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Strategic Pricing: Three steps to higher profit margins

Running a manufacturing enterprise has never been more challenging. As advances in technology have broken down geographic barriers, manufacturers in developed nations like the United States find themselves in direct competition with “low-cost” producers from emerging regions such as China, India, and Eastern Europe.

Throw in volatile economic forces—constantly changing raw material prices, shifting customer tastes, unforeseen global recessions—and turning a profit from the making and selling of goods becomes more difficult every day.

For the most part, manufacturers have relied on cost-cutting strategies such as lean manufacturing, outsourcing, and offshoring to combat profit margin erosion.

These efforts have made companies more efficient and in many cases eliminated wasteful practices that were indeed cutting into profit margins.

But it takes more than cost-cutting to continue increasing profit margins. Action must also be taken on the revenue side of the equation. Conventional wisdom says the easiest way to increase revenue—and profits—is to sell more of what you make. That may be true, but if the ultimate goal is protecting profit margins, simply increasing sales volume may not be the right approach.

In fact, a growing number of manufacturers are finding that paying closer attention to how they price their products is a much more effective method of not only maintaining profit margins, but boosting them as well.

These manufacturers also are finding that strategic pricing allows them to stay

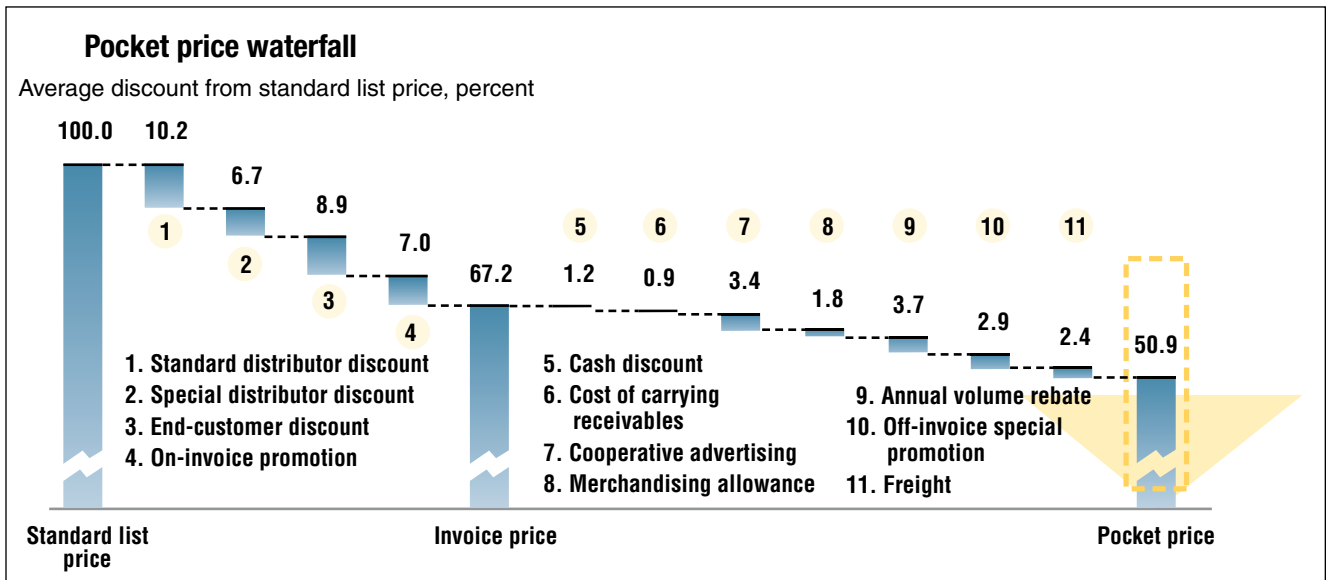
profitable during both good and bad economic cycles.

The real opportunity and impact of strategic pricing

While strategic pricing has not yet become a mainstream practice, industry analysts have been extolling its benefits for years.

As far back as the early 1990s, two McKinsey and Company consultants authored an article for *The Harvard Business Review* in which they declared, “The fastest and most effective way for a company to realize its maximum profit is to get its pricing right.”

They backed up that statement with research that proved increasing the price of a product typically has three to four times the effect on profitability as a proportionate increase in sales.



Reviewing a pocket price waterfall is an easy means of seeing how profit margins can erode. Managing the waterfall is an effective means of not only protecting those margins, but boosting them as well.

Source: McKinsey and Company

For example, a 1 percent increase in sales volume—with no change in price—will yield a 3.3 percent increase in operating profit. But a 1 percent increase in price—assuming no loss of sales volume—will boost operating profit by 11.1 percent.

Traditional approaches to pricing

When setting prices, most companies typically do at least some analysis at three levels:

- **The industry level:** This is where the basic laws of economics—supply and demand, the current price of raw materials, whether the economy is expanding or contracting—impact the price that should be set for a given product at any point in time.
- **The product/market strategy level:** Evaluating pricing at this level requires an understanding of how a company's products are perceived in the market. Are they considered high quality items that customers are willing to pay a premium for? Or does a certain level of service come with the products that can command a higher price?
- **The transaction level:** This level requires deep knowledge of each individual customer. In addition to understanding how each customer perceives the company's products, there must be a way of determining for each individual purchase whether the customer is willing to pay a higher price—and why.

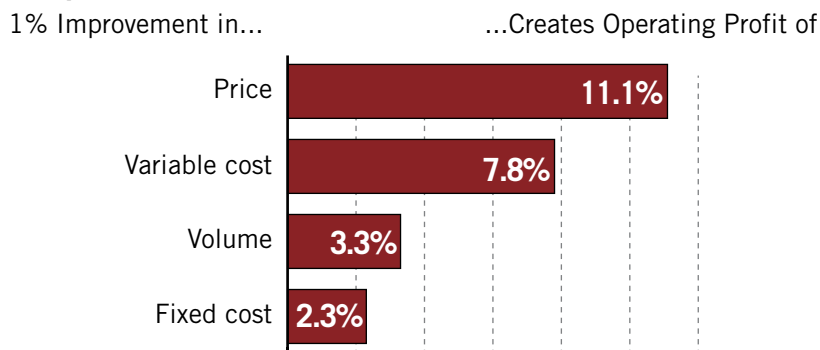
Three steps to higher margins

Transaction level pricing is the most complex, but it also has the greatest potential impact on profitability, which is why analysts and consultants are now urging manufacturers to pay more attention to this area. Mastering transaction-level pricing for maximum profitability is a three-step process.

Step 1: Apply the pocket price waterfall approach to achieve pricing discipline.

The complexity of transaction pricing stems from the many variables that go into setting prices at that level. It typically starts with an invoice price, which is based on analysis done at the industry and product/market strategy levels.

Comparison of Profits Levers*



*Based on average economics of 2,463 companies in Compustat aggregate

Proper pricing management can have a much more profound impact on profitability than simply increasing sales volume.

Source: Harvard Business Review

In virtually every transaction, however, there are discounts in play that make the final price paid for an item lower than the invoice price. Some customers get discounts for buying in volume, some get discounts for paying in cash, others get discounts from current promotions, and so on.

Regardless of the reasons, each discount lowers the actual price—and thus the profit—that the manufacturer gets for an individual transaction.

McKinsey coined the term “pocket price” to define the amount of money that goes into the manufacturer's pocket after all of the transactional discounts have been exhausted. It also refers to the cascading effect of these discounts pushing down the invoice price as the pocket price waterfall.

Step 2: Apply “pricing bands” to pinpoint specific opportunities for maximizing margins.

It's a fact of life in the business-to-business world that no item sells at exactly the same pocket price to all customers. Some customers qualify for more discounts than others, which means each item a manufacturer offers sells over a range of prices. That range of prices is referred to as the pocket price band. When setting prices at the transaction level, manufacturers need to know—for each given transaction—where along that band they can sell a product to that specific customer. The specific price a customer will pay for a product depends on different factors—and those factors can

change over time. For instance, some customers are willing to pay more if they can get a product delivered faster, while others might pay a premium for a certain amount of after sales service. Knowing where all of your customers fall on the pricing band, as well as knowing when they are motivated to pay more than usual, will yield the highest possible pocket price—and thus the highest pocket margin—for each transaction.

Step 3: Align the organization around a philosophy of profitability.

Companies that learn to manage the pocket-price waterfall should consistently yield higher profit margins. The key is making sure that everyone involved in setting prices—from back-office pricing analysts to the front line sales staff—always sticks with the price that results from objective analysis of each transaction.

Many manufacturing executives shy away from imposing such strict pricing discipline out of fear that they will lose customers. What these skittish managers don't realize is that some customers simply are not profitable—and losing customers who are not willing to pay a fair price for products will improve a company's overall profit picture.

A clear picture of which customers are profitable—and which ones are not—can only emerge through a thorough analysis of a company's pricing practices. Such analysis should ultimately lead to the adoption of a disciplined approach to pricing.

Enabling Foundation

Until recently, manufacturers had a somewhat valid excuse for not adopting this disciplined three-step approach to pricing: doing so requires gathering and analyzing large amounts of constantly changing data, something that can only be done properly with sophisticated IT systems. Not even the latest ERP systems are up to the task.

Fortunately, however, there are new business intelligence (BI) solutions on the market that can aggregate all of the data necessary for the three stages of pricing analysis onto a single platform. These solutions also allow users to comb through that data—in real time—to ultimately establish pricing strategies that will yield the highest possible margin for each transaction.

The QlikView platform from a company called QlikTech is a prime example of this new generation of BI solutions.

With traditional BI systems, companies have to build massive data ware-

houses to store and organize corporate data. Analysis can then only take place when that data is partitioned into smaller sets called data cubes that hold information pertaining to certain parts of the business. For instance, analyzing sales trends would require a sales data cube,

the system for information that raises another question, the answer to that question typically is a mere mouse click away. Furthermore, QlikView can be used as a standalone BI platform or as the front end to an existing BI infrastructure.

In today's high-stakes business environ-

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and examining pricing would require a pricing cube.

With QlikView, however, all data needed to conduct any type of analysis can be loaded into the memory of the server housing the application. QlikView uses patented technology to process information fast enough to accommodate virtually any type of query on the entire data set, regardless of the volume of data involved.

QlikView users often say the solution works the way people think. If they ask

ment, those implementing next-generation BI are reaping the most benefit from their data. As Dan Woods, a seasoned CTO, wrote in recent Forbes.com column titled, *The Death of Business Intelligence*, "If you are still running your business on questions you planned on answering last year or last month, you are probably going to quickly fall behind companies that are able to poke, probe, and explore their options based on more visual and interactive forms of analysis." ■

Amcor: Disciplined approach to pricing keeps profits up even when the economy is down

From the middle of 2007 to the middle of 2008, Amcor, a packaging company based in Australia, increased its gross profit margin by 1 percent. That may not seem like much until you consider that this \$76 million profit boost occurred while the entire global economy was locked in a deep recession.

Amcor, which makes packaging for food, consumer goods, healthcare supplies, and industrial products, credits its disciplined approach to pricing for helping it buck the prevailing economic trends. It also lauds the QlikView business intelligence platform for making its pricing strategy work as it was designed.

Amcor sought to change its pricing strategy after numerous rounds of cost cutting proved ineffective at improving the company's competitive position. This effort was part of the CEO's "Value Plus" initiative, which called for identifying specific opportunities for boosting revenue and profit.

Amcor started by collecting all pricing related data for 1 million SKUs contained in the 32 different business systems used across the enterprise, converting that data to a standard format and storing it in a central data warehouse. Next, the company installed QlikView as the front end to its data warehouse, giving



its employees an easy-to-use tool to analyze that data across 300 distinct measures.

The QlikView solution, which took four weeks to install, enables Amcor to trace the exact margin it earns on each product, down to the invoice level. That allows the company to focus on ensuring that it earns the highest possible margin on each transaction.

QlikView's ease of use helped lower any resistance Amcor's employees might have had about doing the detailed analysis necessary to determine the best price for each individual transaction. Amcor also took another step to ensure employee buy in: it now rewards its sales staff on the profit margin—not just the revenue—generated on each sale. With thinking like that, it's not surprising that Amcor was able to raise its profit margin during a major economic downturn. ■

Real-time margin analysis across customer and product bands builds a competitive edge

One of the world's leading manufacturers of pumps and pump systems for heating, ventilation, and air conditioning technology specializes in using innovative technologies to create business processes that give it a competitive edge.

And the QlikView business intelligence platform is one of the technologies this company relies on most heavily. The solution was first deployed to handle margin analysis at a European branch office.

The solution was installed in a matter of a few days, and its success at the initial location led to it being rolled out across the enterprise.

Now, all employees who play a role in improving the company's gross margins—product managers, financial analysts, salespeople, etc.—can use QlikView to retrieve and analyze the pertinent data.

The web-based solution allows analyses of variable gross margins across many dimensions such as products, geography, countries, companies, and distribution channels. Moreover, QlikView is able to perform these analyses based on consolidating the data from different underlying sources of information ranging from the corporate SAP ERP suite to Excel spreadsheets housed at individual subsidiaries.

Thanks to the visually interactive user interface of QlikView, the company has been able to identify the factors impacting its margins quickly, as well as any anomalies so that it can take immediate measures to correct operations.

QlikView also allows users to conduct what-if analyses to assess the operating impact of price and quantity changes.

"It is easy to see that investing in QlikView has paid off very quickly," says the company's group controller. ■



Dean Foods: Tracking commodity costs plugs margin leaks

Dean Foods is the largest processor and distributor of milk and other dairy products in the United States.

Like many manufacturers these days, Dean Foods was struggling to keep track of the volatile costs of raw materials and transportation of goods. Specifically, the company had no way to accurately determine how these constantly changing costs were affecting its profitability.

To address that situation, Dean Foods decided to adopt a business intelligence solution. It selected QlikView for its simplicity and ease-of-use, as well as its ability to easily integrate with Dean Foods' existing applications, thereby eliminating the need for a long, expensive implementation.

QlikView was up and running in three weeks. The first application Dean Foods built on the platform was a dashboard that senior sales employees use to track key performance indicators related to customer accounts. Among other things, the dashboard gives users direct access to a cost recovery model that gives them better insight into raw material and transportation cost trends.



As the cost of raw milk and diesel fuel for transportation continues to rise, the company can now measure and compare real-time commodity costs to sales price, plant production volume, profitability, commodity and trade spend related to marketing, rebates, and volume incentives. By adjusting product pricing according to the commodity cost, Dean Foods is able to recover some of the increased costs it had typically absorbed in the past.

Sales executives also can track sales-related costs in comparison to revenue from key accounts, such as Wal-Mart, CVS and other large retailers, allowing Dean Foods to react and adjust sales strategies to improve the profitability from some of its most important customers.

As Dean Foods continues to enhance its KPI application, the company is working towards the ultimate goal of making each sales manager accountable for the KPIs and profitability relative to his or her key accounts.

"It is difficult to compare QlikView to traditional BI tools," said Jerry Pancini, group manager, business intelligence, Dean Foods. "Other offerings don't really work the way people think. With QlikView, data analysts—who are not specifically technical people—are able to start using the tool in minutes." ■

Seco Tools: Innovative products—and pricing—generate outstanding profit margins

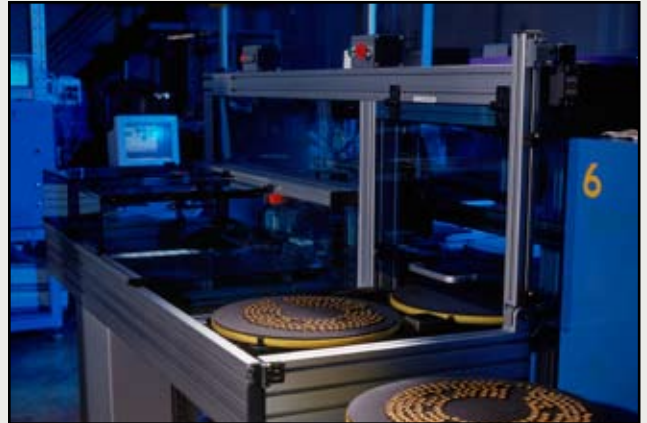
Seco Tools has a history of adapting to take advantage of new market opportunities. Between 1985 and 2005, for instance, the Swedish company transformed itself from a milling company serving only European markets into a worldwide supplier of cutting tools.

What has never changed at Seco, however, is its laser focus on innovation. Since 2003, at least 40 percent of Seco's sales have come from products or solutions that are less than five years old.

Having such an active new product pipeline has enabled Seco to maintain a profit margin—24.7 percent—that most other companies in any industry would envy.

But Seco management doubts that its profit margin would be as high if it didn't use the QlikView business intelligence platform to constantly monitor its performance.

"We have a lot of valuable information in all of our various support systems—particularly about customers, products, and markets—and this is information we can leverage



in a lot of different situations," says Jim Tureson, who oversees Seco's investments in decision support tools.

Currently, Tureson and his small staff of consultants manage roughly 150 applications based on the QlikView platform.

These applications—which tap into data from a central data warehouse—have helped Seco improve processes ranging from product design to manufacturing to the delivery of customer orders. But Tureson says a pricing application built with QlikView has made the greatest contribution to Seco's exceptional profit margin.

"We have benefited greatly from the use of an application that we use to price products correctly for different markets," says Tureson. "We can easily see how a product should be priced and what margins we will have at different price levels. Of course, the application also takes currency effects into account. This application has definitely helped bring us to our current level of profitability." ■



For more information

QlikTech is the world's fastest-growing Business Intelligence (BI) company. Its flagship QlikView product delivers instant business answers, enabling users to easily explore their data without limits. Unlike traditional BI, QlikView delivers immediate value with payback measured in days or weeks rather than months, years, or not at all. Through QlikView's disruptive, in-memory associative approach, business users have experienced unprecedented success and satisfaction. QlikTech has more than 12,000 customers in 95 countries and over 800 partners worldwide.

For more information, please visit www.qlikview.com