

Think Twice before You Reprice



During an economic downturn, companies struggle to maintain levels of revenue, growth and profitability. Everyone is called upon to “do something.” Spending is restricted. Discounts increase. New—usually lower—prices are announced. This article provides a framework that pricers and others can use to take coordinated action. The framework focuses on ways to increase or accelerate the only thing that counts in times like these: Cash Flow. The author of the piece, Jim Geisman, is principal and founder of MarketShare, Inc., Wayland, MA. For more information he can be reached at: jimg@softwarepricing.com.

Prices are often the first thing to go during a recession. Often, prices are lowered on an ad hoc, deal-by-deal basis in the form of negotiated or discretionary discounts. Sometimes companies try to stabilize or increase revenues by lowering prices across-the-board. In both cases, the results are often disastrous. Dramatic cuts don't lead to more customers, and revenues drop. Avoiding this doomsday scenario cannot be done by the pricing group alone. It requires the support by, and coordinated action of, many parties. This paper suggests a way to accomplish this by focusing on improving cash flow.

Happiness Is Positive Cash Flow

Although price is an obvious variable in a business model, it should not be the first thing to change. If economic forces suggest the need for lower prices, then (before taking this step) focus on how to improve cash flow. By doing so, you can often identify creative ways to improve financial performance without changing prices.

Why cash flow? Too often, we need to be reminded that cash, not earnings, is what gets deposited in the bank. Earnings may have something to do with cash, but frequently they do not. Enron was a prominent example of how misleading earnings can be. Follow Warren Buffett's lead and devote most of your attention to cash and cash flow and less attention on earnings.

When you look at pricing as a means to increase or accelerate cash flow, several non-price alternatives to lower prices may emerge. These alternatives may be out of the purview of the pricing department but can be used as an opportunity to engage other areas and decrease the pressure for price adjustments. Some of these are non-price changes and can be implemented quickly; others are low risk and have modest organizational costs. Lowering list prices should be your last resort.

Look for Improvements Systematically

Economic downturns are periods when companies desperately search for ways to maintain revenues. A large number of options seem possible—often too many. To find the best ones affecting cash flow, there are two keys to success. First, search systematically for improvements and find the most effective ones. Then,

select a few of the most promising ideas, implement them carefully and apply them consistently. Good management is 1% inspiration and 99% execution.

A benefit of a systematic search for improvements is speed. One can more easily engage other groups since an orderly search usually takes less time than a disorderly one. A carefully thought-out approach also helps people get comfortable with the available options, make contributions and adapt to change.

The “fishbone chart” shows how cash flow is related to some common financial metrics and can be a useful framework for systematically searching for alternatives to cutting prices.

Increasing or Accelerating Cash Flow

Before exploring the options, here's a quick overview of the relationship between price levels and cash flow.

When list price levels increase, so do the realized revenues, which, in turn, should result in higher gross margins and more contribution dollars. More contribution means more funds are available for operations, investments or simply increased profitability (which by itself may contribute to better cash flow, but the timing of payments is equally important). Any efforts to improve profitability will be for naught if the money comes in too slowly. Should profit levels be high enough, but insufficient to pay current expenses, then get paid sooner (customer advances) or stretch out payables (pay in installments), while getting control over costs.

The credit department may set credit terms, but the pricing group can influence the timing and predictability of cash flow by encouraging the equivalent of layaway plans—especially in industries with seasonal or cyclical demand—and discount policies that encourage early payment. The essence of all cash-flow improvement techniques is well known: Buy Low, Sell High, Collect Early and Pay Late. Pricing can greatly influence the Sell High/Collect Early elements.

Improving Profit

Moving up the fishbone from cash flow to profits, there are two ways to raise the latter: Increase contribution or decrease costs.

Trimming major cost areas is one part of profit improvement, but the sales and marketing groups may be able to affect total contribution by reallocating costs instead of just cutting them. (In the next section we discuss actions that can increase total contribution.)

Although most marketing and sales departments know how to improve their effectiveness, these adjustments take time—a scarce commodity in this challenging period. (Desire for immediate results is one reason why there is such pressure to cut costs and change prices.)

Recognizing that nothing can happen overnight, here are some ways cash flow can be increased beyond the effect of cost reductions:

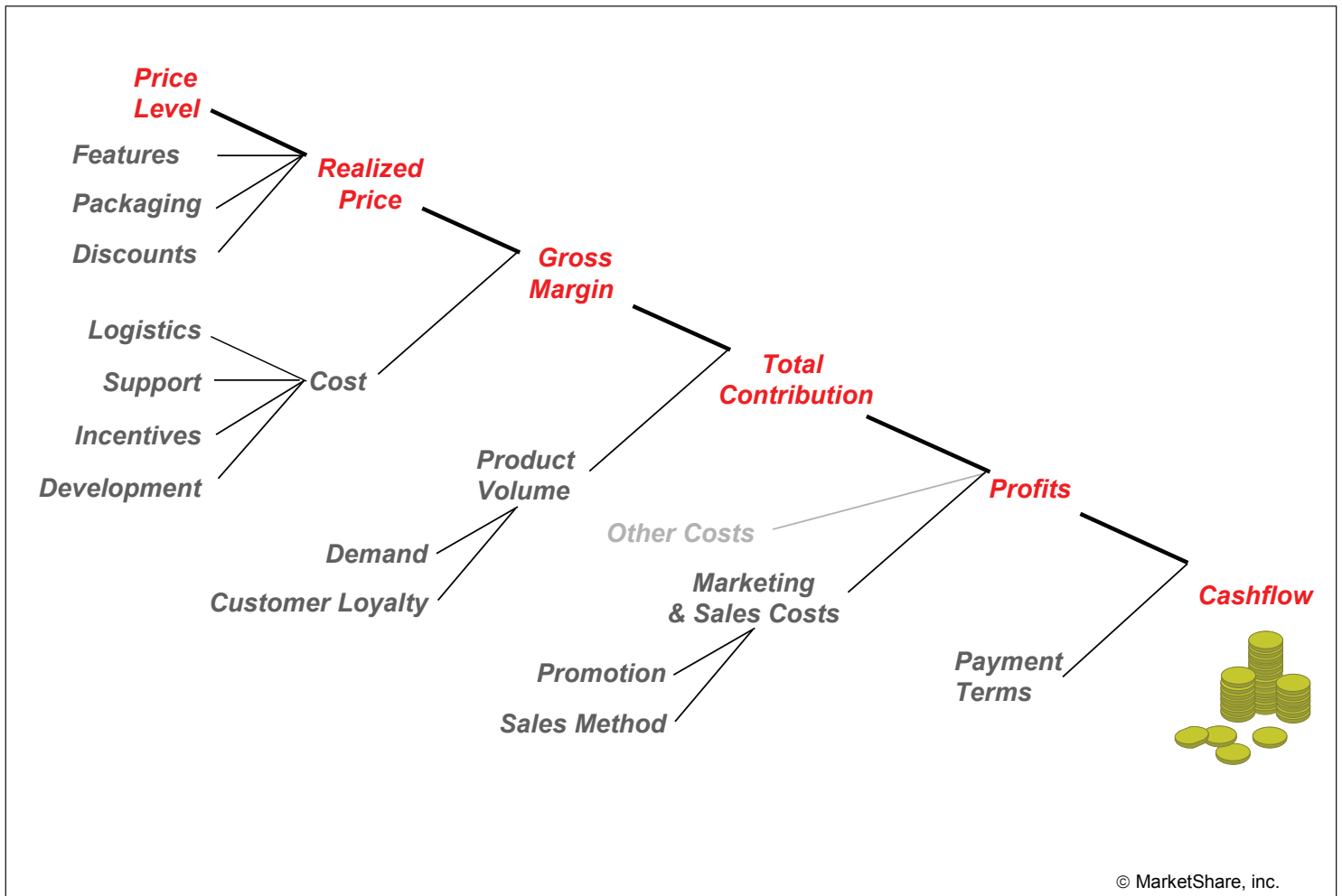
- Find more cost-effective promotional or sales methods.
- Substitute telemarketing for more expensive direct-sales prospecting

- Service smaller customers with telesales instead of direct sales
- Use commissioned sales reps instead of salaried salespeople
- Overlay sales compensation programs with profit-focused sales incentives

Marketing may be able to pursue a segment-focused effort aimed at less price-sensitive customers with help from the pricing group and its analysis of customer data. If sales are slowing down and closing deals is getting harder or happening later, look for ways to reduce the sales cycle, which will free up time for more selling or will reduce sales costs.

Companies that focus on cutting costs often do so across the board, but these actions won't do much for total contribution. It is probably better to look into ways marketing can help with this rather than the sales group, which will be under incredible pressure.

Figure 1: Profit Drivers: Price, Costs, and Volume



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Increase Total Contribution

While it is always useful to look at ways to increase efficiency/effectiveness to lower costs, consider focusing on total contribution (gross profits) to overhead, the other factor affecting profit and ultimately cash flow.

It requires doing something to influence average gross margin and total unit volume across all sales. Increasing one or both of these two variables will increase total contribution.

First, we will explore the impact of volume which comes from heightened demand or customer loyalty. Then we will consider gross margin.

In order to spur demand in the short run (without changing prices), one must segment the customer base to exploit any volume opportunities. But when competition intensifies, the traditional approach—volume discount schedules—tends to become less effective in attracting the “heavy user” segment in a particular market or the existing customer base.

Therefore, more volume must be achieved by increasing penetration into existing customer groups. One way to do this is, for example, using low- to no-cost incentives like training to get referrals to new prospects inside or outside the account. If the incentive is a discount, then make sure the cost of the added discount is offset by the savings in sales cost from having an internal sales champion who will help sell new prospects.

Sometimes you can get higher-volume customers to increase their purchases by trimming services they don't value and lowering the price to reflect this. In this case, your financial concession frees up money for the buyer to purchase more product. Although the average price may go down, the added volume will generate additional contribution dollars.

While looking for ways to encourage demand in the near term, consider strategies, too, for the long run. One method is add-on sales. In the software business customers tend to spend more on upgrades and support than on the initial purchase of the product. Similarly, you may increase volume through careful attention to customer retention or loyalty.

Note that the latter is not based on lowering prices since that will only attract price-sensitive buyers, a notoriously fickle group. Effective loyalty programs typically work best when price is simply one of many tools.

Engaging customers is limited only by creativity and willingness to try new programs. For example, companies regularly do cross promotions with firms offering complementary products. Newsletters or web downloads provide low-cost ways to get the same “share of mind” as a favorable price. Often, dealer seminars, in-store demos, local/regional events or free factory consultations can stimulate sales and increase customer loyalty.

As an aside, if you want to increase loyalty, you'd better start measuring it just as you would volume changes per transaction from price adjustments. Don't forget rough measures are better than none at all. Roughly right is better than precisely wrong—or late. Loyal customers generate positive word-of-mouth. And this is what sells products.

Improve Gross Margin

Keeping current margins to sustain cash flow is particularly tough as competitors slash prices in a scramble for revenues, and customers tighten their belts. If unit margins are headed towards a cliff, product volumes may not expand enough to maintain contribution levels.

Therefore, look for ways to preserve margins (or at least to minimize erosion.) About the only thing that can be done to keep unit margins high in a price-competitive market is to make sure the variable costs fall faster than prices erode. (We deal with the other way to maintain margins, “realized prices,” below.) Most companies are more adept at cutting costs by elimination, but substitution can often pay longer-term dividends.

In terms of costs, the people responsible for the logistics—costs of manufacturing and distribution—tend to be pretty good at cost control. For example, they may substitute lower-priced cardboard for plastic. Some activities may be moved to sheltered workshops—saving money and providing a community service. (There may even be some tax incentives to encourage this).

Another area for cost improvement is in support, and customers that consume these services. Support costs money and may be provided free even when users would be willing to pay for it. Look for a segmented service offering. In the software business anywhere from one to three tiers of support may exist, but offerings are often not as nuanced as they should be in firms where most sales come from existing customers.

If incentives are paid to sales reps or through indirect distribution “because that's the way we do things around here,” then this may be another area ripe for change. You may be able to alter the rules of the incentive game and create a competitive advantage.

One company used to give rebates or market development funds based on the number of single units sold. They shifted to rewards based on bundles of units sold, instead. (In this case, they paid 1.8 times the old incentive—but for selling two units. The new incentive was a more visible and attractive amount than the old one.)

Longer-term, gross-margin improvement can also come from product development using “design-to-cost” or “design-for-manufacture-and-assembly.” Design-to-cost results in products whose features customers will pay for at levels the company can afford. Design-for-manufacture-and-assembly can reduce prod-

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uct costs by 20-40%, and lifetime support and repair costs by even more.

Products that use standard-sized “widgets” are cheaper to produce than products using customized ones. For software companies, this means leveraging intellectual property by re-using parts of their code base.

As cost-efficient as your variable cost structure may be, when you look at it through the lens of cash-flow improvement, new opportunities for efficiencies will usually result. If variable costs fall faster than prices erode, then contribution dollars will increase leaving companies with the best cost structure in a stronger position when the market recovers.

Realized Prices

Earlier, we discussed how variable costs affect gross margin. But there is only so much one can do on the cost side. A better way to improve margins is to focus on one of the important pricing metrics—realized prices. Although it may not be possible to improve them, they offer a good starting point given the tight relationship between higher realized prices and improved cash flow.

One option is to devise more valuable products that can bear a higher price. Besides simply developing them, you can reconfigure the features of your offerings so their value becomes more obvious. Packaging may also be used to combine products previously considered separate or add-ons to hit a higher price point (and therefore realized prices)—regardless of whether the features are product or services. But make sure the product value delivered lines up with the needs of customers and their willingness to pay.

Customers that have beer tastes and a beer budget don’t want—and won’t pay for—champagne, so don’t serve it. Look instead for prospects or customers who are less price-sensitive. You can’t be all things to all people so focus on what you do well and get paid for it.

Decreasing discounts is another subtle way to change prices while improving cash flow. Perhaps the easiest way to do this is to look for inappropriately-high scheduled discounts. Sometimes, they are related to product volumes; and, sometimes, they are given for specific sales or customer performance. In the case of volume discounts, make sure the discount tier breaks are appropriate and don’t start at unacceptably low volumes. Similarly, make sure the top, published volume discounts are not too high. Both of these changes are subtle and can be introduced over time, so they are likely to be overlooked.

Where discounts are given for sales or customer performance (which is common with indirect selling), often firms need only

to monitor performance and to enforce the rules. Again, these changes can be introduced gradually to avoid disruption.

Customer price sensitivity can particularly affect the sales force. From the salesperson’s perspective price looms large because it can occur twice in the sales process: When the customer is deciding which vendors “are in the ballpark,” and when price stands in the way of closing a sale.

In large contracts (where it counts) scheduled discounts can place a company in the ballpark more often, as suggested above. These can also narrow the gap that has to be filled by negotiated discounts. During an economic downturn, negotiated discounts often increase dramatically due to customer pressure, which reflects

the competitive environment. Therefore, the greatest opportunity for discount reduction is often in negotiated or discretionary discounts.

This is an area where the discount analysis often done by pricers can be invaluable. Since the sales organization will be under intense pressure, now is not the time to make massive changes to negotiated discounts. However, this is the time to understand why some transactions have inappropriately high discounts and provide suitable feedback before a deal is done to avoid future occurrences.

Often a sales rep will avoid over-discounting when they know that other, similar deals were done at lower discount levels.

Price Levels

If there is no way to increase realized prices, and you have looked in every nook and cranny for ways to improve cash flow, then you may be stuck with lowering list prices. If you must drop prices, then be selective and make sure demand is likely to grow enough so that contribution probably won’t decrease. Here are some places to look:

1. **Products Where Value Delivered Is Too Low Relative to the List Price.** If you can’t increase value with features or packaging first, then lower prices only if demand will increase and cause the total amount of contribution to go up.
2. **Products Where Discounts Are Uniformly High.** Make sure it is the discounts that are too high, not the product value that is too low relative to list price. If the discounts are uniformly high, reconfigure the products to either add value so demand will go up; or strip out features or services so gross margin will improve.
3. **Groups of Customers Associated with Higher Negotiated Discounts.** If these customers only care about price, then eliminate as many extras as you can (e.g., features, services, consideration). Maybe these are the buyers who should get



new products last or should go to the end of the service queue. Make sure the assigned account reps have the right negotiating skills and support. If all else fails, then maybe this is the time to fire the customers and redeploy sales in more productive areas.

4. Discounts Are Roughly the Same across All Sales Reps.

This is a case where prices may actually be out of line. In this situation, you need to do two things at once: lower the prices and lower the negotiated discounts given, so one offsets the other.

Now is the time to *really* be selective. Start with products for which lower prices will result in higher demand. Move to offerings whose variable and overhead cost structure can be changed. Make sure salespeople and customers understand the value proposition, and that it is clearly articulated.

Now What?

If all avenues for maintaining cash flow are blocked, and you must cut prices to stay in business, then try harder to find alternatives. Seek ideas from customers, sales reps, other pricing professionals

or consultants (if they can improve cash flow quickly to cover their fees!). In any case, this is where creativity and out-of-the-box thinking can really pay off. This may be the time to be more innovative and to take more risks.

Home-run solutions are possible, but most ball games are won on singles and doubles (and making fewer errors than your competition).

Most companies are taking a number of steps to increase cash flow. Often, some of these activities are not as effective as they might be. A 10% improvement in three things you are now doing ineffectively will very likely increase cash flow more than any one new idea a team might implement over a 12-month period.

Home-run solutions are possible, but most ball games are won on singles and doubles (and making fewer errors than your competition). Clearly, the operational changes which have an impact on cash flow go well beyond pricing. In many companies pricing is an activity that cuts across many areas. Therefore, when it comes time to adjust prices, it may be a good idea to engage other departments to find new approaches that can have the same impact as price changes on cash flow. You'll be surprised at how many useful and often elegant ideas are out there.