

## Comfort Zone

**In search of the perfect price, strategists tune in on customer data. And that's where marketing enters the picture.**

By David Wallace  
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Back when computers were blinking, beeping, room-sized machines used mainly by NASA or James Bond's archenemies, airlines and hotels harnessed them to help manage prices. Armed with reams of customer data, programmers developed formulas that manipulated prices up and down, depending on existing sales, the likelihood of last-minute purchases and other variables (ranging from weather forecasts to competitors' prices). Airplane seats and hotel rooms were worthless if unused; so even selling them at a loss meant gaining some revenue. The practice was dubbed "yield management."

Thirty years later, consumers have exacted revenge, using their own (much smaller) computers to tell companies precisely how much they will pay for a flight, a room, a car, a house or Elvis mementos. The Internet enabled them to compare prices instantly, shifting power once and perhaps forever from seller to buyer.

"In the past, the passing through of commodity price increases was more routinely accepted by customers. More and more, customers do not accept the direct pass-through of those increases," says Michael Marn, a partner with McKinsey & Co. and leader of its pricing practice.

Rising between these two opposing forces is a science that analyzes transactions and other customer data to more accurately explore the cause-and-effect relationship between prices and purchases. Using mathematical formulas and massive databases of sales records, companies can forecast their sales plans and test pricing and demand elasticity under various discount or package scenarios before trying them in the market. Layering in data from other customer interactions can help companies set prices, schedule markdowns and identify top-performing buyers with more sophistication than ever before.

"The benefit of analyzing consumer demand is you can make accurate projections for the first time at a store and SKU level," says Dan Fishback, CEO of DemandTec, a developer of what Fishback refers to as consumer demand management software.

Also known by terms such as price management, price optimization or revenue management, this emerging discipline has found a loyal following among retailers that have tapped into large repositories of point-of-sale data to refine their pricing models. Now, price management is beginning to spread into other product and service industries as companies seek the perfect price to maximize unit sales, price-per-sale and, ultimately, profits.

With the increased buzz around strategic pricing, however, comes the inevitable clutter: Price management is a complex world of historical pricing and profitability, of markdowns and discounts, leading to a lot of head-scratching over the right strategy and the right solutions to support it. Some companies use in-house expertise and homegrown applications to manage prices. Others-in growing numbers-are turning to third-party tools and consulting services for help.

"Right now, you have a lot of good software out there, but also a lot of confusion. It gets expensive to do everything at once," says John Hogan, vice president and research director at Strategic Pricing Group, a pricing consultancy. "The market is still trying to find out the best way to go."

Adding to the confusion is the question of ownership. As price management moves beyond simple cost-cutting to encompass more strategic initiatives, the emphasis shifts from a relatively straightforward accounting function to a suddenly murky area in which marketing, pricing, sales and IT all play potentially important parts.

"We're seeing more of an intersection between the marketing and pricing groups," says Sean Bisceglia, CEO of CPRI, a marketing staffing company that has placed its associates with pricing and marketing groups at several automakers and packaged goods companies. "It's not just about the lowest price anymore. People have really focused on the value proposition of their product. What is the target audience that you're going after for this new luxury car or that new soft drink willing to pay?"

For marketers, that is the \$64,000 question. (Or, in the case of the luxury car, the \$58,000 question.) What, exactly, is the target audience willing to pay?

#### Mix and Match

Pricing, always a key differentiator among competitors in any market, has become even more important in a world marked increasingly by globalization and commoditization. How critical? Marn cites McKinsey research that found a 1 percent change in price could have an impact as great as 11 percent-positive or negative-on a company's operating profits.

**Pricing is more than simply cutting prices to move a product; it's about finding the right price in order to move the most units and maximize margins. "It's not about raising or lowering prices," says Larry Warnock, marketing vice president of Zilliant, a price/revenue optimization software company that counts DHL among its clients. "Optimization is aligning your price with your customer's perceived value of what you deliver."**

Such a strategy, done right, might even require setting prices that convince your most unprofitable customers to leave. That's because sales to value-destroying customers can kill a business, more slowly but just as fatally as having no customers at all.

Haight cites the example of one Acorn client, a steel fabricator that was mulling what (on the surface) seemed like a winning RFP from a sales prospect. Although the contract promised to boost revenue tremendously, Acorn's analysis showed it would also wipe out the client's profitability. The company turned down the RFP and eventually negotiated a more equitable contract.

The transition of pricing from tactical lever to strategic weapon has convinced many senior management teams to integrate their price-setting activities with market and customer segmentation efforts, says Eric Mitchell, founder of the Professional Pricing Society, whose membership has grown from 600 to nearly 2,000 in the past three years.

"We're a mirror of the fact that large companies have moved pricing from an administrative function to a strategic role," says Mitchell, a former pricing manager at Xerox and Ford. A 2004 survey of Professional Pricing Society members supports Mitchell's claims: Nearly one in five price managers said they report to senior management, nearly double from a 2002 survey. Of those price managers, 41 percent reported to a marketing executive, 18 percent to a finance manager and about 10 percent to a sales executive.

"These can't be treated as IT projects," says Michael Stanek, CFO at Northern Group Retail, a Toronto-based fashion chain. "They need to be a corporate initiative. And to get the full organizational benefit, you have to have a lot of team members."

Marketing's role often is to lend perspectives on customer behavior that can be applied not just to cutting prices, but quite possibly to raising them as well. By adding customer demographic or psychographic data to existing pricing formulas, a marketing department might determine that the merchandising group has underpriced a new product. Quantifying the buzz around the new product—a factor that would not make it into a traditional price-crunching algorithm—can lead a company to charge a premium for it.

At American Power Conversion (APC), several teams work in tandem to set optimal pricing for the company's power-protection devices. "Typically, we have the product side set the recommended street price in a given market, and the local sales and marketing teams run the quote process," says Aaron Davis, the company's vice president of marketing. "It allows for a nice balance."

The local teams have much leeway to use channel incentives, end-user promotions and other creative ways to stimulate demand for APC's products, says Davis. The finance team keeps them honest by performing quarterly audits and reporting actual margins versus targets—and any deviations from expectations.

#### Avoiding the Low-Price Death Spiral

Working customer value into the pricing equation has enabled companies such as Tweeter Home Entertainment Group to opt out of low-price warfare with big-box retailers.

"All the Sunday circulars do is encourage price comparisons," says Mark Richardson, chief brand officer for the consumer electronics chain. "In that game, it's the biggest guy who wins because of whoever has clout on low-end items. It's not a way to build customer relationships and loyalty."

Tweeter has shifted its marketing message to emphasize lifestyle over low prices, and it uses its purchase data as part of a broad strategy to create customer relationships that extend from sales to delivery, installation and periodic tune-ups. It negotiates with manufacturers for unique brands or combinations of items that distinguish its inventory from that of the big-box retailers.

The strategy has helped Tweeter keep its pricing above the cutthroat levels of Best Buy, Circuit City and similar chains. It does not, however, avoid pricing as a competitive tool altogether. Store managers have the latitude to adjust prices for particular bundles. And since 1993, Tweeter has backed up its products with an Automatic Price Protection plan—under which Tweeter researchers will scan competitive prices, and if they find a lower price within 30 days of a purchase, Tweeter will automatically refund the difference to the customer.

By understanding who buys what, and why they buy it, companies are discovering that they can set more competitive prices on items that matter to specific consumer segments.

DemandTec's consumer demand management software, for example, can help companies adjust prices, discounts, markdowns and promotions more closely by calculating forecasts of sales, profits and volume details at a granular level. By collecting purchase data and comparing it against various what-if scenarios, companies can identify the impact of price changes at specific stores, and even for specific products within those stores, says Fishback.

These forecasts will help marketing executives more effectively target their promotional investments to the locations and the products that are most likely to drive sales, he adds.

Take the example of a retail chain that used DemandTec software to test a new pricing strategy for baby products. Price competition for baby formula and diapers was fierce, yet the category

was among the company's most profitable. Using DemandTec's forecasting tools, company executives realized that an across-the-board price cut of all baby products would not stimulate sales throughout its drugstores.

Instead, the forecast showed that a price cut only on baby formula-a low-margin, low-volume product for the chain-could positively affect sales of other baby items. The strategy worked: Unit sales of formula increased by 14 percent, while unit sales of disposable diapers grew by 10 percent-more than enough to offset the extra margins lost on formula.

Discounts and markdowns are perhaps the most complex elements of pricing to manage efficiently. While new product launches generally are backed with voluminous research, price reductions on existing products "tend to be more emotional," says APC's Davis. "Companies see reductions as a defensive maneuver. That [tactic] can decimate an industry, because they're easy to start and hard to stop."

APC, as a leader in the power-protection market, is all too aware of rivals' attempts to steal market share by igniting price wars. The company has tried to remain above the fray, using extensive modeling and data analysis tools-along with regular surveys of buyers and channel partners, competitive research and staff feedback-to keep its prices in line.

"Typically, we look systematically at the manufacturing process and at passing savings and volume efficiencies to the market," Davis says. "Obviously, the higher your share, the greater likelihood that a price cut will hurt you."

"If you drop prices on the lower end, you might take share from a competitor, but you may pull the price down on your whole family of products," he adds.

APC so far has managed its pricing internally, using a mix of Cognos and Oracle applications, along with custom databases that integrate information with data flows purchased from third parties to develop trend analyses around sales, pricing elasticity and so forth. An in-house analysis team runs ad hoc reports and analysis using whatever tools are appropriate.

Many companies still manage their pricing with a similar mix of ad hoc reporting and gut feel. Many, understandably, are wary of another big-bang technology investment. They prefer to steer clear of any technology vendor or service provider that promises to solve a long-standing problem such as pricing, citing the dubious returns many companies received on their hefty investments in CRM and ERP systems.

At the same time, however, many are frustrated with their current pricing practices and know they need to do more. "Most of our clients come to us after trying to do this on their own-maybe with Excel or a third-party application-and finding that they hit a brick wall, or it's too hard to manage," says Acorn's Haight.

The beauty of investing in price optimization software and services, proponents argue, is the clear-cut ROI. Executives will know quickly whether a price cut is working.

**"The return on investment is absolutely concrete," says Zilliant's Warnock. "Within six months, you can see if gross margins are better than when you started."**