

Consumer Industries

The Profit-Orientated Category Manager – How to Optimize Pricing in the Mail Order Business

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To unlock additional profits in mail order trade, category managers have to be turned into price managers. All they need is the support of intelligent tools.

A tool can support but will never replace a category manager's price decision.

Many mail order companies use their prices as a weapon. This approach is reasonable to a certain extent, since the price is important for the positioning of a retailer. But it simply neglects the meaning of the price as the most significant profit driver. Some mail order companies identified this potential and tried to exploit it with the help of a black box. However, their success has been limited since it is almost impossible to incorporate the complexity and dynamics of the environment within some kind of "pricing machine". Furthermore, our consulting experience has shown that in many companies, basic knowledge concerning the influence of the price on the contribution margin and the gross yield as well as concerning the price optimization by the use of price-response curves is lacking. But exactly this knowledge is the key to success. Therefore, mail order companies wanting to use pricing not only to sharpen their profile but also to increase their profits have to focus on their category managers and develop them into price managers. In the course of this development, the category manager needs a tool which supports him to improve his pricing decision. However, the tool will never be able to replace the price manager!

Category manager often do not have the necessary knowledge and information to find profit-optimal prices.

How are prices set in the mail order business? In most cases, prices are fixed as a result of an intuitive decision considering the purchase price, prices of competitors, and (if applicable) the recommended retail price. A systematic identification of the profit-optimal price in mail order trade is rare. One reason is the lack of time due to the multitude of prices which have to be defined in a short period of time. Another reason is the lacking knowledge of the customers' willingness-to-pay – reflected in the amount which is sold at a certain price – which is the basis for finding the optimal price in terms of contribution margin (see figure 1). In addition, the category manager is not accustomed to think about the sales amount at all. This is based on the historically separated responsibilities of the category manager who sets the price on the one hand and the procurement manager

who orders the necessary amount of a product on the other hand. The sales amount is often just the result of the planned turnover.

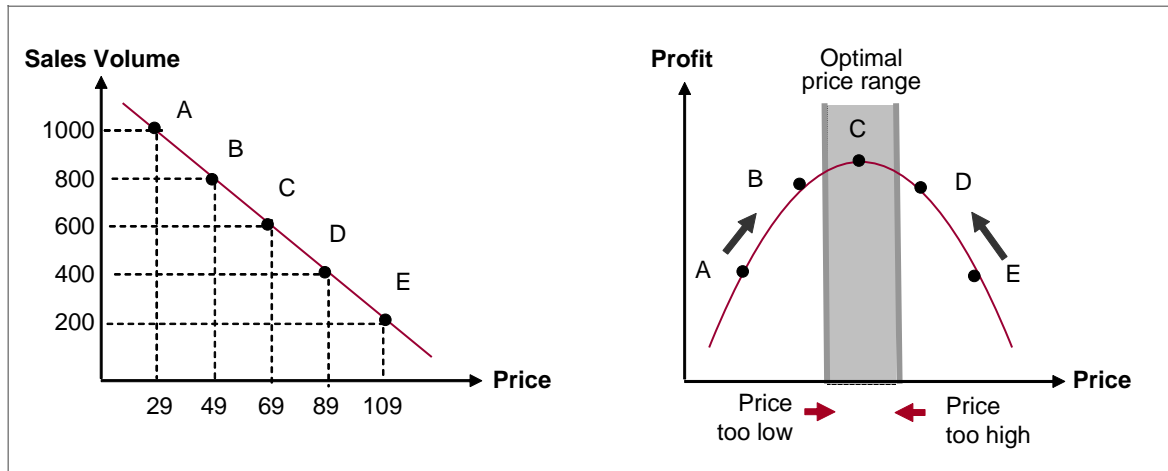


Figure 1: Profit-optimal prices

For a price-optimization the historically separated analysis of price and sales amount has to be resolved.

Profit optimization by setting the best price concerning contribution margin is only possible when this way of thinking is changed. This means that the category manager has to understand that a price for a product cannot be chosen without considering the corresponding demand. The best way to implement this change in thinking is a systematic and tool-based approach where the category manager estimates the sales amount iteratively for different price points. The supporting tool uses the combination of price and sales amount to calculate the corresponding contribution margin. This way, the best price with the "highest" profit is immediately shown.

As a rule of thumb, the category manager should be supported by information relevant to his individual pricing decision. The prices and sales amounts of reference products are one example of useful information. These are products which have similar price-response curves to the product being studied and which are still or were in the past part of the retailer's assortment. Additionally, the analysis of historical data of the merchandise group can deliver the existing average relationship between prices and corresponding sales amounts. Furthermore, external databases containing information on competitive prices and sales amounts should be included. Finally, live price tests can be useful in certain situations. They help to validate and refine the estimated sales amounts at different price points and thus find the

With a targeted support the category manager can become a price manager.

profit-optimal price. Moreover, the category manager can learn from the testing results by comparing the results with his estimates and using them for future price optimizations. In contrast to other retail pricing approaches, we focus explicitly on the retailer's category managers (see figure 2). They are supported with structured information and useful tools during the pricing process but still make the final pricing decision themselves. If the category managers continuously improve prices by systematically estimating sales amounts for different price points using the measures and information named above, they will rapidly turn to successful price managers and increase the contribution margin considerably.

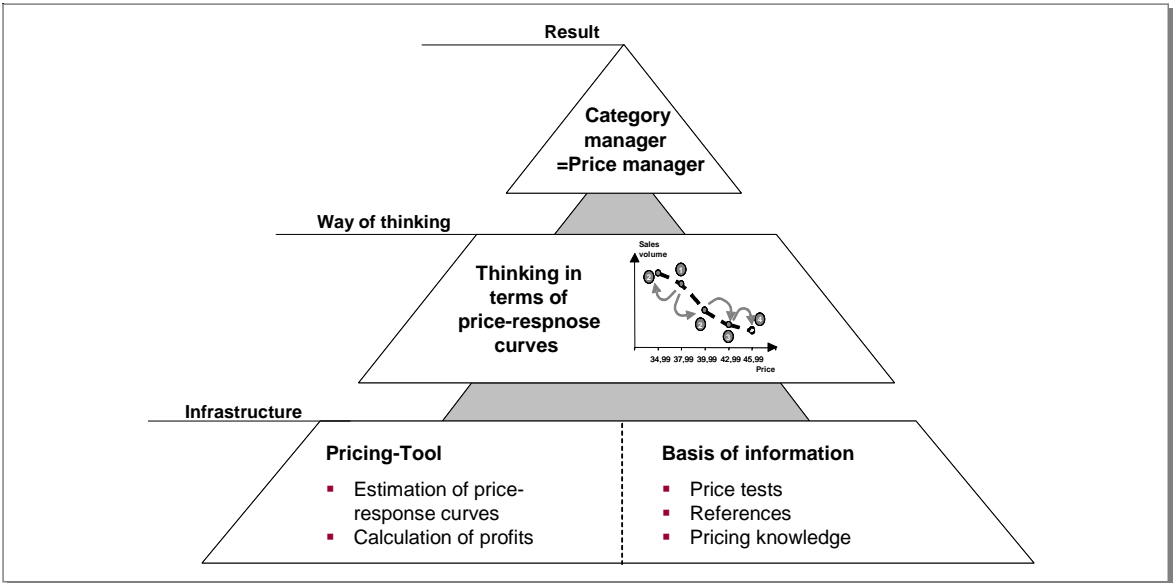


Figure 2: The profit-oriented category manager

Conclusion:

- The price should be primarily used to optimize profits – not only to sharpen the retailer's profile.
- The choice of the "best" price resulting in each case in the highest achievable contribution margin leads to a profit-optimal assortment.
- The basis for profit-optimal prices is the customers' price sensitivity which is reflected in the relationship between prices and corresponding sales amounts.
- The implementation of customer-orientated pricing should be a systematic and tool-based approximation towards the profit-optimal price on the basis of the category manager's estimation of the customers' willingness-to-pay or price-sales amount in relation to the product in focus.
- To support the category manager's estimation, additional information (e.g. on prices and sales amounts of reference products, product groups or competitors) has to be provided.
- To validate and refine certain generally accepted price-response curves, live tests should be adopted.
- A continuous product pricing based on the category manager's estimation of the sales amount corresponding to different price points will turn him into a successful price manager and result in a considerable increase in the retailer's contribution margin.

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