Is Your Business Playing Air Guitar Pricing?

PRICING INSIGHT

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Air guitar pricing is the art of making all the right moves, gestures and expressions that go along with the soundtrack of what everyone in the business wants to hear—but not actually doing anything.

Air Guitar: Part mime, part Kabuki theatre, and part too much drinking of the leftover red cordial at a kids' party.

I first came across the air guitar phenomenon through this DVD, Air Guitar Nation. From the elbows up, playing air guitar looks almost perfectly realistic and convincing--and easy enough to have a go at. In fact, anyone can do it. Just like anyone can set a price. The only difference is that if you get your air guitar moves wrong, the worst that can happen is a slightly damaged reputation or bruised ego. **Getting your pricing wrong has far more serious consequences.**

Every month I come across companies that have lots of processes, analytics and effort expended to manage pricing with little results. It is as if they are miming their way through the pricing function, playing their very own pricing air guitar.

Is your business playing air guitar pricing? Here are 7 classic pricing air guitar moves that could be costing your business:

Air Guitar Pricing Move #1: Issuing a price override report that nobody reads

You know the report that's issued every Monday on the previous week's transactions. It shows transaction detail to the SKU or service at a line item level, who the rep was, who made the sale, and the % discount from the regular sell price. It's usually sent to about 20 people on the management team.

Here's the problem with this approach: It looks like the data that gets reported is the data that gets measured--but that's not actually the case. In fact, the noise of this report almost becomes spam due to its frequency and lack of context.
The data is isolated from the context of the sale, the bigger picture, and--more importantly--any actionable consequence. It goes on the mental pile of "read it", or "issue noted", or "I will do something about it once I put out the immediate brush fires encircling us". As we all know, the fires keep burning—so if you come across this situation, just stop sending the report. If nobody complains or just one or two mildly ask if it is being issued, you know you have a pricing air guitar situation.

The key here is to rework the report as a set of ratios. For example, total discount dollars measured against gross margin dollars as a trended ratio is more meaningful. This way you can see if reps are driving discounts to generate more gross margin or just sending profitless volume through the system. Review this monthly and quarterly to refine pricing strategy and tactics.

Price floors and fences around key products should be identified prior to the new trading year and locked down via stringent system controls. Training should also be provided to sales staff to give them the ability see their ratios and refine their sales approaches to drive higher prices and margins.

Air Guitar Move #2: Bill and Ted's bogus sign-off authority limits that control nothing

This is another case of governance by red tape without science or structure. The bogus sign-off game goes like this: A sales rep can sign off discounts of up to 5%, their manager up to 10% and their manager's manager up to 20%--and so on.

One cement company had set this process up with a Lotus Notes automatic email that was forwarded to the relevant manager if the discount request was large enough or went over the % threshold limit. The largest discount request of 20%+ went to the General Manager of sales and marketing. When I asked to see his email inbox of discount authorisation requests, I counted no fewer than 45 individual emails--all with 500+ words of explanations and details of the situation. These emails had not been read and were over 5 days old. This was just two weeks' worth of requests. **The sign off process had just become a rubber stamp and no real control or oversight exercised.**

There are several risks here:

1. The reps learn to game the system to get discount approvals
2. The managers are too busy to really review each discount request and so just approve the request with limited time to evaluate it.
3. The approval process is too slow so that the legitimate request doesn't get approved in time and the customer buys from a competitor.
4. There is a mistaken belief that this sign-off process is protecting margins.

The first opportunity here is to issue clear tactical pricing guidelines each week or month depending on the sales cycle and market volatility.

The second opportunity here is to install a pricing team to review and manage discount requests that fall outside the tactical discount guidelines, so that strategic pricing conversations can be had at the end of the month or quarter. Is our list price too high? Are we targeting the right customer? Do other reps sell this product without discounts, and why?

Senior managers should provide a discount summary position for each sales rep and for each product trended--and compare against last year--to establish next steps and maintain controls and governance.

Air Guitar Move #3: Three tiers of tactical discounts, with 80% of all discounts in the lowest price band

Many companies set up tiered discount levels to automate the pricing process to customers. Typically, there are 3 levels of discounts – low, mid, and high. In some cases, there are 5 tiers, with essentially the same concept. Three market tiers seem to make sense: The three levels are governed by rules to guide who can access each discount level. As an example, a materials handling company came up with these three levels:

Standard discount – average 30% reduction off list price

Major accounts discount – average 33-35% reduction off list price

Fruit and vegetable markets discount - average 36-40% reduction off list price.

The salesperson simply had to decide which of the three tiers the customer fell into. But the trouble with this salesperson-validated approach was that almost 70% of customers had some relationship to the fruit and vegetable industry. Like the Kevin Bacon "six degrees of separation" game, all these customers had deep ties to the fresh produce markets.

Whilst it is almost comical to see this discounting behaviour at a distance, up close the results are disturbing. Sales reps again learn to game the system when there is an ineffective pricing discount shorthand in operation. Products or services that don't need to be discounted receive discounts because the sales team want to secure the sale--and they don't want price to cause any friction or resistance to purchase.
You damage profitability under this simplistic three-tiered scenario in two major ways:

Firstly, does the product even need to be discounted? In many cases, the answer is no. Secondly, what is the magnitude of the discount? When you create these step change-level movements in increments of 5%, you often give away an unnecessary 1-2 points of margin because that is what the discount guidelines dictate.

The most optimal solution is to create a well-balanced and thought-out List Price structure, then determine net selling prices per product by customer. This is complex work, but the reward is there. By developing a sophisticated net price for products / services at a customer level, you create market segments of one. If this level of sophistication is not practical, then you can create a specific discount per customer across all products instead of placing them into bands of three tiers.

Then, look to create discounts by customer at the category level of product hierarchy.

Air Guitar Move #4: Endless scatter plots and bubble charts that measure exactly how the ship is sinking

Data is everywhere now. Excel does wonderful things, including making great charts. Software like Tableau allows for all kinds of visual representations of data.
We came across an ASX Listed company that had started down the road of looking at pricing. They decided to see what they could do themselves. Nine months later they called up again and wanted to meet urgently, for help managing their next price increase.

When we asked them how they had progressed over the past nine months, they showed us a 30-page PowerPoint deck full of charts and graphs--showing examples of margin inconsistency, extreme price bandwidths and potentially excessive discounting. "This report is interesting, but what else has been done?" we asked. "Ah, that's it!" came the reply. Painful: Nine months to make a PowerPoint report. Yes, the report may be useful--but the time taken to create it was too long.

Margin erosion and opportunity cost are a function of time. In most mature businesses, sales are generated every week. Time to action becomes a critical factor. Too many executives wait until they have endless evidence, data and reports and then hold a consensus-style meeting where everyone must be on board and agree before a single action gets taken.

If you are a business with revenues of $400M per year and you identify a 3% margin improvement--and approximately $100M of that $400M in revenues is addressable--then you have a potentially missed a margin opportunity of $3.0M or $250,000 per month. This makes that PowerPoint deck very expensive. Every business needs data and analysis to support decision making.

The key here is to balance the need for information with the imperative to take action. It is far more useful to create a series of pricing hypotheses and test these live in the marketplace than to spend nine months trawling historical data trying to find answers. Here is a recommend timeline:

> Spend 1-2 weeks discussing the problems and challenges with multiple stakeholders
>
> Spend 1 week creating hypotheses to test
>
> Spend 4 weeks modelling numbers and scenarios
>
> Spend 4-8 weeks testing in the market to validate hypotheses and new ideas
>
> Spend 1-2 weeks analysing results against expected plan, then write up recommendations

Rinse and repeat this process. Timeline to action is less than 8 weeks and a new pricing strategy can be formulated with real controllable data in 16 weeks. The key here is to spend more time on planning actions and testing than on trawling and digging for data at the expense of any action at all.

Air Guitar Move #5: Using costs and margins as proxies for value to set price

We once saw a pricing analyst at a large Fortune 500-owned stationery supplies company going through margin data by SKU or line item, and reducing the prices where the margins appeared “too high”. He thought that since the category margin was around 40%, seeing a single product with a gross margin of 50% must mean the product is priced too high and won’t sell.

No, you can’t make this stuff up.

We regularly see executives asking for the costs of a product so they can then set a price for a tender or a quote to a customer. I’ve seen a senior sales director of a transport company openly exclaim “How can you set your price if you don’t know your cost?” By relying on margins to be a proxy for value you.

If you don't test the market and segment customers based on what they value, in many cases you create a self-induced commoditisation of what could have been great value to a customer.

You will never know, because you are looking through the lens of a supply chain arrangement--not an end use case which created the demand in the first place.
If your company insists on putting true product costs in the system for all to see, you put margins at risk because all prices will get anchored to costs in some way. Cognitive psychology has proven that this anchoring phenomenon occurs almost every time when humans are presented with one set of numbers and then asked to estimate prices for a range of items.

People mentally "anchor" to the first number they see. Subsequent pricing decisions are influenced by your costs, thereby denying you the chance to discover greater price points and increase margins.

Train your team to think about creating prices based on value checklists or frames of reference. For example, think about how global franchises have been created out of speed of service: Kwik Kopy printing is one example. There's nothing cheap about their prices. Define as many value drivers as you can, and develop a set of surcharges for each if they are not core to the intrinsic product or service.

Remove all visibility of costs from the system. This may appear controversial, but you won't look back. It will create a pricing discipline built on principles and structure. Will we lose money? No--because the decision to sell is independent of the decision to set price.

Of course, you need to measure margins and review costs weekly and monthly--but these relate to business model and supply chain issues, not price setting strategies and tactics. It's crucial to ensure that all margins are analysed at the SKU level and then consolidated up to sub-category and category level. At the category level, it's important to review margins by unique customer or sold-to party. This always reveals some interesting accounting anomalies and issues with costing. It also further supports the idea that system costs are not a great way to set prices, if you're aiming to maximise profitability.

Air Guitar Move #6: Issue blanket 5% price increase letters to customers with 28 days' notice.

We see many companies in transport and building materials post standard price increase letters advising customers of a 5-7% price increase, effective within the next 28 days. What happens next is a round of conference calls with state managers all indicating that they have "X" number of customers who cannot take the price increase just for strategic reasons.

Sales reps then create a series of price overrides in the system to negate the increase in List Prices. New rebate structures are created or greater levels of rebate offered to existing customers. Throw in some threats of lowered revenue and volumes and you have a recipe for the price increase that never was.

Setting blanket price increases to market undermines the very principles of value and selling to unique customers. Not every customer should get a 5% price increase. Some

customers will easily accept a 1-3% increase whilst others will accept a 7-9% increase. The risk is that pricing too high means you lose customers and volume, while pricing too low means you lose margin and earnings.

When sales team start creating pricing schemes such as price overrides and rebates to dilute the price increase (or render it void to the customer), the result can often mean taking a price increase that leads to margin and earnings decline. The new reality of pricing is that margin expansion is being won at the line item level. This means decisions at the category or customer segment level are too ineffective for navigating the value vs. price landscape.

Your next price increase needs to optimise prices by products and discounts by customer.

This is a complex piece of work. The work to analyse your customers and products can generate an additional point of margin. If you have revenues of $400M, that translates into $4.0M EBIT. If your average EBIT margins are 10%, that is equivalent to winning a $40M account. The business case can then be made to provide the relevant investment and focus in order to manage your next price increase at a more detailed level.

The other key price here is to ensure your customers have awareness of the potential for price increases that are aligned to their stock turnover ratio. In other words, if they have a stock turnover ratio of 2 you need to provide ideally 4-6 months' notice. If their stock turnover is 4 then 2-3 months' notice is likely fine. Rarely do your customers have stock turnover ratios of 12, so somebody always loses when short notice is given--and this in some part creates resistance to price increases.

Air Guitar move #7 No dedicated, trained and appropriately resourced pricing team

In companies turning over $10M revenue annually—and companies turning over $10B revenues annually (and companies in between)—pricing is often set on an ad hoc basis by a whole raft of people who are doing the work part time in addition to their day job. It might be a commercial manager who handles month-end reporting and who doubles up to manage the pricing analysis for a major tender or bid. Another common scenario is the sales director acting as the quasi pricing manager overseeing all deals, prices and deciding the economics without any further oversight--and having their incentives paid based on winning deals and hitting KPI targets.

This drives behaviours which may be at odds with optimal pricing. When you are required to manage multiple areas of responsibility you excel after a period of time--but you usually don't become great or outstanding. Experience shows that having specialist heavy hitters on your team is far more effective than having a group of generalist all-rounders.

In the double-up scenario, no one really becomes great at pricing--so it is owned by no one, open to abuses by everyone, and results in missed opportunities, pricing mistakes and earnings erosion.

When the Sales Director becomes the pricing manager, there is a natural cognitive bias toward making the sale at the expense of margin. There is also a Sarbanes Oxley-

type conflict when the sales manager is able to set, negotiate, sign off and release rebate payments or discounts to customers without oversight. The solution for this problem is straightforward: If you have no pricing team it is time to build one. But it needs to be done the right way.

Detailed mapping of current process is required, stakeholder engagement is needed, and the charter and remit of the pricing team needs to be agreed on in advance of the team coming on board. The existing team members need to feel a sense of ownership and accountability to the success of the pricing team--not resent its presence.

The establishment of a pricing mastermind or advisory board is also recommended, to ensure the lines of communication remain open across many fronts within the business. Pricing management is an information- heavy function with information "use-by" date measured in hours and minutes--not days and weeks. For this reason, one pricing manager and analyst is required at a minimum, and an additional analyst is needed for every $50-$100M in revenues under management.

How many other pricing air guitar moves are out there? There could be a dozen more. Here are the air guitar details: Be warned—it's not for those who take themselves too seriously.

http://www.airguitarworldchampionships.com/en/program/

To arrange a discovery call, please go to www.pricinginsight.com.au to schedule a booking.

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