Pricing

Where is it heading?

Five suggestions for CEO's and managers

By Hermann Simon

Pricing has traditionally played a tactical rather than a strategic role. Most companies based their prices on cost-plus considerations or competitive comparisons, not concrete strategic goals. But the role of pricing is rapidly changing.

What drives this change? Many factors. The Internet, the pervasive emphasis on shareholder value, and the availability of increasingly more sophisticated methods to measure value and price effects have begun to pull pricing to the forefront of strategic thinking. To take advantage of these changes, CEO's and managers should consider the five steps described in this article.

1. Link pricing more closely to shareholder value

Ask CEOs and top managers what their main concern is, and most will put shareholder value and market capitalization at the top of their lists. And how does pricing fit into that picture? Traditionally, hardly at all! Price has rarely been recognized as a major factor behind the creation of shareholder value.

We all know that price is one of only three profit drivers, the two others being volume and cost. But one has to be honest and admit that pricing has not received the same share of management attention as cost and volume have.

This has to change – and it will change! A major factor is the pressure of the capital markets. Let me give you a current example: DaimlerChrysler. In spite of a good performance, the share price has declined sharply. What do analysts cite as the main reason behind this decline? The company's pricing.

The leading German business magazine *Wirtschaftswoche* recently quoted an analyst as saying that "Chrysler has increased sales

in the first half of 2000, but their current prices are too low and their buying incentives much too high. That will hurt profit." This analyst directly addresses the dilemma between profit and sales growth. Nowadays, profit and growth are the essential drivers of shareholder value, with somewhat similar weights. But it is difficult to achieve both. If you raise prices, profits rise, but volume growth suffers. Witness Chrysler's competitor Ford, which recently chose the opposite route from Chrysler: prices up, market share down. This did not help its share price.

Compaq provides another example of how inconsistent pricing ultimately puts a drag on share prices. In an interview on August 10, 2000, Compaq CEO Michael Capellas said that Compaq makes "... a conscious trade off between profitability and market share. For a certain time it will be more important for us to be profitable. Later on we will take back market share." Only a few years ago Compaq declared exactly the opposite. The Wall Street Journal wrote in March 1996 that "Compaq set the stage for a bruising price war, saying it will sacrifice some profit in an aggressive move to build market share." This does not sound like a long-term, consistent, and convincing price strategy. It is no surprise that Compaq's stock price has strongly lagged behind the technology index.

The real challenge for pricing in the future will be to help managers achieve both profit and growth. Pricing must become more directly aligned to shareholder value goals.

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2. Give pricing more power in the corporate hierarchy

This point is closely related to the first. Pricing can help exploit opportunities to enhance shareholder value only if it holds a position of maximum strength. Why? Because price is a conflict-prone instrument. Price changes directly affect every function in the organization, from finance to controlling, from sales to marketing, and from production to logistics. And these functions will oppose each other if they don't like the effects.

Take, for example, the traditional promotions in fast moving consumer goods. A temporary price cut typically increases volume by a factor of five to ten. This volatility creates havoc on production and logistics. This – and not the ineffectiveness of promotions – is the real reason why more companies are moving to everyday low pricing.

Pricing and its effects require a comprehensive, holistic view which is achieved only if the pricing manager holds a high position in the hierarchy.

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As in many other fields, General Electric is leading the pack in radically upgrading the pricing manager's role and position. Recently GE launched a major new initiative. Since early 2000, a pricing manager in each of GE's 40 or so divisions reports directly to the CEO. A central Chief Pricing Officer who reports directly to Jack Welch coordinates the initiative across divisions. This represents a substantial upgrading of the pricing function, a shift which many other companies will emulate. This upgrading will also make the pricing function more attractive for high-achievers.

3. Avoid aggressive pricing

Achieving an attractive profit on low and aggressive prices is difficult. When I recently discussed pricing's prospects with Peter Drucker in his home in Los Angeles, his spontaneous comment was that "Low prices and high profits rarely come together." The inordinate amount of attention heaped on successful low-price companies – Southwest Airlines, Wal-Mart, Ireland's Ryanair, Germany's Aldi or Japan's Watami restaurants come quickly to mind – overshadows the sad fact that legions of firms with aggressive pricing strategies have become long-forgotten failures.

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Aggressive pricing works only with extremely low costs. This requires a corporate culture of frugality, characterized by self-negation, self-sacrifice, almost masochism. It is extremely difficult to replicate such attitudes or to work permanently under such conditions. I see a value strategy as a much better way. I agree with Jack Welch that this is the "value decade".

The aggressive pricing syndrome seems poised to prey on some of the more successful Internet companies. Take Amazon.com. According to express shipping experts, one needs at least $6 per order for logistics, packaging, etc. Can you realistically recover this amount and make a profit if you sell a book for $10 or $15? And are consumers still willing to buy online if they have to fully pay for these costs? I have my doubts.

Priceline, the name-your-own-price homepage, faces similar difficulties. According to a Wall Street Journal article, Priceline's lowest prices for car rentals are hardly lower than those of the rental companies themselves. Where, then, is the advantage? Furthermore, the margins for Priceline are razor thin.

The high price transparency on the Internet will make it more difficult for companies to succeed on low prices alone. There is always somebody cheaper somewhere. With the Internet, customers will find this supplier. It's a hopeless race!

My third point in summary: Aggressive pricing alone is not a viable strategy for the future unless one has a penchant for self-sacrifice.

4. Remember that Internet pricing favors the buyer, not the seller.

Who will eventually profit most from the Internet? The jury on this question is still out. But I expect that the buyer will be the main profiteer. Why? In most markets, capacity is higher than demand, i.e., we have buyers' markets. It also seems that most industrial firms expect more from the Internet on the purchasing than on the selling side. Furthermore, auctions, customer-driven pricing, and shopping robots tend to lead to lower prices. This is particularly true for commodity markets. So, if you are in commodities, be warned. Price competition is getting very, very tough.

This situation reverses, of course, if capacity is scarce. The Internet may actually generate higher prices, because buyers now bid against each other for the limited resource. But that is rather the exception than the rule in highly developed industries.

Dynamic pricing – which continuously adjusts prices according to the current demand-supply situation – is also likely to lead to lower average prices. Will higher volumes more than offset the likely reduction in margins? This varies from case to case. For airlines, revenue management seems to achieve this. But even there, long-term consumer education could alter the picture. The consumer may learn that you can always find some cheap bargains. Is this the reason that the stock market does not have much trust in the sustainability of current airline profits or why the airlines' valuations are very low?

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The Internet also tends to drive down prices for the simple reason that price is much easier to communicate than value. On the Internet, price is just a number. Value is a much more complex construct. It requires additional information, trust, and confidence – things which media convey much less effectively than people.

Does this mean that companies can afford to neglect the Internet and its pricing opportunities? Of course not! In fact, the reverse is true. Every firm faces the constant danger that existing or new competitors will use Internet pricing to their advantage.

5. Treat pricing as a "science" similar to finance

Over the last two decades, the "finance" discipline has become very quantitative and theory-driven, almost a kind of rocket science. Pricing is experiencing a similar development. Masses of data already exist, and the Internet will lead to an explosion of new data. With the notable exception of the airline industry, these data are hardly used effectively to manage and control price decisions.

Take auctions as an example. Although a large body of theory has been developed in the last 30 years, the models sounded very academic and nobody believed in their practical relevance. But now all of a sudden, these insights

are applied to auction models and yield superior results. The record revenues of more than €80 billion from telecom auctions in the UK and Germany provide conclusive evidence. The huge amounts raised from the auctions were due largely to the theory-driven design of the auctions.

What does the emergence of a "pricing science" mean for pricers? It is a double-edged sword. The older ones, like myself, will have to learn a lot of new things. This is demanding. We have to continuously upgrade our know-how – and that of our teams. We have to recruit people with excellent quantitative qualificiations. In my company, Simon, Kucher & Partners, we now have eight consultants with Ph. D.'s in physics. Very smart people! This is the kind of caliber you need to cope with the new challenges.

In short: Pricing will make a quantum leap towards higher professionalism.

Summary

CEO's and managers can take full advantage of today's pricing opportunities if they:

- **Link pricing more closely to shareholder value**
- **Give pricing more power in the corporate hierarchy**
- **Avoid aggressive pricing**
- **Remember that Internet pricing favors the buyer rather than the seller**
- **Treat pricing as a "science" similar to finance**

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