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Pricing Strategies in a Downturn

Which pricing strategies address falling demand in an economic downturn? The pundits generally say 'wake up, pay closer attention to customers, and be more targeted in your pricing.'[1] Good ideas certainly, but what should you do specifically? Which price initiatives do, or do not, work?

From working with clients in industries which entered the recession early (e.g. print media, construction and commodity capital goods) *we believe there are five key strategies, generally requiring intelligent use of tools, to combat falling revenues*. The key to success, in all cases, is not to assume that market-facing management becomes magically smarter. You may need tools to change behaviors.

So, the answers occur in strategy + tool combinations. Most of them focus on understanding the customer buying decision, which is the driver of price sensitivity. Know the decision, and you can optimize your pricing.

Strategy 1: Adjust your understanding of value and its capture.

With the downturn, the value of your offer has changed both in aggregate, and by component. For many industries the value of your after-sale service has increased, while the value of new widgets has fallen. This is a direct consequence of your customers feeling poorer, or having their budgets cut. While such cuts will preclude purchase of new units or services, the old units are now integral to customers' businesses, and so must be maintained, recession or not.

Evidence of this sort of shift comes from recent IBM earning results. Unlike its more manufacturing-oriented peers who experienced sharp revenue declines, IBM exceeded earnings because it had shifted its business to over 60% service and lease revenues—which were less subject to capital expenditure cuts.

The tool required to best propel a change in focus is a quantitative assessment of your offer components' value. That tool may take three forms:

-- A detailed model of your customer's business, showing how they make financial and purchase decisions
-- Conjoint or other analysis of customer views, or
-- Best of all, a rigorous analysis of customer behavior and testing of purchase/price behavior through regression or similar techniques.

[1] We suppose the pundits include us, as we wrote Chapter 6. "Boom and Bust" in *Winning the Profit Game. Smarter Pricing, Smarter Branding* (McGraw-Hill, 2004) before we had dealt with it.

The sooner you understand which categories of spend must continue, and which categories will be cut, the sooner you can adjust your price structure. We have found this analysis produces the best programs for preserving revenues. Often, a price increase on less price sensitive offer elements will offset reduced demand for former flagship products.

In simple terms: assuming your "normal" revenue mix is 70% new sales, 30% follow on, and the recession causes new sales to fall by 20%, we find that often *you can make up much of that fall* by raising follow-on prices (by as much as 50% in some cases!) Naturally, to avoid customer rebellion, finesse, messaging and superior bundling techniques are required to pull that off.

Strategy 2: Improve the value message.

This strategy is linked to the first strategy; in a nutshell it says that customers do not always realize the value of what you offer. While many sales forces say they sell value, in fact most do not. This is because in good times, in many industries, a sales rep does not do best by selling value. Rather the rep does better by raising awareness and inserting themselves into a buying process. In a downturn, the value communication role becomes more important.

The tool required for this role is to equip and train the sales force with specific messages and evidence of your product's or service's value. For instance, surprisingly few companies engage third party evaluators to compare their product with competitors. Credible third party evaluators are plentiful: often university professors will evaluate your product for little more than the cost of samples. Evaluation organizations such as J. D. Powers are very important elements of a value message when customers are parting with their money with increasing care.

Strategy 3: Make a third party pay, e.g. the IRS.

Many companies believe that once the product or service has been delivered, the pricing process is over. Wrong. We find that many buyers are able to obtain reimbursement of their costs, and that a majority of buyers can be educated on the tax consequences of their purchase. You as the seller impact both taxes and reimbursements, and you neglect an important element of net realized price if you ignore these impacts.

The means to effecting this is to understand your customer's tax or reimbursement opportunities. For instance: if you sell to lawyers who can obtain client reimbursement of electronic research but not books, sell your electronic and print research in bundles and on the invoice allocate most of the price to the electronic. For instance: if you sell bundles of telephone and video services, do not allocate them equally on the invoice. Allocate more of the bundle price to the potentially tax deductable telephone line, and educate customers on why you have done so. A final example: if you are a not-for-profit performing venue selling 10 performance season tickets for $300, and individual

performances for $50, then grant season ticket holders who donate back tickets for a performance they cannot attend a tax credit of $50, not $30.[2]

Strategy 4: Better identify customer price sensitivities.

In some cases, a high priority should be to better understand a particular customer's price sensitivity and the possibility of cancellations and defections. This will identify when you may need to offer a greater discount to retain the business, or when a discount is unnecessary. It takes segmentation and moves it to a more granular level.

The tool is a "risk scorecard" which rates the likelihood of customer cancellation due to price. It takes the collective wisdom of your best sales managers, and some quantitative testing, and distills the 4-6 key measures which precede a cancellation. Such measures might be usage, your price relative to competitors, or the process by which your customer makes buy/cancel decisions. Use of such a card is simple: sales management answers the 4-6 questions, and you get a score which says "Discount X%, Y% or None at all."

We recommend a simple execution of this tool. The reason for this is that humans know more about key customer price drivers than do your systems. Frequently, the most important inputs to such a tool are known first by sales representatives or brand managers. For instance, a key factor could be a change in how purchases are approved, such as the switch between single decision-maker and committee, or a credit crunch in a particular geography or end user industry.

The benefits of this tool can be enormous. We repeatedly find that less than two-thirds of cancellations are price driven, so should not be addressed through price. Indeed, lowering price can sometimes destroy trust and set in motion further purchase reviews.

Strategy 5: Scenario planning and price adjustments.

All downturns are not alike. For pricers the key scenario question relates to the direction of price, in particular: inflation or deflation? Additional questions are the costs of inputs, down-stream products, duration and recovery mechanism.

Scenario planning is the tool which has historically performed best for companies planning for downturns, e.g. Shell Oil is superb at this technique. Comparing two previous down-turns highlights differences which should be part of your scenario planning:

-- The mid-1970s recession manifested itself with very high inflation, high unemployment and high commodity (particularly oil) prices. That

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[2] The idea is that context sets price. While the customer may buy the same thing as always, the value and ability to price are different. For instance, while the orchestra may be the same, the price of a *single* performance is *not* the same as a series. So, if the season pass holder turns back in a *single* performance, it's worth $50, not $30 ($300 divided by 10 performances.) This is hard-nosed value assessment.

recession ended as oil prices dropped with deregulation of that industry and the collapse of OPEC.

-- The early-1990s recession also saw a spike in oil prices, but was further propelled by a Savings & Loan/Banking credit crisis. Consequently consumer confidence crashed, but later recovered along with our financial institutions to lead us out of recession. Inflation was not severe.

How will this recession unfold? Abbey Road Associates suggests that one scenario may be a short period of modest *de*flation (declining prices in e.g.: housing, energy and luxury purchases) followed by an uptick in inflation and interest rates. Labor costs may lag inflation. This scenario has very clear implications for pricing, which differ by industry.

For some of our clients it means that long term contracts being negotiated today must have contingencies based on inflation rates, e.g.: if inflation tops 10% there is an automatic adjustment incorporated into the agreement. For many companies our scenario means holding the line on list prices, but relaxing discounts for the next year. For almost anyone who drops prices under pressure now, the message to customers must clearly include: 'We are dropping price now because our costs are falling, but when inflation starts to rise in 2010 you should budget for increases.'

Any deflation highlights a peculiar management conundrum. Most companies of any size sell to the market at different realized prices, usually straining the resources of price management organizations. We recommend that while prices are falling you avoid the temptation to regularize pricing. In other words, do not consolidate rate cards or contracts. There are usually many small customers or distribution partners buying at higher rates because your product/service is not a major expenditure to them. These customers/partners often will not examine price, and change can only provoke scrutiny— as some software providers have found-- leave sleeping dogs lie.

Summary: Cheap tools for depressing times.

We observe that when a downturn comes, pricing grows in importance because management price actions become less routine, and strategy is required. However, to some extent you must play the hand you have been dealt in terms of manager mind-set and skills. Economies change more rapidly than corporate culture.

The way to make the best of this situation is to rapidly build inexpensive pricing tools and insist on their use. Large systems projects might be an option, but they take time and need to be designed with a full range of scenarios in mind. Many companies will do best with simple, fast and inexpensive tools, which recommend both changes in structure and price levels. These are likely to be highest return efforts in challenging environments.

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Abbey Road Associates is a business consulting firm specialized in pricing and pricing strategy. We offer highly evidenced strategic and tactical pricing recommendations to companies across a wide range of industries. Recent assignments have been in the entertainment, telecom, computing, information services, software, consumer products and transportation industries. They have focused on new price structures, new product pricing, pricing processes, discounting reduction/improvement, new market penetration, bundle configuration and pricing, and countering price attacks.

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