



Companies Must Learn to Achieve the Price Advantage (or Pay the Price)

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Pricing, the intersection at which untold numbers of buyers and sellers meet every minute of every day, lies at the core of any business -- large or small, old or new, Rust Belt or high-tech, local or global. Yet pricing remains misunderstood and poorly managed, according to *The Price Advantage*, a new book by three consultants at McKinsey & Company. Even executives at highly successful companies may not fully appreciate how small changes in price can lead to large changes in profitability.



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Several software programs have been developed in recent years to help companies strengthen their pricing capabilities. But the authors – Michael V. Marn, Eric V. Roegner and Craig C. Zawada – argue that companies can truly achieve the price advantage only by making deep and lasting changes in their organizations. Such a major shift takes time, they say, but the effort can pay big dividends. Wharton marketing professor [David J. Reibstein](#) recently spoke to Marn, a partner in McKinsey’s Cleveland office, about the major themes that he and his co-authors discuss in the book. Over the years, Marn has developed some of the most widely used analytics for identifying pricing opportunities.

Reibstein: Mike, a good place for us to start is with you defining what you mean by the price advantage.

Marn: When we talk about the price advantage what we mean is not that a company has a product with a low price relative to competition. We’ve got a much more holistic definition. We think of price advantage as a superior capability to use price as a source of real competitive advantage that at the end of the day makes your company more successful. You’ll often hear companies talk about their other advantages. They’ll talk about a purchasing advantage or a cost advantage or an innovation advantage or a distribution advantage or a service advantage. You never hear them talking about having a price advantage - that they price better than their competitors do.

What we’ve observed over the years, and one reason we wrote the book, is that we had so many clients that worked so very hard to create advantages in other areas only to give them away because they didn’t have the price advantage, because they didn’t know how to price to make sure that the advantages they created really delivered benefit. Why bother to work so very hard to cut your costs if you’re just going to pass it on to your customers without taking anything for yourself? Why bother to work as hard to innovate if you’re just going to charge the same price for the old product that you’re replacing? Why bother working so hard to be a high-service provider if you’re going to match the price of a low-service provider in the marketplace? In a lot of ways, the price advantage is more than just an advantage unto itself. It’s an advantage that enables companies to realize the benefits of the other advantages they work so hard to create.

Reibstein: My understanding of a cost advantage is that I have lower costs. My understanding of a

distribution advantage is that I have easier access to distribution. But you're not talking about a higher price or being able to command a higher price or charge a lower price than the competition.

Marn: No. We're talking about having the capability to come up with the right price more consistently. I would insist that the mistake most companies make, if you look at it over time, is they typically price too low. They have real benefits for which they don't charge appropriately. The error bias is much more toward companies under-pricing. But at the same time, having the price advantage would let you know when you are indeed pricing too high and appropriately adjusting downward when that makes sense. It's not about always being too high or too low. It's about understanding the power of having the right price for as many transactions in the market as you can.

Reibstein: You make a strong point in the book about how you can leverage a small price change into big profit changes, and I think you articulate that pretty well. I'm curious how you see the tradeoff between price and market share, where the price advantage happens to lead to more of a short-term profit advantage versus going for market share, which might gain you a longer-term advantage in terms of distribution or, ultimately, lower costs.

Marn: That's a good question. I think you have to read *The Price Advantage* in the context of overall strategy. In other words, what we're talking about in most cases is, against the backdrop of the strategic decisions you make, how can you manage pricing? If indeed a management team says, 'We need to have 35% market share or more in this particular market to survive, to support our infrastructure, to run our plants at adequate capacity,' then we would suggest that even if you pursue that 35% market share, there are things you can do to maximize your price that will likely improve your profitability.

Reibstein: Is the issue of price critical across all industries? Let me tell you why I'm asking that question. I was looking at the numbers that you threw out for where a company gets leverage on price and it's more the case for companies that have very high variable costs. I was wondering about industries where the variable costs are quite low, such as the airline industry or software. I was wondering how critical you think the pricing component is in those contexts?

Marn: I would make the case that the pricing lever is crucially important in all situations. What you often see happening in high fixed-cost, low variable-cost businesses is that, despite the fact that gross margins are very high, it's not uncommon for actual operating profits, or earnings before interest and taxes, to be relatively thin. So the leverage of improving pricing is just as high on the bottom line. The way it trades off versus volume might be a bit different. But, that said, the upside of improving pricing is still equally powerful. Quite frankly, I think the one time I would take care about backing away from a strategy driven by understanding very carefully the tradeoff between price and volume and margin, would be a situation where you think your market is growing very, very quickly -- in other words, situations where early penetration into a market or development of markets is crucially important. But any market that has grown to maturity where growth rates aren't wild and where competitors have settled in -- the payoff of doing this well, whether you have a heavy fixed cost or heavy variable cost structure, is extremely high.

Reibstein: What readership do you envision for the book?

Marn: We wrote this book for individuals in businesses who have a role in pricing. We believe there's a role for the general manager, the CEO. There's a role for the VP of marketing. There's a role for the product manager. There's a role for the sales manager. There's a role for the salespeople. We wrote this

book for the whole range of individuals up and down the hierarchy of most organizations who play a role in pricing decision-making.

Reibstein: What was your motivation for writing the book?

Marn: At McKinsey we've been doing pricing work as a major part of our marketing efforts for the better part of 20 years. It's one of the largest single function areas of marketing in which we help clients. The thing that's amazing is, you would think that after 20 years there would be a bit of a collective awareness of the pricing opportunity and of the basic frameworks and tools to create price advantage in organizations. It continued to amaze us that we would go into some business units of very good companies, *Fortune* 1000 companies, companies all around the world, and start talking about pricing as if we just turned on the light bulb for the first time. Our thought was by writing this book we could give managers a practical way of understanding and capturing this still-elusive opportunity for so many companies. Twenty years ago, I would have thought, golly, there wouldn't be a need for a book like this because everyone had signed on to the powerful ideas around pricing. But we're sitting here in 2004 with 50% of companies not being good at this. It's one of the biggest surprises of my professional life.

Reibstein: Actually, I share in that amazement and, frankly, some disappointment that industry is not moving along a lot faster.

Marn: When you find a company that is really good at pricing, it goes beyond doing the Excel spreadsheets. Courage is required to really nail this. A lot of companies don't do a very good job of creating the institutional courage to price right. It's easier not to price well. It's easier to cave in when customers ask for low prices, or competitors lob a low price into a situation. It takes a lot of intestinal fortitude to do it well. I'm wondering out loud if that behavior has prevented this from catching on like other more cut-and-dried management function improvement processes over the years.

Reibstein: Are there some industries where you think achieving price advantage is more developed than others?

Marn: I cannot point to one industry and say 80% do this well. It comes down more to individual players in a variety of industries.

Reibstein: I've been surprised to see how well the chemical industry does it.

Marn: I think a few chemical companies have really stepped up their game in pricing in the last five years or so. But I cannot point to a single industry where the top five players all do pricing well. Typically, you find zero or one in an industry that do it really, really well. Or maybe two. And that, to me, is what's so exciting about pursuit of the price advantage. It's not something everyone has already. It is still an advantage that can really cause you to stand out in terms of your performance. This is not about playing catch-up. This is about getting out ahead and investing in creating an advantage that most others in your industry probably don't have already.

Even industries that invest tens of millions of dollars in pricing processes and systems don't do it all that

well. Look at the airlines. For all the sophistication they have in how they price, the performance of airlines today is not that great. You wouldn't put a big part of your investment portfolio into airlines. In the specialty chemical industry a couple of players do it really well. In consumer packaged goods there are a couple that do it well and a bunch that don't. You look at service industry and there are a minority that do it well and most don't. You go right down the list and there's no one industry you can point to and say across the board this is one industry that's got it really nailed.

Reibstein: I want to pick up on something you said earlier - that there's always a temptation to cave in. Where do prices really end up being set in a company? You talk in the book about how pricing departments have sprung up in companies in the last 10 years. But it's one thing to have the price set at corporate and another thing when you get down to the front line where the salesperson is talking to the customer. First of all, how much of whatever ends up happening concerning pricing really happens on the front line rather than at corporate? And, second, how much leeway should you give the sales force in determining prices?

Marn: That's a very rich question, and it's one that I think is misunderstood by a lot of companies. I have seen companies price exceedingly well with very centralized pricing processes and very decentralized pricing processes. By centralized, I mean all price decisions are made at headquarters. By decentralized, I mean there is considerable discretionary authority to discount price out in the field. Now, I think the mistake a lot of companies make is they say, 'You know, my sales people have no price discretion. Any price discount that they want to grant customers, they need to get approval from the "pricing desk."' One would think with that control, or lack of field discretion, that they would have the pricing process under control and that nothing bad is going to happen. But that's exactly the wrong point of view.

No matter whether your pricing authority is centralized or decentralized, something very crucial happens at the salesperson/customer interface. Even without pricing authority, what you'll find is the best salespeople, the ones who really understand customers well and know how to sell value, will actually end up charging higher prices. And their customers end up, even if the pricing is centralized, going back to the central pricing desk with fewer price-discount requests. So I would suggest that whether the salesperson has field pricing authority at a high or low level, it doesn't matter. He or she is always going to be a crucial cog in the creation of a price advantage in an organization. That would be point number one.

Point number two builds on the idea that companies can be successful at very centralized and very decentralized pricing. The connection to make is this: The more decentralized your pricing process -- that is, the more pricing authority you push out to the field, be it to regional managers, district managers or salespeople -- the higher level of pricing skill you need to build in those people. You also need a higher level of monitoring of their performance. And you need a higher level of incentives tied to pricing in their compensation plans. A lot of companies push pricing authority out to the field, but they'll fail to create those three conditions for success.

Reibstein: I think that's an excellent point. I'm particularly intrigued by your observations on technology's role in pricing. Do you want to talk a little bit about what you see as the role of technology today and where you see it going?

Marn: What you're seeing now is a number of software companies filling that gap that existed maybe 10 years ago or so when companies were trying to get their pricing processes supported by systems. It turns out that a fair number of viable software alternatives out there today support the pricing process. We have

felt for years that investing in this kind of software for most companies usually does make great sense.

Reibstein: Which software systems are you thinking about?

Marn: Some 30 or so are decent. But if I mention one, I risk endorsing it. There are several that are very good alternatives. The point is that the payoff for doing even a little better in pricing, even a half a percentage point or a percentage point, is so high that it makes sense to have systems that let you deal with the issue at that level of precision. By the way, we're not talking about rocket-science software. It's simple software that makes very visible to salespeople and sales managers and market managers and product managers just what the real economics of a customer and a transaction are.

Reibstein: Rather than mention any companies, can you talk about the class of software you're referring to?

Marn: There's a class of software called administrative software that helps you figure out what the so-called price waterfall looks like for a customer or a transaction. So when it's time for you to make a decision when a customer is negotiating with you on next year's contract, you can at the press of a button see where my discounts are but not the waterfall. What's the bottom line, pocket price, pocket margin? Was that realized for that account during the last year? What changed? Are they taking more cash discounts? Are they taking longer to pay? A system that adds it up together for you properly on a real-time basis can be hugely beneficial at times when you're negotiating with customers.

[*Editor's Note:* Many companies use an incomplete metric for transaction pricing, such as the list price or invoice price. *Pocket price* is simply invoice price minus all the off-invoice discounts that occur after invoice price, including items like cash discounts, volume bonuses, freight allowances, promotional allowances and cooperative advertising. Pocket price represents the real dollars and cents that are left in a business' pocket as the result of a transaction. A business does put list price or invoice price in its pocket, but it puts pocket price in its pocket to cover costs and ultimately contribute to margin and profitability.

The *pocket price waterfall* is simply the graphical representation of pocket price. The format is a set of vertical bars, the left-most one being list price and the following bars being the discounts subtracted from list price to get down to invoice price. From the invoice price bar, all of the off-invoice items mentioned earlier are subtracted to get down to pocket price. The picture ends up looking like a waterfall with dollars and cents "leaking away" with every bar down to pocket price.

When a product is custom-made to individual customers -- for example, not a standard packaged product for each consumer -- or if there exist important cost-to-serve items that vary widely by customer or transaction, then pocket price itself can be an inadequate representation of the attractiveness of a transaction. In such situations, Marn and his co-authors often suggest the extension of pocket price down to *pocket margin*. Hence, pocket margin is pocket price minus standard costs and minus any special costs-to-serve that a company might incur. The pocket margin metrics allows the comparison of transactions where the product is not standard or the cost-to-serve is highly variable. The *pocket margin waterfall* is the graphical representation of pocket margin.]

The second class is what I call optimizing software, which tries to provide some intelligence on how to price. This software looks up past transactions and tries to judge at what price level you'll get an optimal price/benefit tradeoff for a certain category of products.

There's a third category of price-testing software that I find very exciting. These products let companies that either sell online or sell through call centers on a real-time basis test price levels. If you are a computer company selling personal computers online, for every 20th PC that you sell in a certain class you might bump the price up 3% or bump it down 5% when you quote it. If you do this on a regular basis, if you have enough of a high-volume transaction stream, you can get a sense, with this real-time testing, how sensitivity to price is changing over time.

Reibstein: I'm a big believer in that.

Marn: That's some of the most exciting software that's come out in recent years, and I think companies are just beginning now to reap the benefit of that real-time understanding. The idea is that you *always* have a price test going on. You always have your thumb on the pulse of how price sensitivity is changing for products all the time.

Reibstein: Mike, is there something I haven't asked you yet that you'd like to mention?

Marn: I'd like to say that all too many well-intentioned companies approach price improvement as a project, as something you can knock off in six months or a year and then go on to the next thing you need to fix. When you look at companies that have really created the price advantage, it's not that way at all. This is at least a medium- to long-term journey. To get it right in most companies, you have to potentially touch hundreds, even thousands, of people. You have to change their day-to-day behavior, change the tools they use, change the way they think about price versus volume versus market share. It's more work than you think. It's a larger investment than you think. But the good news is that it's worth it.

We've seen clients that have stuck with this over the years and they keep accumulating benefits over time, in terms of stretching out their margins on a year-over-year basis. But there's almost a change in the feel of the culture of the company. If you go into a company that has created the price advantage, you see a couple of things. You see people who really are customer focused. They understand that they can't create the price advantage unless they create value for their customers. And, you see workers at all levels who understand, 'If I work hard to create an advantage for my customer or an advantage for my company, I know we're going to get a payoff for it. My hard work at a company where the price advantage exists always has a payoff. It's not going to be given away to the market. It's not going to be frittered away in a temporary volume increase.' There's a certain spirit in companies that achieve the price advantage. It's a long-term cultural change.

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