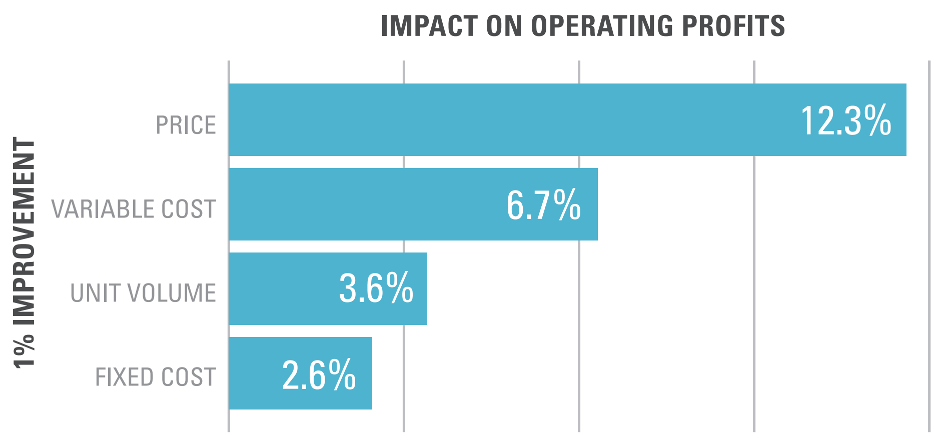
5-Steps to Double the Net Worth of Your Company through Value Based Pricing

By Rich Bond



Source: Compustat, Deloitte Analysis from *Pricing and Profitablity Management*, 2011

Although price (as shown graphically) is clearly the most powerful profit driver a company can use – a 1% increase typically results in a 12.3% increase in operating profits – it is an area most companies surprisingly tend to avoid.

A recent McKinsey survey of 1,000 North American companies, 70% of respondents admitted they do not control their prices. This has major effect on the worth of a company, as McKinsey found the stock prices of the 30% of companies with control over their prices were worth twice as much as the 70% of businesses that did not have control.

Companies that don't control their prices have largely been forced to save their way to prosperity, which normally doesn't work because prices, if not managed, tend to go down between ½% and 1% per year, offsetting the any cost savings. A price decrease reduces profits two to five times more than an increase in volume or a decrease in costs.

Pricing is scary because most companies manage their business on the basis of cost, not value. Companies know what their costs are, and what their product costs a customer, but most have a limited understanding of why their customers buy their products. The "why" customers buy (or can be induced to buy) is "the value proposition," which has huge profit potential over time.

Value Case in Point:

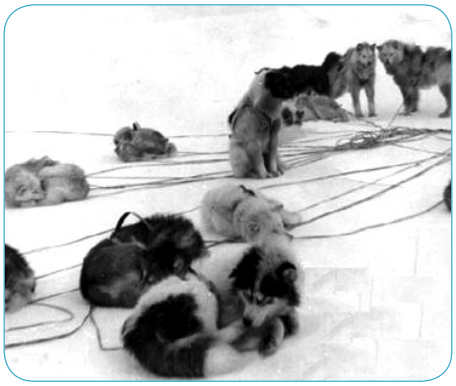
The salespeople at a company, which sold a $35,000 submersible pump that had been the industry standard, wanted to lower the price to $25,000 to be more competitive with a $30,000 pump sold by another company, which was gaining market share. Management disagreed. A study showed the $35,000 pump went twice as long between the required maintenance shutdowns, which could cost up to $50,000. The company's pump had a clear, quantified competitive advantage. As a result, the company raised the price and switched to selling the pump based on the total cost of ownership – a clear value sale.

The new approach resulted in increased sales and a recapturing of market share. Profits rose even more than sales. Lowering the price would have probably resulted in a "price war," which would have further reduced profits.

Correcting the pricing sins of the past is neither easy, nor is it quick. It requires the commitment of management and a longer-term plan.

Here are the 5 strategic steps you can undertake to regain control over your prices, grow your bottom line, and increase your company's net worth.

The 5-Step Value Based Pricing Solution



Pricing team in most companies

1. **Identify and Acknowledge that Pricing Is a Problem, and then Assign the Problem Solver.**

   The first step in increasing your profitability is to recognize that failing to track and control your prices is a significant strategic problem that affects your company's bottom line. Sales, marketing, and finance departments all need to work together to understand the effect of your pricing practices and to implement changes as needed. As noted above, the Deloitte study showed that if you are allowing your sales department to set prices, chances are that your prices are falling ½ to 1 ½% annually. These price drops offset any cost savings programs, which translates in flat or declining profits.

   To address the problem successfully, you need to ask some hard questions:

   - Do you have a pricing problem, and do you want to fix it?
   - How does your company set prices?
   - Does your company track prices?
   - Are your prices going up or down?
   - What are the factors that influence pricing?
   - Is anyone specific in charge of pricing?

   If no one is in charge of pricing decisions, then you need to create and define a pricing position. The person in that position would be in charge of both tracking and taking action on pricing. Give that person the authority to make definitive decisions and set pricing policy. That person can then work to bring about communication, collaboration and cooperation between the departments that have been setting pricing traditionally and the departments that understand the strategic effects of pricing policy.

2. **Set Up the Right Price Reporting Systems.**

   Your reporting systems need to be able to show you how prices are influencing your company's profitability. You need to ask the right questions to set up a financial reporting system that will give you the information you need to track prices and profitability over time.

   - What is the profitability of each of your accounts?
   - What is the profitability of each product line in each month?
   - How much does each customer contribute to profitability on an annual basis?
   - Who is setting prices?
   - How are those price reported?

You do not need elaborate or expensive software to set up the reporting systems. Marketing, sales and finance departments can work together with the person in charge of pricing to set up P&Ls for each account, each product line, and each customer. Then the pricing person can create a system for recording prices and price changes. The P&Ls will show how price changes flow to the bottom line of each account and each product line.

Plug the biggest profit leaks with corrective action

3. Plug the Biggest Profit Leaks with Corrective Action.

Once you have identified and quantified how much profit each account, product line, and customer contributes to your company, you are ready to take corrective action to plug profit leaks and reward high profit generators.

To understand where you have profit leaks, ask yourself these questions:

- Do you compensate your sales force with commissions that are a portion of revenue, without regard to the profitability of the sale?
- Do you have profit centers set up with managers responsible for their own P&Ls?
- Is anyone compensated from the profit they help generate?

The most effective means to controlling pricing is to align your sales force's and your managers' goals with your company goals. That will take redesigning your compensation structure to reward your people for managing profits. Eliminate, as much as possible, situations where your sales force is compensated with commissions based on revenue – no matter the profitability of the sale. Salespeople paid on commissions rather than a portion of profits will remain focused on lowering prices to get the sale. If they are paid out of profits, they will strive to make more sales based on profitability rather than price. Their focus will be on developing more profitable customer relationships.

4. Sell Based on Value Proposition.

Direct all groups involved with product development, sales, and marketing to develop strong value proposition for existing products. Begin the process with questions:

- What is the need for your products?
- Why do your customers buy your products?
- What other products would they buy from you if they could?
- Do you sell commodities or value-based products?
- What quantifiable value or benefits do your products deliver to your customers?

Use the answers to these questions to develop value propositions. Your sales force can then sell based on value – not price. In fact, higher prices may help create more sales – in addition to delivering more profit to your company.

5. **Test New Product Profitability**

   As you develop new products, test their potential for profitability:

   - What is the value proposition for the new product?
   - What is its competitive advantage?
   - Does the competitive advantage allow for premium pricing?
   - What will the gross margin be on the new product?

   Only when you have analyzed the gross margins of your current and future products, will you be able to determine how much additional profit each new product will contribute to the bottom line. Establish a policy to only go forward with products that are the most profitable. Eliminate new products with marginal profitability to prevent a pyrrhic victory.

Effective pricing practice

Pricing, Value and Profits

Implementing value-based pricing requires a cultural change. The change starts with management and the hiring of a Pricing Manager to be in charge of pricing policy, monitoring, and analysis. All the members of the pricing team must work together to implement the new pricing structure and to adhere to selling by using a strong, quantified value proposition. Once all those pieces are in place, and the interests of the people involved are aligned, then your company can move forward to control prices and increase profits.

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Rich Bond founded Bond & Company in 1986 as a boutique financial recruiting firm but has been spending more and more time in the last three years recruiting pricing people. He sees this space as a great opportunity for his clients and for his firm.

If you want to talk with Rich about pricing, he offers a complimentary, no obligation, 30-minute consulting discussion.

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