual negotiation by identifying concessions, starting and walk-away points, and practicing to anticipate behavioral biases and develop sound skills.

It takes more effort to build the necessary skills to become a "value consultant," but it pays off in the long run. Sales reps start to identify significant price-increase opportunities, prepare better fact-based negotiations, and feel more confident in executing the increases and explaining them to customers. One rep who took part in a pricing-excellence transformation explained, "It had become increasingly challenging to defend overall price increases to customers. After this program, it was much easier to understand and communicate the increases, and to actually succeed in the negotiations."

4. Provide on-the-job training to build confidence

While most companies understand it's important to build the pricing skills of their people, few move beyond basic training in classes or online. Successful companies, however, use adult-learning techniques, such as experiential learning, to embed the new skills in the front line. The most effective programs rely on a mixed model of education and implementation known as "field-and-forum."

Forums consist of two- or three-day workshops. Participants learn theory and frameworks by reviewing case studies and using more interactive formats. After each forum there is a “field” stage, in which participants apply their new knowledge to real-life situations, accompanied by experts who can provide feedback and guidance. This not only sustainably upgrades the company’s pricing capabilities; it also delivers sizable bottom-line impact throughout the program.

One company used coaches to help each person on the salesforce understand the new pricing process, including how to get the most from the pricing tool. This one-on-one support was intensive, but also crucial in ensuring pricing insights translated into higher prices-and higher profit. “This is the first time we can truly benchmark and understand the performance of our salesforce,” said its national sales manager. To reinforce the importance of building capabilities, employees need to see facts, not just anecdotes, about how ineffective pricing hurts the bottom line.

The field-and-forum approach boosts the salesforce’s confidence in communicating about and defending price increases to customers.

A global petrochemical company, for example, rolled out a pricing-excellence transformation program that included several intense training sessions on how to use the new system as well as group coaching sessions to analyze each sales manager’s portfolio with the new toolkit. In roughly five months, sales managers in the pilot division identified more than 400 transactional pricing opportunities, contributing to a total bottom-line potential increase of EUR 10 million.

5. Sustaining long-term success

In our experience, even the best pricing programs will fail in the long term without a deliberate commitment to making necessary cultural changes. Companies need a specific approach to overcome entrenched habits and shifting priorities that doom most change programs. Ingraining pricing success over the long term requires putting in place an “influence model” that includes: role modeling, fostering understanding and conviction, developing talent and skills, and implementing reinforcement mechanisms.

Even the best pricing programs will fail in the Long term without a commitment to making necessary cultural changes.

While all aspects of the influence model are important, pricing leaders should pay particular attention to developing talent and skills by providing coaching to their people. “The power of coaching was a critical success factor for our pricing transformation,” says Tom 0’ Brien, group vice president and general manager for Marketing & Sales at Sasol. “We now want to improve the levels and capabilities of our people’s coaching so that they can coach each other. And that’s going to lead to sustainability long term.”

The other aspect to focus on is the reinforcement mechanisms: key performance indicators (KPis) across all commercial activities. While these performance-management systems can be detailed, the best ones automatically consolidate results into a single reporting system that allows management to monitor overall pricing performance as well as the individual sales rep’s performance against targets.

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A pricing transformation that delivers the most impact is tightly integrated with a broader set of initiatives that improves commercial performance for the business overall. But at its core, pricing excellence is about combining effective analytics with relevant capabilities.

A longer version of this article appeared in Sales Management Review, 9/10, 2013

ARTICLE

Understanding your options: Proven pricing strategies and how they work

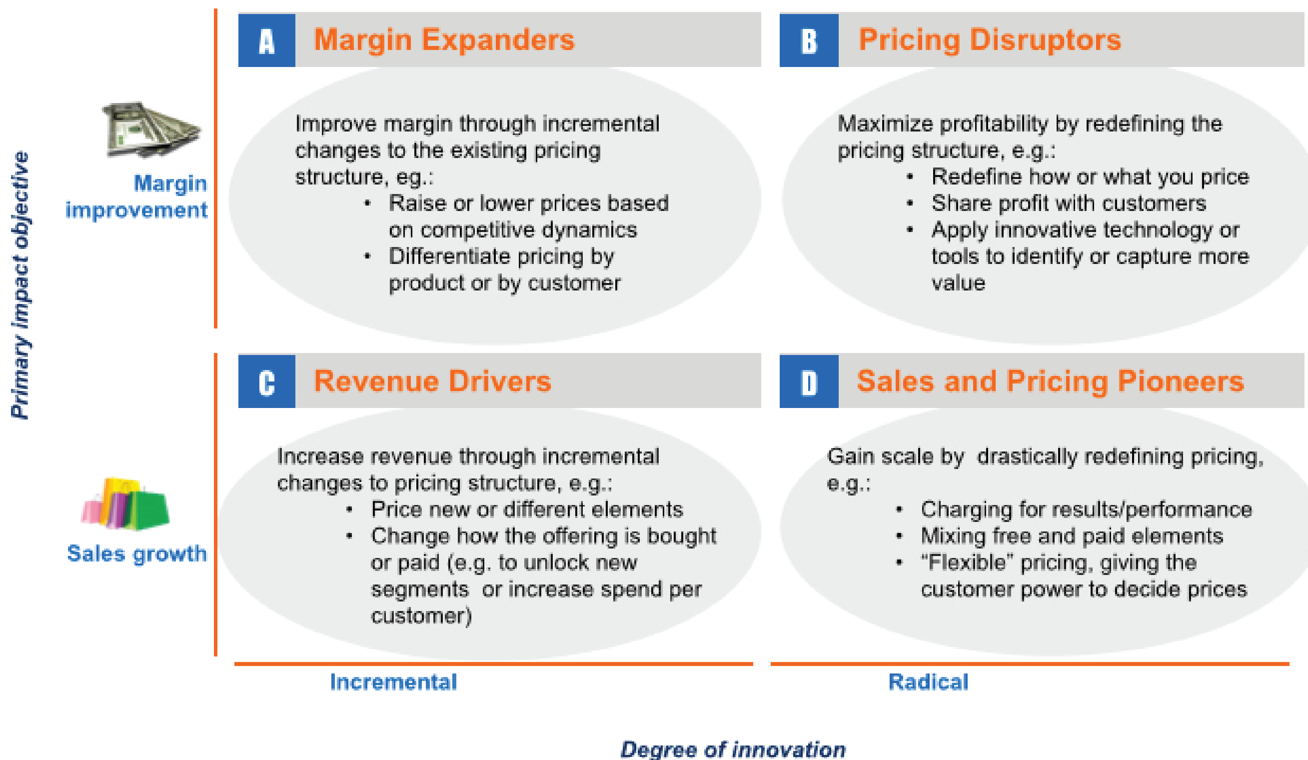
by Kevin Chan, Jay Jubas, Berenika Kordes, Melissa Sueling

"The single most important decision in evaluating a business is pricing power," Warren Buffet, CEO Berkshire Hathaway, once said. "If you've got the power to raise prices without losing business to a competitor, you've got a very good business. And if you have to have a prayer session before raising the price by 10 percent, then you've got a terrible business."

As the quote reflects, pricing is the most powerful lever for driving or destroying the operating margins of a company. In our experience, effective pricing strategies and tactics can deliver a 2 to 7 percent increase in return on sales.

In an analysis of hundreds of companies and pricing approaches, we found four pricing strategies that deliver sustainable results (see Exhibit 1). Not every strategy will be relevant or even feasible for every company- much depends on the market context, the business strategy, and your own capabilities. Still, we've found that periodically reviewing strategic options is helpful in challenging established thinking and sparking new ideas about how to approach pricing.

EXHIBIT 1: Four Types of Pricing Strategies



A. Margin Expanders

For many companies in mature markets where there is heavy competition, the prudent and realistic pricing strategy involves small, incremental steps to improve margins, usually within the existing segments, products, and pricing structure. This can mean expanding margins through small regular price increases, defending against unnecessary giveaways, segmenting the offering, applying surcharges, passing on changes in cost to serve, and pricing in additional sources of value (e.g., service). This approach allows companies to expand their profitability over time without disrupting competitive dynamics or customer expectations. To succeed, margin expanders must have clear insight into margin leakage (i.e., where, when, and how the "pennies roll off the table" and what the impact of that is) and relentless discipline in rectifying the issue.

Example – Dow Corning: Price and brand differentiation

In the late 1990s and early 2000s, the silicone industry was seeing declining margins due to commoditization, unfavorable changes in legislation, and increased competition. Instead of succumbing to price pressure, Dow Corning did a deep analysis of their customer segments and discovered a large and emerging group of price-sensitive customers who were pulling prices down. To cater to this group, Dow Corning introduced a low-cost brand (Xiameter) at a much lower price point while at the same time keeping the existing Dow Corning products at the premium price point. The tiered pricing strategy allowed Dow Corning to target a much broader part of the market while protecting the profits of its existing offering.1

B. Pricing Disrupters

Companies in new categories or in categories under significant threat often look to bolder, disruptive pricing strategies to define or defend their business model. These approaches are often founded in a belief that more value can be unlocked for the customer and the supplier through a new model that reduces the downside or increases the upside for either party. These models can include profit sharing with customers, pricing agreements that factor in risk (e.g., cost-of-materials triggers), and changes in the unit sales model (e.g., per hour of use vs. per box). To succeed with this strategy, companies need to conduct in-depth analytics and model scenarios to understand the range of outcomes for both sides. In addition, they need to be thoughtful about how to manage the downside, how competitors will respond (disruptors can face dramatic reactions from competitors), and what to do if I when others follow suit. Companies can gain an early advantage by disrupting the pricing model, but keeping that advantage can be difficult.

Example—BASF: Change in business model by moving to a pay-for-results pricing model

BASF, like many of its competitors, used to sell car paint at a price per gallon to OEMs and automotive dealerships. Quite naturally, workshops wanted to keep paint consumption at a minimum to reduce costs, which led to lower-quality paint jobs, reflecting poorly on the customer and, by extension, on BASF. As BASF's web site details, the company decided to go from being a paint supplier for automotive OEMs to a solutions partner with its customers to improve the final product, so they moved from price per gallon to price per painted car. Taking over the OEM's paint shops to deliver painted cars also removed a distraction from the customers' core business, allowing the car-painting process to become better managed. The impact? With the new pricing model, BASF reduced paint consumption per car by 20 percent and saw 20 percent higher margins and a 40 percent increase in its European market share.

C. Revenue Drivers

Pricing improvements that focus on growing revenue look at the pricing strategy as an enabler to bring in more business and drive deeper penetration in the existing customer base. This can mean providing introductory offers to bring in new customers, subscription models to build on an installed base, contracting to extend the lifetime value of a customer, and bundling to increase revenue per customer. Success in this model requires maintaining profitability (i.e., not giving away too much), keeping churn low, managing customer acquisition costs, and monitoring competitive dynamics to avoid price or share wars. "Freemium" pricing has quickly emerged as a popular pricing model in online service offerings. With the Internet pushing the marginal cost of content distribution close to zero, and a large number of new players competing for users, freemium pricing (giving the basic offering for free and charging for a premium version or additional content) has quickly caught on.

Example-Expensify: Freemium subscription model enabled fast market penetration

Expensify, an online expense-reporting and management system established in 2008, uses a subscription model offering customers 10 free scans per month for its receipts-scanning and transaction-organizing service. Users can elect to upgrade to one of the tiered subscription models based on their needs. The service became hugely successful; by 2012 Expensify was used by over 100,000 companies.

D. Sales and Pricing Pioneers

Perhaps the most radical pricing strategy is to go after large-scale sales growth and radical margin change simultaneously. This is about more than just finding a new channel or replicating an established model from another sector; it's a new way of thinking about pricing. Sales and Pricing Pioneers drive top-line growth by implementing completely different ways of working to find new pockets of growth and value, such as introducing new services or new business models that integrate new portions of the value chain. This approach is most often used in relation to new technological advances (e.g. tablets, apps, cloud computing) with the potential to disrupt the business environment. To succeed in this model, companies need to pay constant attention to balancing the objectives of sales growth with margin attainment while making selective adjustments to strategy when necessary.

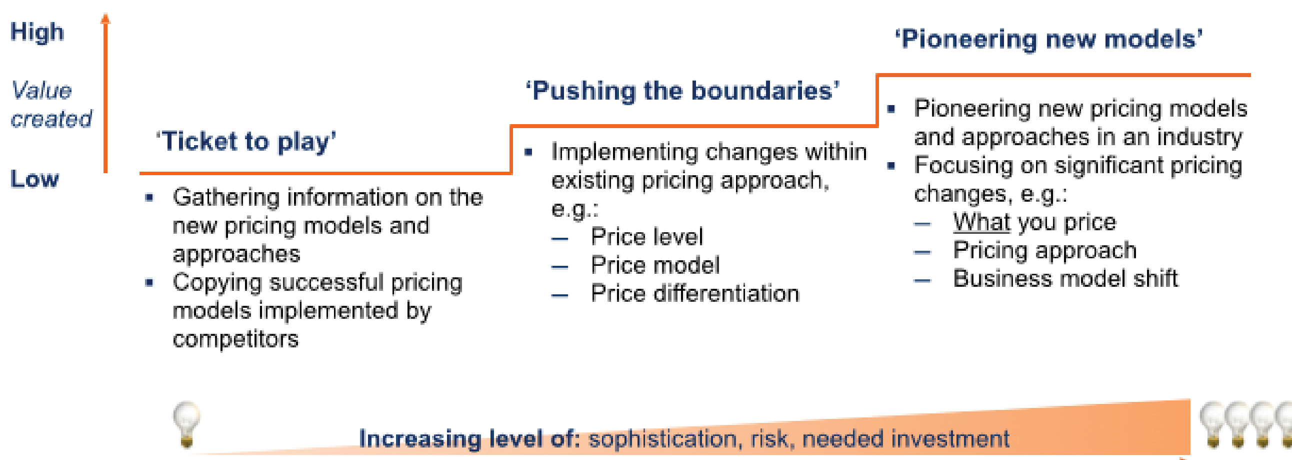
Example: Rolls-Royce: New software advances to lure risk-averse customers

The term "power-by-the-hour" first appeared in aircraft engine vocabulary in the 1960s. Rather than selling capitalintensive engines, Rolls Royce sold airlines "power-by-the-hour" contracts that charged a fee for every hour a plane flew. According to the company's annual reports, it was an answer to the airlines' capital shortage and its frustration with unpredictable service costs. It was a win for airlines since the more the plane flew, the more revenue they earned. Rolls Royce considered it a win, too, since the company had bolstered aircraft engine performance by acquiring software companies to collect cockpit data and monitor engines, allowing them to develop predictive maintenance technologies that kept aircrafts flying more. In addition, Rolls Royce differentiated its services, offering four packages with increasing degrees of service. According to its annual reports the bundled solution increased customer loyalty with a more tailored offering ("Pay only for what you want"). This radical approach to pricing provided the company with underlying services revenue growth of 9 percent per year between 2004 and 2011 and led to a greater than 30 percent improvement in average time between engine removals.

Moving up the curve

While these four models show different pricing strategies, the pace of innovation within a strategy depends on the depth of a company's commercial capabilities, its customers, the marketplace, and the appetite for risk.

EXHIBIT 2: Pricing Innovation Curve



We have found that companies generally progress along three phases of a maturity curve, each with its own set of goals and necessary capabilities:

- **Phase 1: Ticket to play.** These companies have emerging-to-strong analytic capabilities that help them form and execute against a pricing strategy. They are aware of the pricing situation in the market and understand the pricing schemes of their competitors and of companies they aspire to emulate. This basic competitive intelligence, however, does not necessarily extend deeply into pricing, and companies at this level rarely have experts dedicated to pricing analytics and insights about pricing behaviors.

- **Phase 2: Pushing the boundaries.** Here companies are masters of the traditional pricing model and are experimenting with new variations-bundling, segmented offers, partnerships, etc. This approach requires more sophisticated capabilities and tools that move beyond analysis to developing even more granular views of prices and needs by product, customer, channel, and region. Those insights feed into product development, marketing messages, salesforce quotas, and overall company aspirations. These companies have instituted a systematic process for reviewing deal wins and losses, checking competitor pricing, understanding what customers want, and making the necessary price adjustments. Their pricing teams push to understand what is driving the customer. An effective organization in this phase has cross-functional teams who meet at least monthly to discuss pricing, analyze historical data, and decide on actions to take based on the insights derived from analysis.

- **Phase 3. Pioneering new models.** Companies at this level have stretched the traditional pricing model as far as they can (or want to), and have decided to differentiate themselves with a new model. This requires a common commitment to the importance of pricing, dedicated pricing leaders, well-defined pricing processes, and performance management that supports those goals. These more innovative companies embrace a test-and-learn approach, where new pricing models are quickly tested on the front lines, results reviewed, and adjustments made. They understand that innovation doesn't happen in a vacuum so they invest in experiments, learn from them, and develop a comfort with failure. In many cases, there are dedicated and nimble cross-functional teams tasked with driving innovation. When ready to commit to a new opportunity, for example, these companies are able to identify and secure the necessary talent (either from within the organization or outside) and get them on the job quickly. Speed and action are at the heart of these organizations.

Companies considering evolving and deepening their pricing capabilities need to understand how pricing fits into the business's overall strategy. Only at that point does it make sense to evaluate various pricing models and develop a forward-thinking commercial organization that sets prices, and doesn't just take them.

[1] *hbswk.hbs.edu/archive/4677.html; Dow Corning's Big Pricing Gamble, Harvard Business School; 3/7/2005 by Loren Gar*

CASE STUDY

Turning pricing complexity into a price advantage that boosts return on sales

by Marco Guida, Jorge Postigo, Stuart Schardin

In this case example, McKinsey helps a client to become an organization that effectively used analytics to make better and more profitable decisions.

Pricing has become a Big Data question without an easy answer. The vast complexity around pricing today presents many B2B companies with a dilemma: how to increase returns by making better pricing decisions without investing prohibitively high amounts of time, effort, or resources.

That challenge bedeviled one multinational chemicals company. The majority of its pricing decisions tended to be based on across-the-board "mass pricing," resulting in significant losses. Unwarranted high prices were driving "good customers" away, while opportunities were squandered with customers who were willing to pay more. Pricing complexity-thousands of products for tens of thousands of customers-made it difficult to develop a manageable fact base for sales reps and get to a level of detail that would unlock pricing opportunities.

The technology exists to make better pricing decisions. What is often lacking, however, is a complete program that integrates the technology with the people on the front lines who will be using it and a system to sustain pricing excellence over time.

1. Build an analytics engine

Before analyzing the data, the team had to create a useful data set. Pulling in and cleaning data from several different sources, they created a huge data warehouse containing all the transaction history on price, products, and customers for the previous year. For the first time, the company had full transparency into the real cost of deploying pricing and salesforce discount strategies.

Making sense (and use) of the data, however, required a sophisticated tool. The company developed one based on statistical algorithms that allowed the team to get a much more granular view of prices and customers. For example, it clustered segments by product and recommended target prices for each one. The tool also incorporated advanced visualization techniques so that pricing and sales reps on the front lines could easily understand and manipulate the data.

2. Involve the front line

The tool determined pricing guidelines, but they had to be tested. The pricing-analytics team incorporated active input from the front-line pricing and sales managers, who had good experience with individual customers and the marketplace. The managers and reps reviewed each price recommendation and adjusted it for the risk of losing customers.

This risk-adjustment phase incorporated quantitative and qualitative factors (such as average profitability per client or recency of the pitch) covering market, customer, and product specifics. To help with the assessment, the team developed a simple salesforce risk survey that only took fifteen seconds to answer for each customer.

3. Keep the implementation simple

Many good pricing solutions get bogged down in cumbersome validation procedures. To eliminate that problem, the team developed an online workflow management system that used advanced visualization techniques so that sales managers and reps could quickly review and validate the size and timing of every price increase. It also provided standardized validation analyses, such as benchmarks vis-a-vis other sales reps, to help sales managers challenge the salesforce to perform better.

Many good pricing solutions get bogged down in cumbersome validation procedures.

This referral and approval process was simplified by incorporating it within a single system, while the output of validated prices was tailored so as to be uploaded to the client's existing software systems. Critical to the success of the approach was having the client influence how it was developed (such as choosing how to quantify the risk variables) as well as tailoring the output to be easily integrated into existing Enterprise Resource Planning (ERP) systems.

4. Build for the long term

The most difficult part of a pricing program is getting beyond the initial short-term burst of energy. The company committed to a program grounded on training a set of trainers, who were made responsible for replicating the initial program throughout the organization. The training focused on helping pricing managers better segment customers, design the right risk assessment for a specific business unit, and build support across the organization.

To build confidence in the front-line salesforce to negotiate and implement pricing changes, the team developed experiential learning programs that required reps to take part in tailoring the pricing approach, practice customer negotiations in specifically designed role plays, and engage in brainstorming sessions to generate price-increase arguments/counterarguments.

Impact

This effort resulted in a return on sales between 3 percent and 7 percent across seven different countries in which the company rolled out the program.

INTERVIEW

An inside view: turning pricing into long-term value

Tom O'Brien, Group Vice President and General Manager, Marketing & Sales at Sasol, speaks with McKinsey director Dieter Kiewell about how he brought a new pricing mentality to the company, and how improving marketing and sales practices increased profits.

Profits in pricing: focus of change

"When we started on our journey toward marketing and sales excellence, our key objectives were improving profits and increasing customer satisfaction. Initial diagnostics of our marketing and sales practices showed that 30 to 50 percent of the value that we felt we could find and deliver was in price-to-profit realization (i.e., refining pricing practices to realize greater profits), so we focused on this.

"Our estimate-that there was around a billion rand of profit-improvement opportunity-gave us the incentive to look in more detail. Deep quantitative analysis identified two to three billion rand of profit -improvement opportunity that we felt we could realize by improving marketing and sales practices.

> **"Deep quantitative analysis identified two to three billion rand of profit improvement opportunity ...."**

"The culture and the history of Sasol have been very volume-oriented. Coming initially from the synthetic-fuel side of the business, then growing downstream into the chemicals business, we had a lot of 'fatal production.' As a result, marketing and sales teams became very oriented to moving volume, too. Clearly, a constant balancing of pricing and volume is critical to any successful business, so we purposefully decided to focus on pricing first, then on the whole idea of growing our business in a profitable way."

The secrets to making a change program work

"As we worked with the business units to start implementing changes in the way we did pricing, we saw that we had units with will and very little skill, and we had some units with very high skill but very little will. Obviously, a combination of high will and skill is best, but we found we had high success with those with will, even if they had little skill, because they were open-minded about coming along and learning. So we sought individuals who were willing to

say, 'You know what? I didn't do everything perfectly in the past. I'm willing to listen to somebody else and have the opportunity to learn, regardless of where I am in my career.' That's who we worked with.

"A program like this-and I've been through many-always has its skeptics. That's a normal part of the process, and one has to be prepared for it. Just face it straight on, not in a confrontational way, not in an argumentative way, but by sitting down with individuals, human to human, and having an open discussion about their concerns, and about what we can do to assist them. Fortunately, more times than not, that works. Sometimes it doesn't, and one just has to move on.

"The foremost factor in making people willing to change was the incentive to improve the bottom line. Second was the opportunity for capability-building. This wasn't 'us' coming in and doing it to 'them'. This was them taking ownership of a process where they're doing the work, they know the business; they're identifying the opportunities, developing business cases, and delivering.

"Coaching is not something we were used to in our culture, and early on in our journey, we underestimated its power. Improving the capabilities of our people so that they can coach each other is a critical success factor that we have to get right. It's going to lead to sustainability in the long term.

A new way of looking at—and benefiting from—data

"We're a company full of engineers who deal with data all the time, but, ironically, our sales and marketing teams were not dealing with data to enable decisions. So we brought facts based on data into the discussion about price-to-profit realization. The teams knew their pricing, they may have known their volumes, but this was something more, extremely granular data, literally from each and every invoice, by product, by customer, by packaging.

> **"Through experiential learning and working with the new tools, the skeptics realized, 'Wow, I can actually make better decisions with data' "**

"Data in a form and of an accuracy to allow teams to analyze their business and make better decisions wasn't something we'd had in our culture. Now we give them the tools and the training to be able to do that.

"There were skeptics about this, because they'd run their businesses for a long time without data. But through experiential learning and working with the new tools, they realized, 'Wow, I can actually make better decisions with data' "

Building for the long term

"The real success of this is not if we deliver two to three billion rand, but if we deliver that and then identify another two to three billion, and deliver on that, again and again. This goes on each year, delivering margin improvement every year in the range of, say, 1 to 5 percent.

"To make sure the change was working, we set up a very rigorous process in which the businesses tracks this from the very beginning of opportunity identification through seven stages to the point where we can actually reconcile the delivery of the money in the income statement."

ARTICLE

Using Big Data to make better pricing decisions

by Walter Baker, Dieter Kiewell, and Georg Winkler

It's hard to overstate the importance of getting pricing right. On average, a 1 percent price increase translates into an 8. 7 percent increase in operating profits (assuming no loss of volume, of course). Yet we estimate that up to 30 percent of the thousands of pricing decisions companies make every year fail to deliver the best price. That's a lot of lost revenue. And it's particularly troubling considering that the flood of data now available provides companies with an opportunity to make significantly better pricing decisions. For those able to bring order to Big Data's complexity, the value is substantial.

On average, a 1 percent price increase translates into an 8.7 percent increase in operating profits.

We're not suggesting it's easy; the number of customer touchpoints keeps exploding as digitization fuels growing multichannel complexity. Yet price points need to keep pace. Without uncovering and acting on the opportunities Big Data presents, many companies are leaving millions of dollars of profit on the table. The secret to increasing profit margins is to harness Big Data to find the best price at the product-not category-level, rather than drown in the numbers flood.

Some of the most exciting examples of using Big Data in a business-to-business (B2B) context actually transcend pricing and touch on other aspects of a company's commercial engine. For example, "dynamic deal scoring" provides price guidance at the level of individual deals, decision-escalation points, incentives, performance scoring, and more based on a set of similar win/loss deals. Using smaller, relevant deal samples is essential, as the factors tied to any one deal will vary, rendering an overarching set of deals useless as a benchmark. We've seen this applied in the technology sector with great success-yielding increases of 4 to 8 percentage points in return on sales (versus same-company control groups).

Too big to succeed

For every product, companies should be able to find the optimal price that a customer is willing to pay. Ideally, they'd factor in highly specific insights that would influence the price—the cost of the next—best competitive product versus the value of the product to the customer, for example-and then arrive at the best price. Indeed, for a company with a handful of products, this kind of pricing approach is straightforward.

Source: multinational energy company (disguised example); McKinsey analysis

It's more problematic when product numbers balloon. About 75 percent of a typical company's revenue comes from its standard products, which often number in the thousands. Time-consuming, manual practices for setting prices make it virtually impossible to see the pricing patterns that can unlock value. It's simply too overwhelming for large companies to get granular and manage the complexity of these pricing variables, which change constantly, for thousands of products. At its core, this is a Big Data issue.

Many marketers end up simply burying their heads in the sand. They develop prices based on simplistic factors such as the cost to produce the product, standard margins, prices for similar products, volume discounts, and so on. They fall back on old practices to manage the products as they always have or cite "market prices" as an excuse for not attacking the issues. Perhaps worst of all, they rely on "tried and tested" historical methods, such as a universal 10 percent price hike on everything.

Four steps to turn data into profits

The key to better pricing is understanding fully the data now at a company's disposal. It requires not zooming out but zooming in. As Tom O'Brien, group vice president and general manager for marketing and sales at Sasol, said of this

approach, "The [sales] teams knew their pricing, they may have known their volumes, but this was something more: extremely granular data, literally from each and every invoice, by product, by customer, by packaging."

To unlock the power of their data, companies need to do four things:

B2B companies tend to manage data rather than use it to drive decisions.

1. **Listen to the data.** Setting the best prices isn't a data challenge (companies generally already sit on a treasure trove of data); it's an analysis challenge. The best business-to-consumer companies know how to interpret and act on the wealth of data they have, but B2B companies tend to manage data rather than use it to drive decisions. Good analytics can help companies identify how factors that are often overlooked-such as the broader economic situation, product preferences, and sales-representative negotiations-reveal what drives prices for each customer segment and product.

2. **Automate.** It's too expensive and time consuming to analyze thousands of producs manually. Automated systems can identify narrow segments, determine what drives value for each one, and match that with historical transactional data. This allows companies to set prices for clusters of products and segments based on data. Automation also makes it much easier to replicate and tweak analyses so it's not necessary to start from scratch every time.

3. **Build skills and confidence.** Implementing new prices is as much a communications challenge as an operational one. Successful companies overinvest in thoughtful change programs to help their sales forces understand and embrace new pricing approaches. Companies need to work closely with sales reps to explain the reasons for the price recommendations and how the system works so that they trust the prices enough to sell them to their customers. Equally important is developing a clear set of communications to provide a rationale for the prices to highlight value and tailoring those arguments to the customer.

Implementing new prices is as much a communications challenge as an operational one.

4. **Actively manage performance.** To improve performance management, companies need to support the sales force with useful targets. The greatest impact comes from ensuring that the front line has a transparent view of profitability by customer and that the sales and marketing organization has the right analytical skills to recognize and take advantage of the opportunity. The salesforce also needs to be empowered to adjust prices itself rather than relying on a centralized team. This requires a degree of creativity in devising a customer-specific price strategy, as well as an entrepreneurial mind-set. Incentives may also need to be changed alongside pricing policies and performance measurements.

We've seen companies in industries as diverse as software, chemicals, construction materials, and telecommunications achieve impressive results by using Big Data to inform better pricing decisions. All had enormous numbers of SKUs and transactions, as well as a fragmented portfolio of customers; all saw a profit -margin lift of between 3 and 8 percent from setting prices at much more granular product levels. In one case, a European building-materials company set prices that increased margins by up to 20 percent for selected products.

To get the price right, companies should take advantage of Big Data and invest enough resources in supporting their sales reps-or they may find themselves paying the high price of lost profits.

A longer version of this article originally appeared in McKinsey on Insights & Publications.

ARTICLE

How to price risk to win and profit

by Dieter Kiewell, Sam Saatchi, and Kevin McLellan

Any project has an associated risk-delays, cost overruns, unexpected government interventions, market dynamics, etc. For large projects involving significant operational commitment, these risks can turn into considerable and unexpected financial costs. We've seen overruns hit tens and hundreds of millions of euros/dollars or more.

Despite these significant financial penalties, companies rarely give risk its due when it comes to pricing. In many cases, companies still treat risk as an afterthought. Large construction projects, for example, often simply add a standard "contingency cost" of 5 or 10 percent to cover the risks.

For large projects involving significant operational commitment, risks can turn into unexpected financial costs.

We believe that companies need to take a more deliberate approach to managing and pricing the risk in their portfolio. If risks and their potential costs are low for a project, the company can undercut competitor bids knowing they will still hit their target margin. If risks and potential costs are high, the company can either price the risk into the proposal or simply choose not to bid on the project.

More transparency into the risks across their portfolio can also allow executives to make more informed decisions about budget and resource allocation, create more accurate forecasting plans, and take concrete steps to reduce risk exposure when necessary.

When does it make sense to do risk-pricing analysis? In general, when the business model is changing (e.g., moving from per unit pricing to per use pricing); if the provider carries significant operational risk around service management and implementation; and when there is high volatility in the marketplace. While financial instruments to hedge against risk are sometimes available, they generally don't apply to these kinds of risk.

The risk challenge

We have seen some notable examples of companies successfully (and profitably) incorporating risk into their pricing. In healthcare, some device companies are starting to manage volatility in ordering by implementing "unfulfilled volume" clauses in their contracts, where discounts are withheld if the buyer (a hospital, usually) doesn't reach the agreed thresholds in ordering. In healthcare services, entire companies are springing up based on their ability to manage risk on behalf of payers. NaviHealth in the U.S. was founded to improve utilization management of care after a serious illness or surgery. It raised $35 million in September 2013 before the company even launched.[1]

Far more often, however, companies don't capture all the benefits of risk-based pricing. Part of the reason is a reluctance to use what are perceived to be overly complex risk models when "experience" has worked well enough in the past. This is compounded by the fact that many companies don't have the skills to develop sophisticated risk models.

But it's not just about running models; it's also about understanding how to actually price and track risk. That requires understanding the cost, risk, and value drivers of all aspects of a project. A business doesn't just need to understand what can go wrong; it also needs a fact-based perspective on the probability that something will go wrong. And because projects often last years, companies need to track and adjust their risk over time.

A significant issue is the disconnect between the commercial people who negotiate the contracts and the operations people who execute them.

The other significant issue is the disconnect between the commercial people who negotiate the contracts and the operations people who execute them. The incentives of the current contract structure generally reward salespeople for closing the deal, not for carrying it through. On the other hand, the incentive for the operations people is to build in as much risk mitigation as possible, which drives up the cost of the bid. Regardless of incentives, these two groups simply do not sufficiently share insights to competitively price risk.

How to capture the benefits

1. Know the risk

With the wide availability of data and advanced analytics, companies now can develop risk models that weren't possible before. They can scale the complexity of the analysis up and down, but the deeper the analysis, the better the information for making decisions. Most companies, however, start with almost nothing, so even putting together a set of "orders of magnitude" estimates based on hypotheses lays a useful foundation for creating awareness of risk and factoring it into the process.

From this starting point, companies can focus on the top-priority risks and do deeper analysis and develop simulations of potential outcomes for each. For example, construction projects should incorporate pricing trends and market dynamics into the cost estimates of raw materials. Risk analysts then need to calculate the probability of each risk occurring, factoring in distributions and deviations. Calculating the cost of risk outcomes and the probability of their happening leads to a probable-cost range.

2. Develop a risk-pricing plan

Once the risks have been identified, the company has to price and come up with an approach for each (or at least for the most important ones). Generally this is a choice between pricing the risk into the contract, mitigating it, managing it during implementation, or simply walking away from it. Each option, of course, comes with a trade-off and cost. Almost any risk, for example, can be mitigated. Locking in the price of a basic material needed for a project can reduce the risk of price volatility though it may increase costs. Understanding these trade-offs helps in deciding on which risks to take.

Companies need to carefully consider how the price of risk affects their bid compared to their competitors'.

When quantifying risk, companies need to carefully consider how the price affects their bid compared to their competitors' bid. That requires alignment between sales and operations. One international telecom company addresses this issue by having a deliberate two-phase process. In the first phase, the company assesses the cost of the identified risks. In the next phase, there is a negotiation between the sales and delivery teams about risks and costs. The idea is that through healthy debate, the groups can arrive at a price that is both feasible and competitive. This approach requires first

thoughtfully considering risks and mitigation plans, but then building in a reality check so that the company is competitive during the bidding process.

An important benefit of this internal negotiation approach is that it provides the company with a much deeper understanding of which deals to take and which to walk away from, as well as ensuring that excessive risk buffering does not inhibit the price competitiveness of the offer. One telecoms company that took this approach improved win rates by 5-l 0 percent in deals where risk played a role.

3. Negotiate the risk

Risk has a cost and a value. In many cases, however, the customer has little idea of the risks and therefore has a limited appreciation of what they are worth. For this reason, contract negotiation has to include a clear articulation of risks and their value, which is why prior risk analysis is particularly valuable. Negotiators need to understand both the risk and the rationale for pricing it, and be able to defend it when speaking with the customer.

Contract negotiation has to include a clear articulation of risks and their value.

Given the uncertainty that's inherent in risk, pricing leaders will often work with their customers to manage and build it into the contract. Managing risk in this way is actually less about coming up with a specific "number" to quantify it than it is a matter of building in agreed-on trigger points over the course of the project that are specific opportunities to adjust the prices or change the offering/service levels if a potential risk occurs.

Capabilities needed to unlock value from risk

To better manage and price the risk inherent in their deals, companies need to:

- Be targeted with the analysis and simple with the output. The temptation in analyzing data is to use all the data that's available. That's a waste of time and resources. Part of any effective risk analysis is identifying which data are relevant and important and working them into the model deliberately. Any model will need to allow for sales reps to get risk-based pricing recommendations by segment.

- Train the reps in risk-pricing negotiations. Front-line reps will also need to be trained to understand the risk calculations and communicate them to customers during price negotiations. Effective training should include mock negotiations so reps understand how to position the risk as well as defend the price. That training needs to be supplemented with support from managers during actual negotiations so that the rep can get quick feedback and build his/her confidence.

- Create a risk review process. Risk needs to be treated like any other contract term with a systematic process for reviewing it and addressing any resulting issues. Risk-review milestones should be part of the contract, to allow teams to reassess risk with the customer (using traditional green, yellow, red codes, for example) and make any necessary adjustments. The process should be both systematic, and flexible enough to respond to changing situations. How regularly a risk review needs to be done depends on the length of the project. This kind of active and deliberate risk management also provides leadership with great transparency into changing risk exposure before it's too late.

Risk review should be both systematic and flexible enough to respond to changing situations.

- Capture learnings for the future. In many cases, we find that companies do not have a strong foundation for assessing risk. Most analysis, when it happens, basically starts at zero. To redress that omission, companies should

invest in basic knowledge management to capture and organize risk learnings that can then be referenced for all future risk analysis.

- Build risk analysis talent and capabilities. Companies need to invest in sophisticated analytical tools and models that allow sales reps to both analyze and segment risk as well as develop differentiated pricing recommendations based on that analysis. Developing effective risk-based pricing often requires multiple interactions with the customer to continuously improve its accuracy. Identifying risk and quantifying it are, of course, two different skills. Companies need to find people who can not only create probability calculations but also develop plausible risk scenarios.

- Connect the commercial and operations functions. Both groups need to have a shared understanding of the drivers of risk and costs, which requires actively working together during the bidding process. This coordination can't be an ad hoc effort but must be part of a deliberate schedule of meetings tied to milestones in the bidding process. To foster the feeling of shared risk and build incentives for working well together, part of each group's compensation should be tied to how well risk is managed, not just during negotiations but over the life of the project. That often creates some knotty governance questions, but leaders need to address this issue so that both sales and operations people are accountable.

Risk is often the most important element in determining a project's profitability. While businesses need to actively invest in new capabilities to manage for it, even taking initial steps to better understand the cost and value of risk and build it into contract negotiations can have a significant impact on profits.

[1] *"The President Wants You to Get Rich on Obamacare", New York Times, Oct 30, 2013*

ARTICLE

How much value did you give away to close your last SaaS deal?

By Brian Stafford, Shawn Lankton, Nhaim Khoury

Sure, software buyers never expect to pay list price, but SaaS companies are exposing themselves to eight times lower customer lifetime value when they follow the usual on-premise discounting practices.

Not to put too fine a point on it: they're taking a hit on annual recurring revenue per customer, and suffering from uncomfortably high churn.

The upshot? SaaS companies have got to figure out how to control discounting if they expect to maximize customer lifetime value (CL TV). If they don't factor in discounting's impact on future monthly revenue streams, there's a real risk that they won't be able to recover their customer acquisition costs (CAC). One hint on how to do this: be willing to pay for good reps.

Traditionally, buyers of on-prem software have been used to getting discounts of 60-90 percent on the license price. In subscription models such as SaaS, the offerings are usually aligned to value metrics, which should limit the risk of "shelf-ware" and reduce the need for discounting. But the truth is that customers aren't about to let go of those big discounts, and that makes negotiations tough.

To understand these issues better, we looked at 30 companies in our SaaSRadar benchmark database and found that discounting has a big impact in Saas.1

Our research found a "sweet spot" in which SaaS players can discount just enough to attract bigger customers. Those in the 'mid-discount' cluster-10-30 percent off list-are seeing revenue per customer grow by 4 percent per quarter.

By contrast, the deep discounters (offering 30 percent and more off-list) do get faster annual customer growth-50 percent versus 25 percent for the mid-discounters-but their growth in ARR per customer is half that of the middiscounters. And those that discount little or not at all get almost no growth in this metric.

Our work also revealed a clear correlation between rates of revenue churn and levels of discounting by SaaS companies. Interestingly, there's not much difference in actual customer churn across SaaS companies, regardless of how much they go off-list. But there's a definite 30 percent-plus hike in revenue churn for those that offer deep discounts, suggesting that discounting pulls in lower-value customers.

Getting discounting right

So what does it take to establish discounting levels that drive growth in revenue and profit? We have identified three best practices that SaaS companies can follow:

- Reduce discounting when switching costs increase. Discounts can and should be reduced as their leverage diminishes. One way that companies do this right is to allow customers a sizeable discount in year one, a lower discount in year two, and no discount at all from year three onward.

- Strengthen the capabilities of the sales team. It appears that low discounters are hiring (and retaining) more skilled and more experienced sales reps: the SaaSRadar data reveals that reps at the low discounters are typically being paid twice and three times more than those at the firms that discount more. This finding is very relevant for legacy software companies that are moving into SaaS; they must retrain their reps to prevent them from reflexively giving the huge discounts that they been used to offering.

- Formalize discount thresholds for sales teams. As a rule, SaaS companies have not yet mastered laddered discount strategies-but they must. The SaaSRadar data tells us that companies that rely on direct rather than online channels typically offer much higher discounts. The difference? Online discounts are fixed because prices are public, but sales reps sell direct-often with inadequate guidance about what levels of discounting must trigger intervention by senior sales managers.

These findings are the latest from McKinsey's SaaSRadar database-a proprietary benchmark of private and public B2B SaaS companies with annual revenues ranging from $10 million to $500 million. Participants receive a report comparing their performance and metrics to those of a hand-picked cohort of peers. The report's findings help management teams to gain actionable insight into the drivers of growth and CLTV To participate or just to learn more, please visit saasradar.com.

[1]We clustered the companies into three tiers based on their discounting practices: those offering discounts of 10 percent and less, those offering 10-30 percent off list, and those whose discounts averaged 30 percent or more. The companies surveyed have annual revenues of $10-$85 million and similar ranges of ARR per customer.

ARTICLE

Pricing's secret weapon: A well-trained salesforce

by Soenke Lehmitz, Kevin Mclellan, Patrick Schulze

Imagine you supply soup. You sell millions of tins of soup to thousands of supermarkets across a vast set of regions. Having a single price for each tin of soup you supply would certainly make life easier, but you would also be missing out on massive potential profits.

This example may oversimplify the point, but it brings out in sharp relief a fundamental pricing issue across B2B markets today: Companies do not price their products in a way that reflects the value of the product in each local environment. To do so requires a number of capabilities, but one that is often overlooked is a fundamental and sustained change in the mindset of the salesforce (yes, the salesforce, not just the pricing team). We have found that turning your salesforce into a pricing powerhouse leads to a 2-5 percent additional return on sales.

Powering up the salesforce

Most B2B companies have a pricing team, but few elevate the function to a high level of excellence. This group often performs an array of important but basic functions, from capturing pricing intelligence to providing pricing guidance on new products to providing analysis of competitor negotiations. That's a good start, but in our experience, it's not enough. Because their teams don't have the necessary capabilities, companies are still missing substantial opportunities to adjust prices and increase profitability.

Really successful companies empower their salesforce with the right tools and capabilities to get better prices. In many cases, this kind of support leads to sales reps attaining higher

Successful companies empower their salesforce with tools and capabilities to get better prices.

prices than those imposed from above, because they know the customers and have a better sense of the local competitive situations and opportunities. Sales reps at a large engine-manufacturing company, for example, identified a potential price increase of 6 percent over two years-well above the 2 percent target set centrally. The salesforce also identified which customers would accept the rise and which would be likely to look elsewhere. The 2 percent target set by upper management, by contrast, was just a blanket price rise, which historically had created a lot of issues because it was hard to defend it with every customer.

The new breed of sales rep uses insights about the customer, advanced pricing analytics, and strong negotiating skills to get the best possible price. Unfortunately, this sort of sales rep doesn't come ready-made. While recruiting can bolster pricing capabilities with new talent, more often companies need to transform the salespeople they already have. Here's how the best companies do that:

1. "Co-create" the right tools for the job

Companies are awash with data, but sales reps may not have access to it or know how to interpret it, and it's rarely granular enough for sales managers to make informed pricing decisions.

Introducing tools that provide transparency into the price of different product -customer combinations is helpful, but in many cases still overwhelming. There is, however, no single "magical" tool that will solve this problem. What's needed is a tool based on what the sales rep needs and how s/he might use it for a given company's unique situation. Simplifying the analytics output, for example, through user-friendly visualizations (e.g. color-coded deal ratings) is important.

Even a good tool, however, is meaningless unless sales reps have faith in the prices it recommends. To build confidence in the tool requires involving the sales team early and often in the development process. An important byproduct of this process is the "soft training" of salespeople by helping them to become familiar with the tool itself. Many of the rules and analysis are based on assumptions that the sales reps need to challenge, test, and inform. The tool needs to work within the processes that sales reps are already comfortable with, rather than force an entirely new set of processes and behaviors on them.

Even a good tool is meaningless unless sales reps have faith in the prices it recommends.

To accurately guide sales reps on what price they should achieve, deal-target pricing tools should enable real-time comparisons to similar deals, tailor pricing to each customer's profile (e.g., sales history, volume, product mix), and have the flexibility to factor in "local" considerations such as competitive intensity and market conditions. These tools are not directive but show a range of pricing possibilities, empowering reps to make decisions based on their knowledge and understanding of real-time factors affecting the deal.

One medical-products distributor decided to empower reps by building a deal-target pricing tool they could use to determine the right price for every deal. The company started by deciding on the most important factors for each dealin their case, product mix and volume. They added financial factors that influenced the final price, such as payment terms and the competitive environment in the local market. An important aspect of the design was close collaboration with the sales teams in each region to tune the target prices to their customer base.

2. Build confidence by building experience

Translating confidence in the tool into confidence in negotiating prices is a critical next step. Sales rep confidence is a major determinant in capturing price and margin in any negotiated transaction. "There is nothing worse than a sales rep who offers a price to a customer and then has to duck because they fear having a chair thrown at them," said an SVP of sales for a medical-products distributor.

"There is nothing worse than a sales rep who offers a price to a customer and then has to duck because they fear having a chair thrown at them."

Building confidence requires building capabilities through a sustained and dedicated program. Today's leading companies engage in a "field-and-forum" approach that combines workshop sessions with real-world experience in the field, where salespeople can put what they've learned to the test. This is a proven technique for both overcoming resistance and reinforcing the lessons.

The problem is that even these kinds of programs can become overwhelming and cumbersome. And nobody wants to pull their salespeople away from their day jobs for too long to do training. We recommend a rapid "train the trainer" approach. The idea is to quickly provide a basic level of insight to trainers, who then train first -line managers, who in turn train the sales reps. They then practice what they've learned in the field, with periodic opportunities over time to refresh, reinforce, and evolve the learning. Involving the front-line manager is particularly important because sales rep performance is most affected, positively or negatively, by the manager.

Speeding to scale is a critical component for making this approach work. At a medical products and solution company, the team trained the top 100 people in two days. Those people then trained first-line managers for three days over three weeks. Those front-line managers then trained 1,200 people in a day and half. Another company made training the trainers the full-time job for 18 months for four high achievers, which communicated the importance of the effort and greatly increased the program's credibility.

Pay special attention to helping build sales reps' negotiating skills.

It is hard to overemphasize the point that salespeople should train each other in an organization. In this way, they own the process right from the start and have accountability for its success as well. This kind of program also needs to pay special attention to helping build sales reps' negotiating skills. We have found that there are three simple questions sales staff can ask themselves as they prepare for price negotiations: Has anything changed? Do we now have more information? Can I get more information? These lead to more detailed questions around whether the customer's behavior incurs more cost for the supplier, whether the customer is paying for the benefits of the product, and whether any external factors are in play.

What's less simple is to then take these answers and actually negotiate with a customer. Salespeople are often insecure about translating hypothetical concepts into actual discussions. One-on-one coaching by the workshop facilitators during the fieldwork stage is essential, therefore, to help overcome this resistance. First-line managers and even more senior leadership should accompany reps in the field.

For the medical-products company mentioned above, this training approach (combined with upside incentives) resulted in reps who were more confident and captured higher prices in the first six months.

3. Rethink how you manage performance

Periodic reminders from the executive team and communicating success stories are important to build momentum. But developing a pricing approach that reflects the company's goals and sustaining it over time require putting in place the right incentives and key performance indicators (KPis). KPis should focus on goals that are meaningful to the company, such as those that track value created, consolidated profit margin, EBITDA, or growing faster than competitors, for example. In addition, those incentives have to be the same across all the commercial functions (e.g. product management, pricing team, salesforce) so that people in the organization don't work at cross purposes.

Key performance indicators (KPis) should focus on goals that are meaningful to the company.

Meaningful incentives tied to relevant KPis are important. But the best companies go further by tracking performance against those KPis much more actively than their peers. While most companies already require sales managers to review account managers' performance, those conversations often happen annually and are a rigid process primarily based on hindsight. It's better to have regular monthly or even weekly one-on-one meetings in which sales managers quickly check progress against objectives (good visualizations can be particularly helpful here). But they also work with the rep to identify pricing opportunities or potentially profitable measured risks. These meetings can serve as problem-solving sessions that can focus on difficult accounts, identify and develop plans for future value-pricing opportunities, or work on building capabilities. This last point in particular is often overlooked by managers yet is highly motivating for sales reps.

The reality is, however, that for all the careful planning and frequent support, there will always be bumps along the way. The best performance-management programs both anticipate and plan for them. When they happen, companies designate a team to gather the facts quickly and determine the root cause of the problem. They set acceptable ranges for negative events such as customer churn, so that the organization doesn't panic and abandon the new regimen when they occur. Instead, they create a forum for dialogue that's supported and sponsored by senior people in the organization with the authority to resolve problems. This approach often includes an escalation plan for contacting leadership to resolve issues and make any necessary decisions.

This incident planning was invaluable for one medical-products distributor. Soon after it rolled out a new pricing program, one region reported that their prices were wildly off target. This was serious. But instead of abandoning the program, a team came together to figure out the source of the issue. They discovered that the region had a different competitive environment that hadn't been understood before. They then adjusted the program and continued. By keeping their "eye on the prize," they realized their objective of a 3- 5 percent improvement in profit while at the same time identifying additional opportunities through better customer segmentation and offer design.

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The best salespeople are entrepreneurs who know their customers and can spot opportunities. Harnessing that talent in the service of pricing can not only extend their capabilities but also deliver significant value to companies.

ARTICLE

How tools & technology can help manage and track pricing performance

by Brian Elliott, Nicolas Magnette, and Stuart Schardin

A construction-materials company sold exclusively through distributors, and sales reps were incentivized based on volume. Prices were set, however, by a central team. To protect margins, the team increased prices across the board; volumes fell, which hurt the company and alienated sales reps.
Too often, staff-and sales reps especially-struggle to see how their own goals match those of the organization. Companies introduce all manner of performance-management systems, but they can become complex, cumbersome tools that leave

Too often sales reps struggle to see how their own goals match those of the organization.

employees less motivated than before. More worrying is the research showing that a large share of employees simply don't believe that performance-management systems actually help companies achieve strategic objectives1.

The biggest challenge is usually that the outcomes on which sales reps are rewarded sit too far beyond their control. Compensation is often tied to volume rather than value. As a result, sales reps can feel especially frustrated because their incentives aren't aligned with what the company values. The sales reps at the construction-materials company referenced above certainly thought so.

The challenge for companies is to develop a performance-management system that benefits both the sales reps and the company. That requires both a system that works and a way to track performance. In our experience, companies that outperform their peers do the following three things well:

1. Uncover data on performance

Measuring performance requires transparency into data that matters, such as profitability. Without that data, managers can't tell whether sales rep pricing activities are helping or hurting. A European steel producer had data, for example, on how overall profitability was broken down according to the levers that were most important in the sales process, such as different types of rebates, transportation costs, and direct -marketing costs. Sales managers, however, lacked the tools to drill down to the individual customer or product level, which meant that they could never measure the profitability of any given transaction or take actions to improve it.

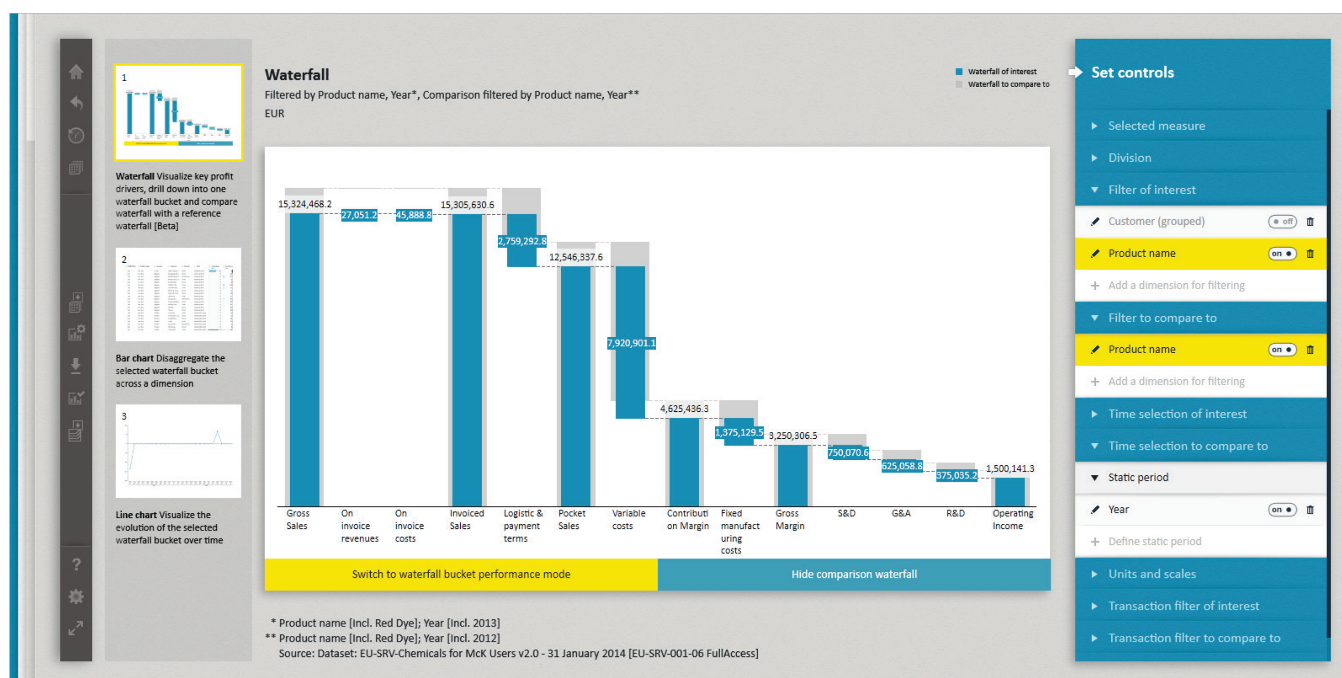
Measuring performance requires transparency into data that matters.

What was lacking was a system that brought together relevant data at the level that sales reps cared about and that was critical to understanding performance-that is, at the level of their individual customers.

Setting up dashboards that analyzed data on a weekly basis at the customer level provided a new understanding of where profits could be won and lost. They pinpointed, for example, customers who were frequently unprofitable but had passed under the radar because they were small. Perhaps the customer always asked for express shipments, the cost of which wasn't factored into the price. That type of insight is critical for performance management, because it allows leadership to understand where to direct their salespeople. Reps who perform well, for example, in attracting customers who are ultimately unprofitable clearly aren't helping the company overall.

2. Design the system with the sales rep in mind

Putting a pricing dashboard system in place can be useful, but it's meaningless if the salesforce doesn't use it. A system should be both easy to use and relevant to the sales rep. Data visualization, simple outputs, and an ability for a rep to easily run queries against the data is a prerequisite for the success of any technology (see exhibit).



When done well, creating a useful system is profoundly motivating to sales reps, who find they can not only increase their win rates and margins-and thereby their own financial rewards-but also do their job better. Getting reps to use the system then also creates data about the decisions they make and the outcomes of their work with customers. Systems and tools can generate useful insights, but sales reps themselves need to provide them as well. As Linda Crawford, EVP and GM for salesforce.com's Sales Cloud, says, "The people who win here are those who can get the field team, the inside team-everybody-using the system to input more data. Then you can apply Big Data analysis to support salespeople and boost business."

> **"The people who win here are those who can get the field team, the inside team —everybody—using the system to input more data."**
>
> — Linda Crawford, EVP and GM for salesforce.com's Sales Cloud

One company in the chemical sector delivered granular data to the salesforce through a conventional business intelligence dashboard. Unfortunately, the sales reps found it too complex. They could look at the data, but they didn't know how to draw conclusions from it or how to build it into their dealings with customers. The company tried to simplify the system by only showing revenue measures and leaving out key profitability metrics. Now the salesforce felt even less engaged!

The solution was to create a pragmatic set of analyses of profitability data that is refreshed monthly and delivered to the salesforce in predefined templates. In practical terms, each sales rep gets a scatter graph that shows the profitability of all their customers over the previous month and lets them see in more detail, through interactive charts or tables, why some customers are unprofitable. The company also built "insight" apps that enabled sales reps to estimate the value-based price of a product for a specific client. Together, these built up the reps' confidence about increasing a price and helped them prepare for negotiations.

Salesforce performance rocketed, and more than $25 million worth of margin improvement opportunities were identified in the pilot business unit. One year later, both use of the dashboards and salesforce motivation remain high, and the company has improved its profitability by more than two percentage points. None of this required expensive changes to IT systems. It was simply a case of using pragmatic data-upload scripts from existing data sources and implementing the analysis dashboards.

Building skills is also critical to improving performance and building motivation. One company launched a continuous training program that addressed both the concepts of value creation and how to use the tools. One team was given advanced analytics training, which enabled it to carry out more sophisticated analyses such as elasticity or scenario drawing. This meant the team could generate new insights on a regular basis, turn the insights into targets, and make structural changes to the sales process. Letting some reps undertake this more advanced training has also helped keep motivation and engagement levels high.

3. Set the right targets and track actions

The final piece in the puzzle is active management and tracking. That starts with defining clear targets for sales reps based on a systematic analysis of all the facts and factors relevant to price, then identifying the pricing opportunities. When those are established, the best pricing leaders put in place metrics that help track progress.

It's important to balance metrics between revenue targets and pragmatic measures of margin that are relevant to the business but also practical for the rep.

It's important to balance metrics between revenue targets and pragmatic measures of margin that are relevant to the business but also practical for the rep, e.g. "pocket" price, which is the net price after all costs to serve are factored in.

With targets and metrics set, it's then up to the sales rep to develop the ideas and actions to meet the target. A good system will support him/her by providing progress information and prompts to follow up with clients based on new information (e.g. change in market conditions affecting price). Once a sales rep takes action, it's critical to log it somewhere, along with the expected impact and a due date. If the impact isn't realized in time, a good system sends the rep a reminder and alerts the manager to a potential issue as well.

This approach gives sales reps a lot more ownership of their actions, which they can adapt as their customers' circumstances change and as new data becomes available. It also gives managers more confidence in the process, because they can get a view across the many initiatives to track their impact over time.

One company went a step further and customized an app that recommends pricing actions based on a transparent analysis of transactional data. Its sales reps get monthly updates of recommended actions, such as opportunities for increasing prices or cross-selling products, which they use to adapt plans. This ensures the salesforce maintains ownership of pricing and that individual performance management is easy and flexible. To ensure sales reps deliver value, managers

look at gaps in overall improvement targets, rather than at the impact of every action, the choice of which is left to reps themselves.

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Effective performance management is not a one-time event; it requires a commitment to continual interactions with sales reps. Frequent performance dialogues between managers and sales reps, for example, have ensured that high performers are noticed and eventually rewarded. The best performance management in pricing and commercial performance is about both improving margins and building the capabilities of your people.

This article was based on insights and experience from client work with Periscope, a McKinsey Solution. Periscope is an integrated set of solutions designed to deliver sustainable ROS improvement through better pricing, promotions, assortment, and performance management.

[1] *"Study on the State of Performance Management;" 2010, World at Work and Sibson Consulting*

INTERVIEW

The art of negotiation in the Big Data world of pricing

Roger Britschgi (Head of Sales Operations), Robert Krieger (Managing Director), and Pierre Nicollier (Director of Sales), from PanGas AG discuss the value of trust and psychology when it comes to turning pricing analytics into front line profits.

The case for improving pricing

Pierre: Before we started on an effort to transform our pricing, we had a scaled pricing system already in place. But we did not have full transparency into our pricing situation. A customer with the same product and size had different pricing. It just wasn't right.

Roger: We also had a basic foundation in pricing analysis, which didn't provide pricing recommendations with enough granularity or clarity for our sales reps to trust them. What happened in practice then was that every year we had price increases based on scale and volume, but not based on science. Our people just didn't think it was possible to do it any other way. Quite frankly, our people were not well prepared to convince our customers of the need to increase prices.

Robert: We are based in Switzerland, which has a unique situation. Our prices tend to be a little higher than in other countries so we have to be fair and transparent about any price increases. Making matters more complex, we had been in a period of offering price reductions, so customers were expecting more of the same rather than price increases. It was a big challenge to argue for why prices needed to go up.

Making it happen: Strong arguments and leadership support

Roger: We implemented an advanced pricing analytics capability, but just as importantly we focused on building out a system so that all this great analysis would actually lead to more profitable outcomes for our sales reps. Training for our sales reps was absolutely critical. We started with explaining exactly what we were doing, what benchmarks we were putting in place for pricing rules, and how our pricing analytics program created pricing recommendations. This was all about gaining the trust of our sales reps who would have to “sell” these prices to our customers. Then we provided the right argumentation for why we needed to increase prices. I can’t emphasize how important this was. In sales, the most difficult thing is being able to come up with stable and convincing arguments for raising prices.

“We focused on building out a system so that all this great analysis would actually Lead to more profitable outcomes for our sales reps.”

Robert: From the very beginning, it was critical to show that leadership was behind this new approach. And we did this by going beyond nice words to working on the project with our sales reps and joining visits to difficult customers. We believed in our pricing recommendations and during these customer visits, we were able to not only help our sales reps but also show how good argumentation worked. We were very conscious about displaying a “yes we can” attitude. It’s important to note that price increases sometimes aren’t achievable in one step. In many cases, it takes a few rounds of more modest increases until you get to the recommended price. That’s just the reality of the marketplace.

Pierre: Again, this was about transparency. We made sure that the sales reps understood what they had to do and what the arguments were. This was not about giving orders for a new way of doing business; it was about providing the “why”. And then success bred success. At first, our sales reps were nervous about going to our customers with price increases. But they had good arguments that we helped prepare. And after they saw it work a couple of times, they were eager to do additional visits. It’s about building confidence.

A new culture of pricing

Roger: There were three main changes to the way we did business after we implemented our pricing approach based on value. 1. We used to do mass pricing, but now it’s more smart pricing, which is about communicating value. There is no one size fits all anymore. 2. We used to do pricing once a year, now we do it daily. Pricing needs to be part of a daily conversation. And 3, our pricing used to be based on volume, and now it’s based on a multitude of factors that are evaluated for each customer.

Pierre: We had great success with this approach, but something else also changed fundamentally. Our people learned to talk about pricing again. Pricing is always such a negative topic, because we’re always under pressure to defend prices. But we learned that we had a right to raise prices and that there were good reasons for it. Our arguments were about what our products do. We became very clear that there is value for every benefit that our product has, and that has a price.

“There is value for every benefit that our product has, and that has a price.”

Robert: It is essential to talk with customers about prices. I put the subject on the table, and make it an important focus of the conversation, not a slightly embarrassed afterthought. That makes a big difference.

The psychology of pricing to build trust

Robert: Our sales people in many cases are as close to our customers as they are to our company. If a customer loses faith in his/her sales person, that rep is unhappy. Having clear arguments about why prices need to increase, what the value of a product really is, and where the numbers come from is fundamental to building trust with both our sales reps and our customers.

Roger: In building trust, we had to make sure that the pricing recommendations that the model spat out were credible, ie. not too far away from the current prices. If a recommendation is to adjust prices 20- 40%, for example, the sales reps immediately thinks about how difficult that is to explain to his/her customer.

Pierre: There is really an important psychological element here in providing the tools, logic, and transparency needed so that both the sales reps and ultimately the customers trust the prices. These approaches essentially provide the sale rep with a way to bridge the gap between what the price is and what the price should be in a way that the customer understands and accepts.

Developing sound arguments

Pierre: If you have a product and believe in it, and understand the value of it, then you have a much easier time creating arguments for what it should cost. Our sales reps have to know what they're talking about. Reciting product specs just doesn't work.

Roger: We had a one-day workshop where we discussed the products and services around it, the associated costs and the created value. Based on that, we laid out the arguments for increasing the price of it and then then we collected the best five to ten points to share with all the reps. We also recognized the need to prep for the customer visit, so we reviewed and adapted the arguments based on the anticipated customer viewpoints.

"Our emphasis was on selling the value of the product in a clear, accurate, and convincing way. Then you can talk about prices."

Robert: It's a basic tenet of sales that as soon as you talk about prices, you've lost the game. Our emphasis was on selling the value of the product in a clear, accurate, and convincing way. Then you can talk about prices. Frankly there is still room for us to improve by creating a more systematic way to developing, sharing, and improving our process for developing pricing arguments.

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