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## Plugging Leaks

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Most people will endure the drip of a leaky pipe for only so long before they call a plumber. Manufacturers, on the other hand, have tolerated leaks for years, and few have sought professional help.

In this case, the leakage is revenue, and the principal driver, analysts say, is faulty pricing. Products sold for less than optimal prices cut into profit margins, and when a company lacks the discipline to plug these leaks, they become part of the corporate culture, and the dripping goes unchecked.

Comprehensive price management has a relatively short history in the manufacturing sector. In progressive businesses, price managers and analysts have conducted manual excavations of past deals and other sources of pricing insight, and then used that data to establish more profitable pricing. In less-developed companies, salespeople have made concessions and offered discounts that have little to do with the deal's profitability and much to do with increasing sales commissions.

In fact, that remains the prevailing MO of today's manufacturer when it comes to price management. The fallout from lax pricing policies can be significant, as companies across all sectors admit to leaving as much as 5% of margin on the table when selling products. In the semiconductor industry alone, that could mean billions of dollars in unrecognized revenue, according to a recent Accenture survey. While more than three-quarters of the manufacturers in the study said they had formal policies for setting prices, 56% admitted that they use "ad hoc discounting practices" sometimes or often. Accenture calculated that for every billion dollars in revenue, that practice translated into \$16 million to \$23 million in lost sales for those semiconductor companies alone.

Experts point to the lack of centralized pricing analysis and nonexistent enforcement as two main culprits. Many manufacturers are unable to sort through all of their data on pricing and discern the levels that best meet margin goals. Laura Preslan, senior manager of [Deloitte](#) Consulting LLP's Pricing and Revenue practice, says this leads to "management by pricing hunch" instead of by pricing data.

But even if companies set profitable prices, they often fail to enforce those through the sales process, experts say. "Historically, salespeople have been sort of cowboys," says Julie Fraser, principal at manufacturing research firm Industry Directions. "Once they get in front of the customer, they can say and do whatever they want, as long as they rope that thing to the ground and get the deal." The salesperson, she says, wants to make quota and make the customer happy. "Well, in making your customer happy, there's a lot of opportunity to make your company unprofitable. There are revenue leakage opportunities there."

In general, lack of information is not the problem; manufacturers have a wealth of data on hand that can guide them toward the best prices for their products — for example, sales forecasts, current and past contracts, and market demand studies. But few companies have the time or the processing power to collect and analyze it all. As for maverick salespeople who give away margin just to cut a deal, few realize that this is what they're doing, because the company pays commission based on sales volume, not on margin.

Some manufacturers have dealt with revenue leakage by making price management part of their business. Leading — and often large — companies typically maintain a pricing department staffed with analysts who do nothing but study the terrain of past deals and market forces, including competitors' pricing, with the aim of creating contracts that deliver the most profit possible.

Others with resources to burn have retained consultants to help establish pricing strategies. Outfits such as McKinsey & Co. and A.T. Kearney Inc. typically take sizable fees to set a company on a course to higher profitability. Once the engagement is completed, however, there is generally no tool in place to help the company stay on course.

Price management software provides another alternative. These offerings began to hit the market in earnest earlier this decade. In this relatively young technology field, there remain a number of best-of-breed providers

that now share the space with suite vendors, which have muscled their way into the picture by adding price management capabilities to their products.

Predictably, the adoption rate for this software among manufacturers — which have lately been asked to embrace a slew of products that add value to their ERP systems — remains low. "It's still a small, small percentage," Fraser says.

And yet, tantalizing stories of payback are drawing more companies into the fold. Fraser says that the return on a price management software investment can occur in short order, mainly because most companies have never taken a scientific look at their products' prices. Once they do, they may realize that one or two high-volume products are poorly priced, and adjusting those accordingly can quickly fatten the top and bottom lines.

### **Plan of Attack**

AMR Research breaks the price management process into three distinct disciplines: optimization, execution, and enforcement. Optimization is determining the best possible price, an exercise that involves crunching a plethora of data, including similar past deals, customer histories, prevailing market demand, corporate revenue targets, and competitors' pricing. This can be done manually, but not without great effort, and a company with a large product catalog may be better off leaving the data analysis to an optimization engine.

Execution is the process by which those optimal prices — however they may be determined — are disseminated to the sales force and customers. Software for this purpose resembles a customer-relationship model, and indeed can be built into such systems. Governance of those price guidelines is left to an enforcement application, which will observe the parameters set in the execution stage and reject any attempts to price products outside those guidelines.

According to a research note in mid-2006 by AMR analyst Michael Barrett, the vendors looking to enable these processes with software were slow to embrace them as a holistic concept. "Vendor marketing and messaging circa 2001 emphasized the science, math, and horsepower" of optimizations, Barrett wrote. "It was all about proving the black box cranked out the right answer. This was the technology hammer looking for a business nail," he concluded.

The nail that vendors have begun to hit in recent years is an integrated management package that includes the optimization of prices, the dissemination of those prices to the sales force, and the governance structure that ensures that a price will be honored.

That broader scope has also led to another product segment — profit management. Companies such as [pVelocity Inc.](#) market software that analyzes many of the levers that affect a business's income, from manufacturing equipment efficiency to a particular product line's profitability.

Those are important measures, to be sure, but analysts agree that pricing tops the list of factors affecting profitability. A 2003 report in the *McKinsey Quarterly*, for instance, stated that selling a product for 1% less than the optimal price could mean sacrificing 8% of its operating profitability. So, while some vendors tout their ability to maximize profit through many levers, others make no apologies for focusing solely on pricing as a means to that end.

"There are other areas that impact margin," acknowledges Greg Peters, CEO of price management provider [Zilliant](#) Inc. "We are focused solely on pricing because it's the biggest lever out there."

In an effort to keep up with the Joneses, however, a number of price management vendors now describe their products as profit management.

### **Sell It Right**

"I think most CFOs in the world think their sales force is out giving product away," says Peters, himself a former CFO. But that kind of revenue leakage — a perennial nemesis for all kinds of companies — stems from a lack of understandable information, not bad intentions, he says. "People don't wake up in the morning and say, 'Let's go make some really stupid decisions today.' "

The job of a CFO, or any executive, then, is to arm salespeople with data that will let them make more profitable decisions, and to put in place a structure that will govern their use of that information.

A pricing executive at one global electrical equipment manufacturer, who prefers to remain nameless due to the competitive nature of pricing policies, says pricing management software has brought much-needed automation to a process that was growing too cumbersome.

With revenue of more than \$10 billion and a product catalog two inches thick, the company stands to forgo a

substantial amount of revenue if its prices aren't where they should be. Its strategy starts with an internal department of 30 pricing analysts, who cover all of the more than 10,000 offerings in the company's portfolio.

Zilliant's Peters says the idea behind such price management efforts is that deals of a like nature should be priced similarly. "It's kind of an intuitive concept," he says. "But getting deals, product, [and] customers analyzed in that way, where you're comparing apples to apples, is relatively difficult."

That may be putting it mildly. The director of pricing at the electric equipment manufacturer says the process tested the limits of his staff's ability to manage information. "It got to be too much to manage," he says of the work, which involved culling data from spreadsheets and other disconnected sources. "It was just pretty much a nightmare."

In March 2006, the company went live with Zilliant's ZPPS Deal Manager and Analytics, part of a push to set and honor better prices. Although ROI measurement is somewhat nebulous because pricing isn't the only factor that affects profitability, the company is more than satisfied with the results. Based on a run-rate analysis, "the ROI was probably 10-to-1" with the Zilliant system installed, the pricing chief says.

The plan for now, he says, is to retain the pricing department as the intermediary between the Zilliant system and the sales force. But it probably won't be long before sales personnel are getting their ceiling, target, and range prices directly from the Zilliant system.

"The first step was to get the analytics software built into what the price managers see in order for them to make more-educated decisions," he says. "And I'd say step two is getting that out to the field whenever we get some momentum to go do that" — not to mention the funding, too, because 1,200 user licenses amount to a large investment.

For ON Semiconductor Corp., a global manufacturer of semiconductors, the stumbling block in improving profit margins wasn't price optimization but price enforcement. Simon McLean, director of customer marketing and pricing operations at the company, says the sales team was giving away too much on price before the company deployed [Model N Inc.](#)'s High Tech Revenue Management suite.

The legacy system that preceded the Model N application had some basic order quote screens, but they were used inconsistently. "People would quote over the phone or on an Excel spreadsheet — the kind of stuff that can happen in any company if you don't have a rigorous discipline," McLean explains.

Like the electrical equipment manufacturer, ON Semiconductor maintains a pricing department that acts as an intermediary between the sales force and customers. If a customer requests either a quote on an item that isn't in its contract or a lower price on a product that is, McLean's team of analysts provides the guidelines for that quote and enters them into the Model N system. With more than 2,500 employees tapped into the software, including all of the company's sales personnel, ON Semiconductor can ensure that no one quotes outside the parameters they are given, because the system won't accept an input that is lower than the allowed minimum.

McLean says what the company truly needed was to instill discipline in the quoting process. With the software, he says, "We got a very rigorous control process."

As these companies illustrate, software will serve different purposes in different environments. A company that faces only slight price volatility may need an enforcement module but not a price optimization engine. A small company might want to optimize its prices but may choose to handle pricing execution with an existing IT system.

One thing seems clear: It's time to call a plumber.

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