Optimising Cash Flow : Using Price and Revenue Management to Deliver Results

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Moorestone.

Knowledge ▪ Experience ▪ Insight

Agenda

1. **The Changed Environment**

2. **Pricing and Revenue Management Methodology**

3. **Cost Issues**

4. **Discounting vs Premium Pricing**

5. **Contemporary Pricing Strategies**

6. **Concluding Comments**

Thought for the day

The driver of a pick-up truck rapped at the door of the farmhouse and asked the farmer, "How much is that bull out there on the road to you worth?"

The farmer replied with a question of his own. "It depends, are you the tax assessor, do you want buy him, or did you run him down with your truck?"
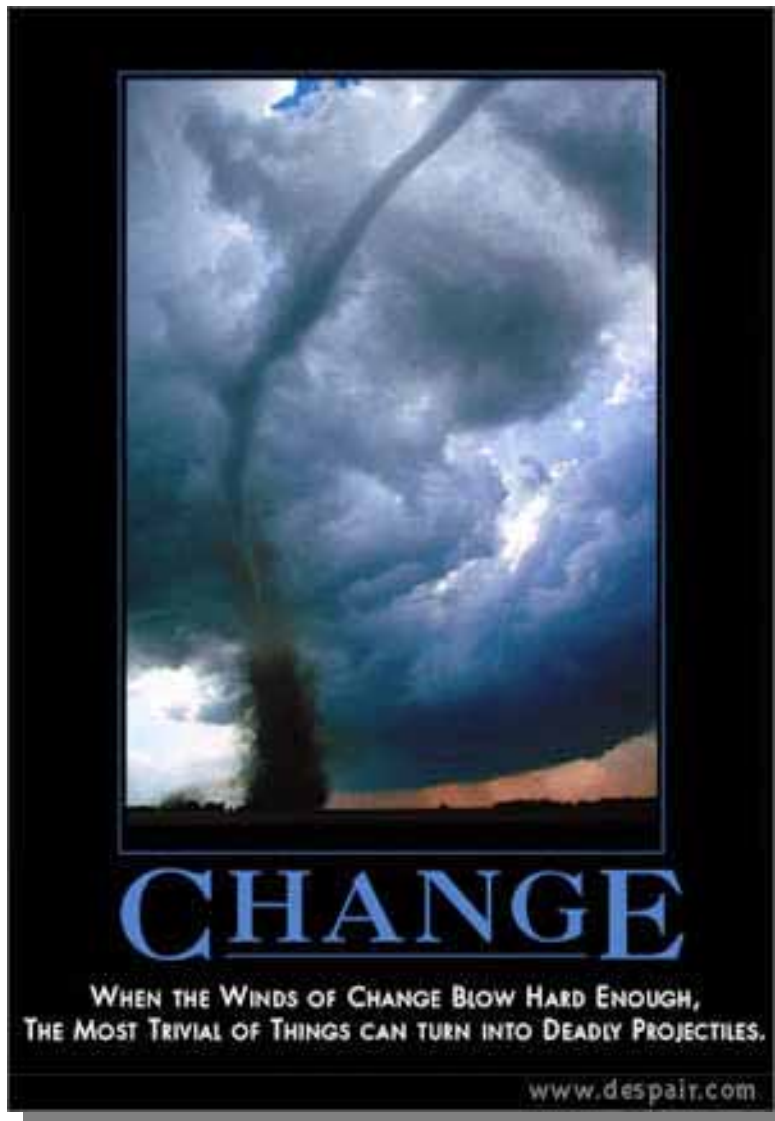
The Changed Environment

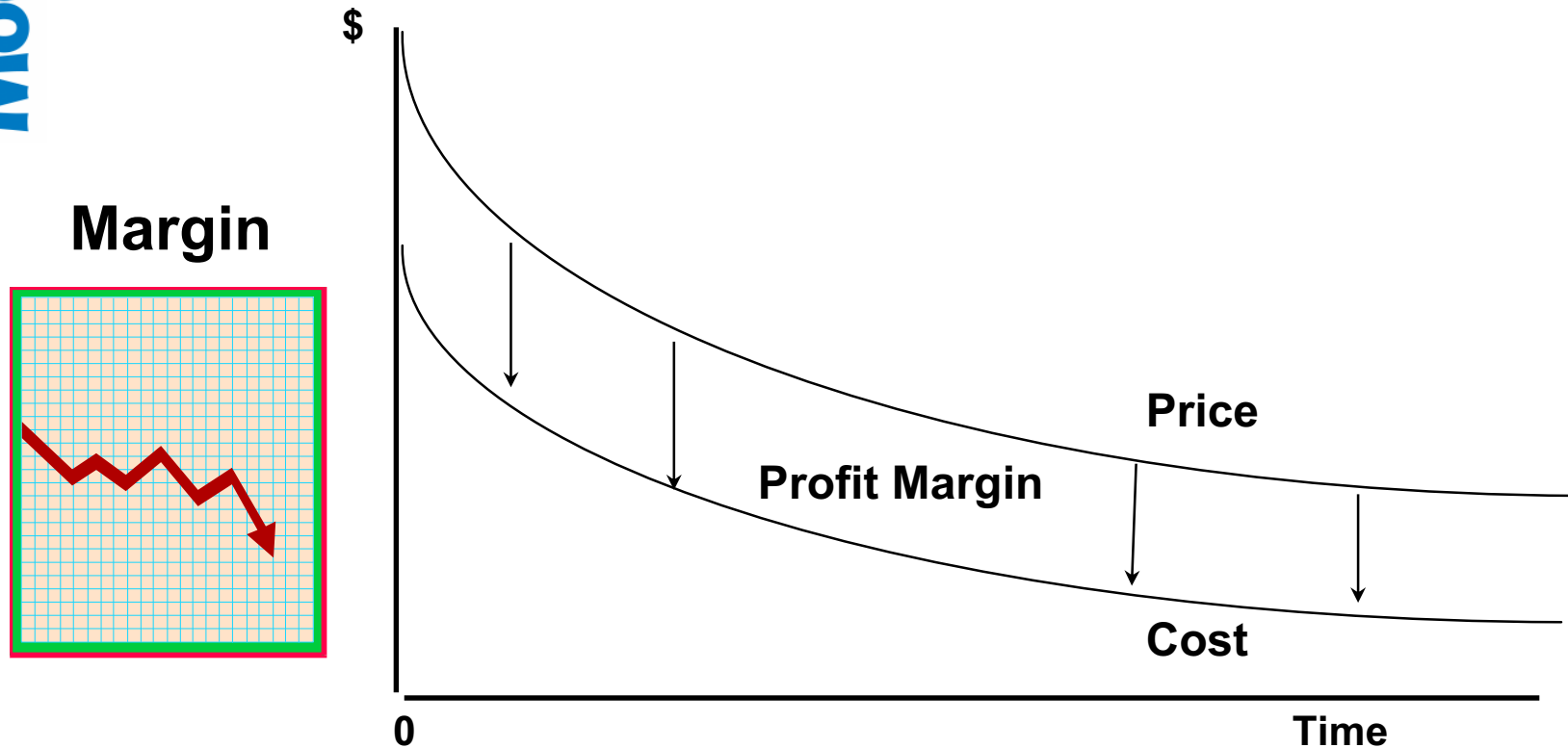# Never forget

Customers **do not care**

about your cost

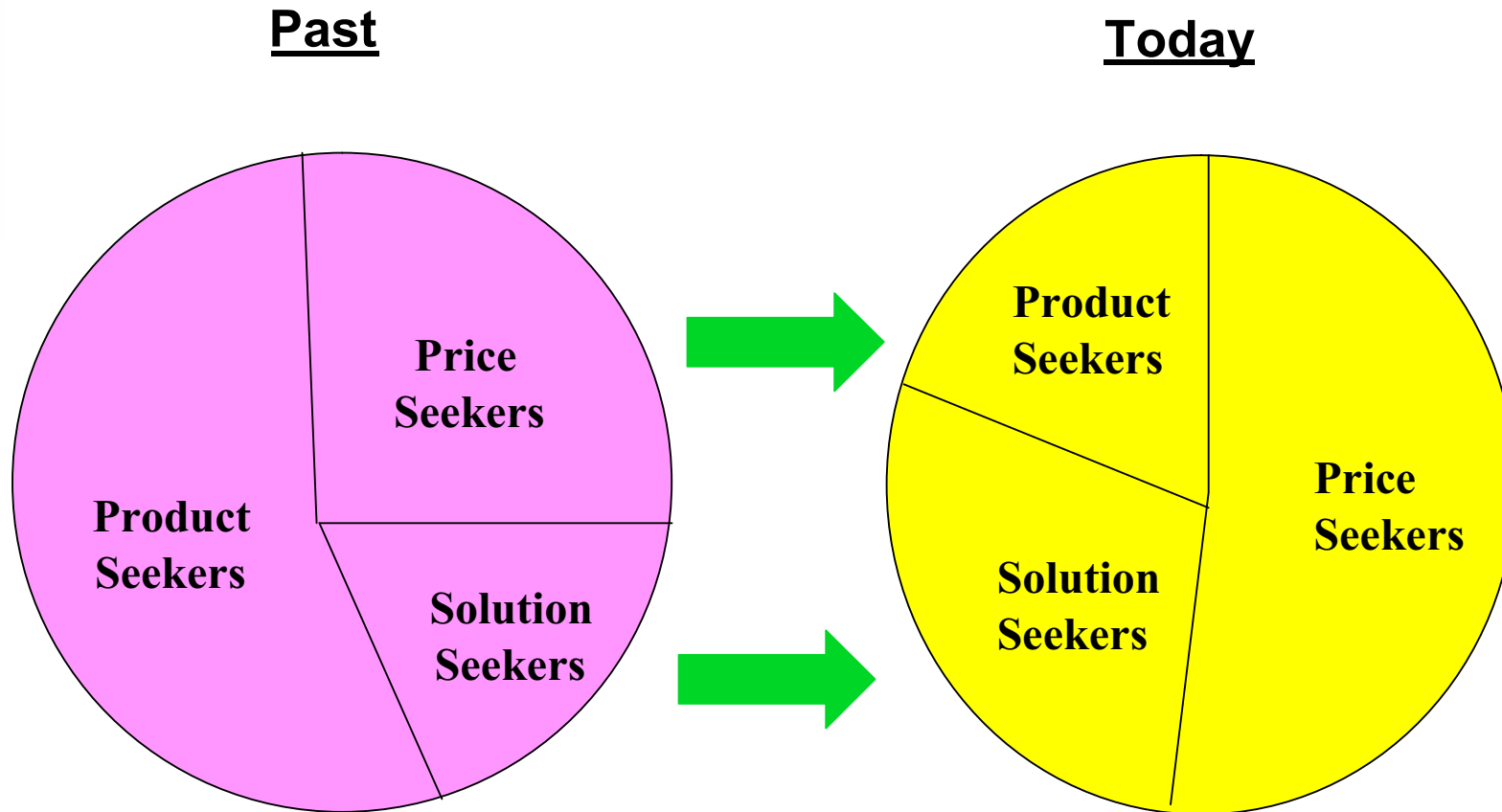only about their own

Pricing is not about Fairness

It is about Profitability and Cash Flow
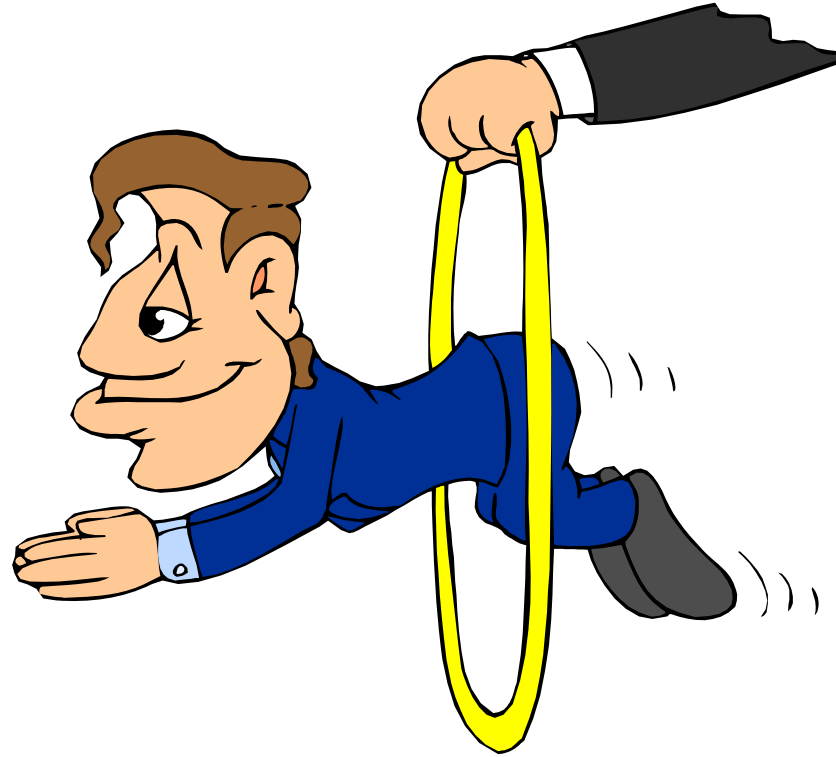
Price/Cost relationships in a competitive environment

Margin

Changing landscape

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<u>Past</u>

<u>Today</u>

Price
Seekers

Product
Seekers

Solution
Seekers

Product
Seekers

Price
Seekers
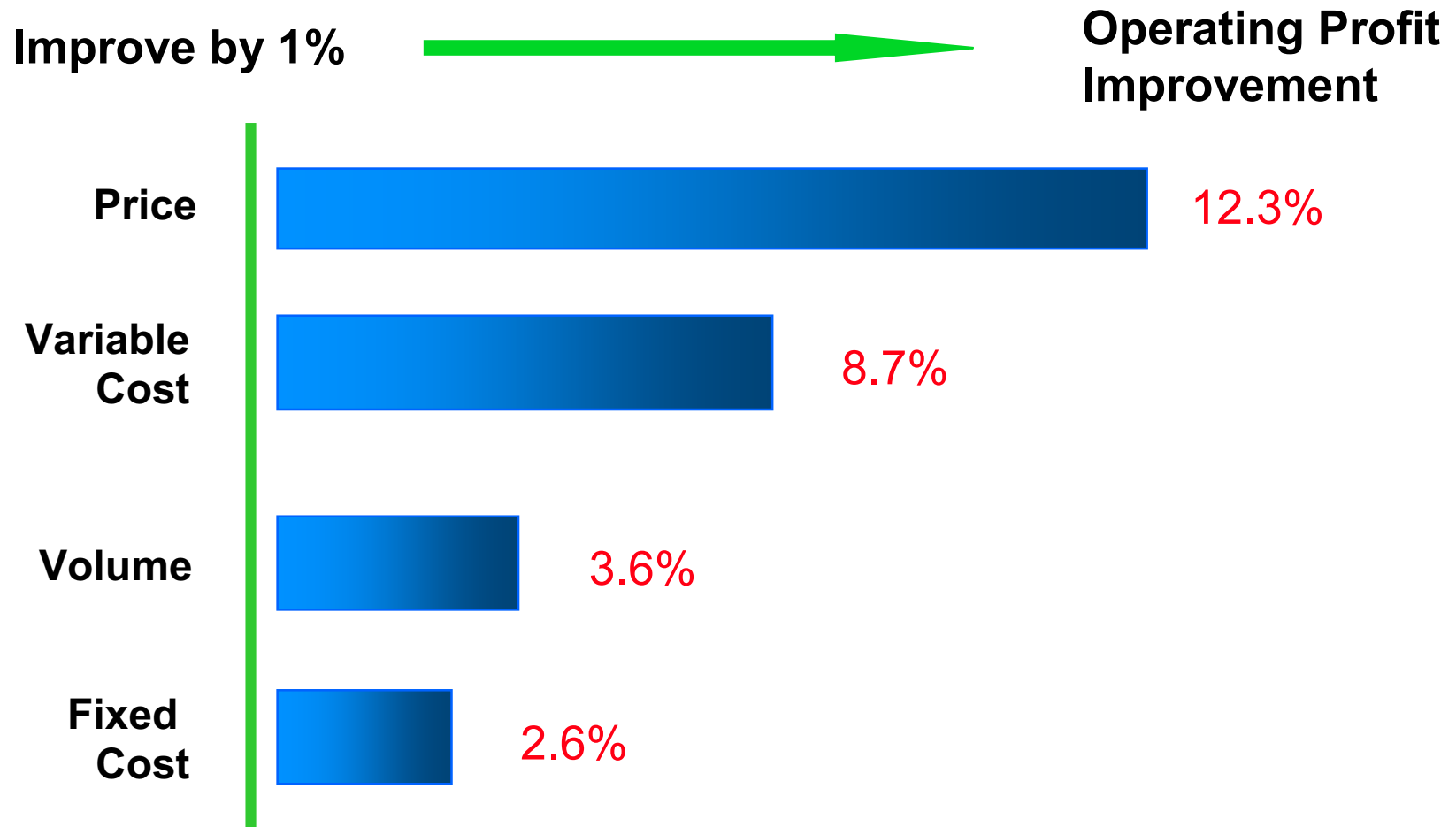
Solution
Seekers

Costs

Costs do not come in a one-size-fits-all category

There are different costs for different purposes depending on the question that is being asked. Moreover, cost information that is prepared for one purpose may be totally inappropriate for another

Understanding pricing

- **Pricing is primarily an art form rather than a science**

- **There is no pricing panacea – multiple strategies need to be utilised**

- **Entire industries are adopting a more analytical approach:**

    - **Airlines**

    - **Hotels**

    - **Car Rentals**

    - **Telecoms**

The impact to the bottom line

Improve by 1% → **Operating Profit Improvement**

Category	Impact
Price	12.3%
Variable Cost	8.7%
Volume	3.6%
Fixed Cost	2.6%

Source: L.E.K.

Pricing & Revenue Management Methodology

Focus effectiveness

Cost Focus

Important but less efficient and effective

Pricing Focus

Delivers immediate and substantial benefit
- Improved cash flow
- Increased profitability

Understanding your pricing methodology

- Do you have an established methodology?

- Do you regularly review your pricing?

- Are you a price leader or follower?

- Can you identify your pricing 'sweet spot'?

- Does your pricing promote 'perceived' value?

- Do you understand your products values ?
  - different values to different buyers – each value can attract different price point

- Is pricing continually discussed in the business?

Methodology Issues

- Cost as the basis for pricing should only be used to establish a floor price – not as the core for recovery plus

- Value based pricing should at least cover incremental costs

- Caveats to value – include competitor pricing where there is no differentiation and availability of substitutes

- Perception of value can quickly change – strategies must be flexible if hidden profits are to realised

Power of pricing

Per $	As is	Reduce O/H by 10%	Increase Price by 5%
Sales	100	100	105
Gross Margin	40	40	45
Expenses	30	27	30
E.B.I.T	10	13	15
% Change in EBIT		30%	**50%**

Price vs value

"A cynic is someone who knows the price of everything but the value of nothing."

Oscar Wilde

The Fluctuating Value of an Umbrella

Why is its value different in dry weather compared to when its raining?

The cost to make it remains constant – the value we place on it however is quite different

Revenue Management

- Understanding your customers:
  - Types
  - Order patterns
  - Requirements
  - Profitability
  - Channels
  - Trading terms

Pricing for extra demands

- Extra volume discounts and commissions

- Additional marketing, promotions and sales support

- Extra display stands or floor space

- Special packaging and documentation, generic brands

- More favourable inventory holding requirements and distribution support

Pricing for extra demands (contd.)

- Special freight or delivery arrangements, less more often

- Special technical or administrative support

- Special credit or payment terms

- Prescribed order entry (Electronic trading)

- Additional customer service and field service

Loyal Customers

- More profitable

- Minimise acquisition costs

- Less prone to discounting

- Will contribute to greater % of the business

- Pricing needs to take in their added demands

Marginal Pricing

- Optimal selling price = greatest contribution to profits
- Any sale that makes a contribution to fixed costs is a good sale
- Marginal pricing has a role - opportunistic

BEWARE

- Volume issues
- Replacement sales
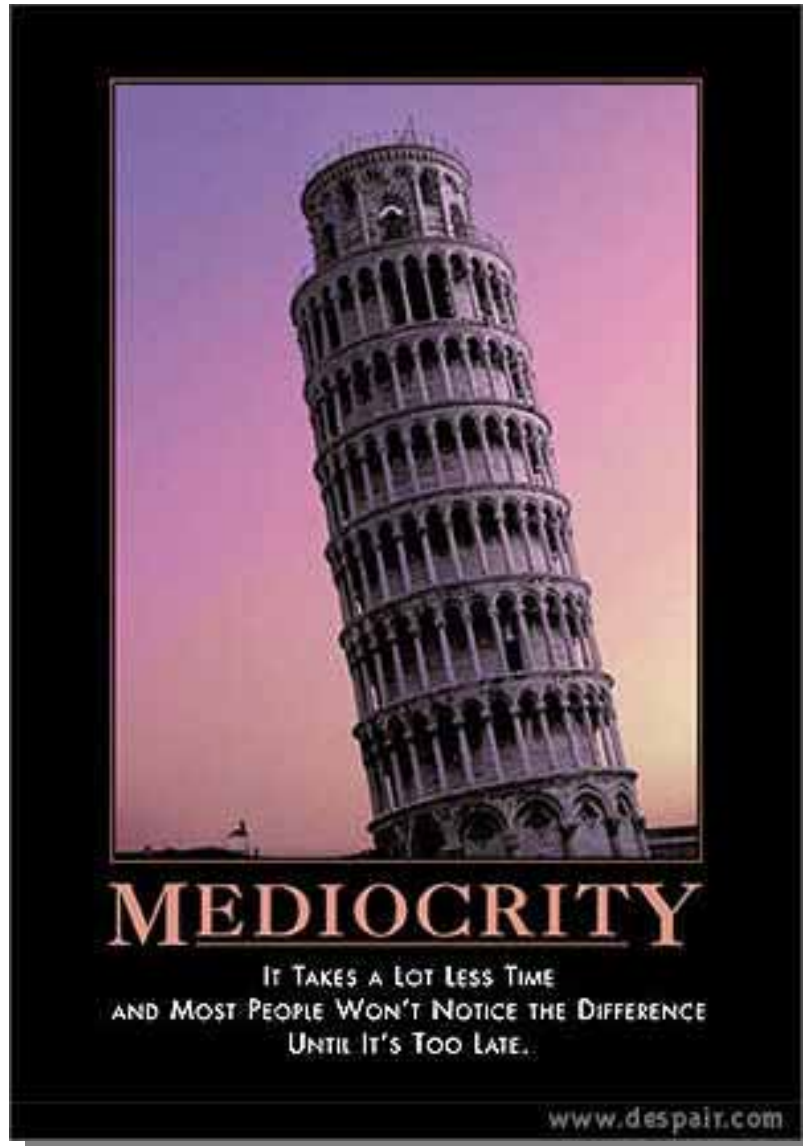- Complexity
- Customer demands

Change impacts

Using the following scenarios refer to the sheets in the workbook:

1. Prices increased by 5%
2. Prices increased by 5% and volume decreases 5%
3. Prices discounted 10% and volume increased by 30%
4. Fixed O/head expenses reduced by 10%

Cost Issues

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Current cost practices

- Inward Focused
- Not Market Driven
- Disregard for the Customer
- Do not Promote Continual Improvement
- Lack Discipline
- Suppliers not usually Involved
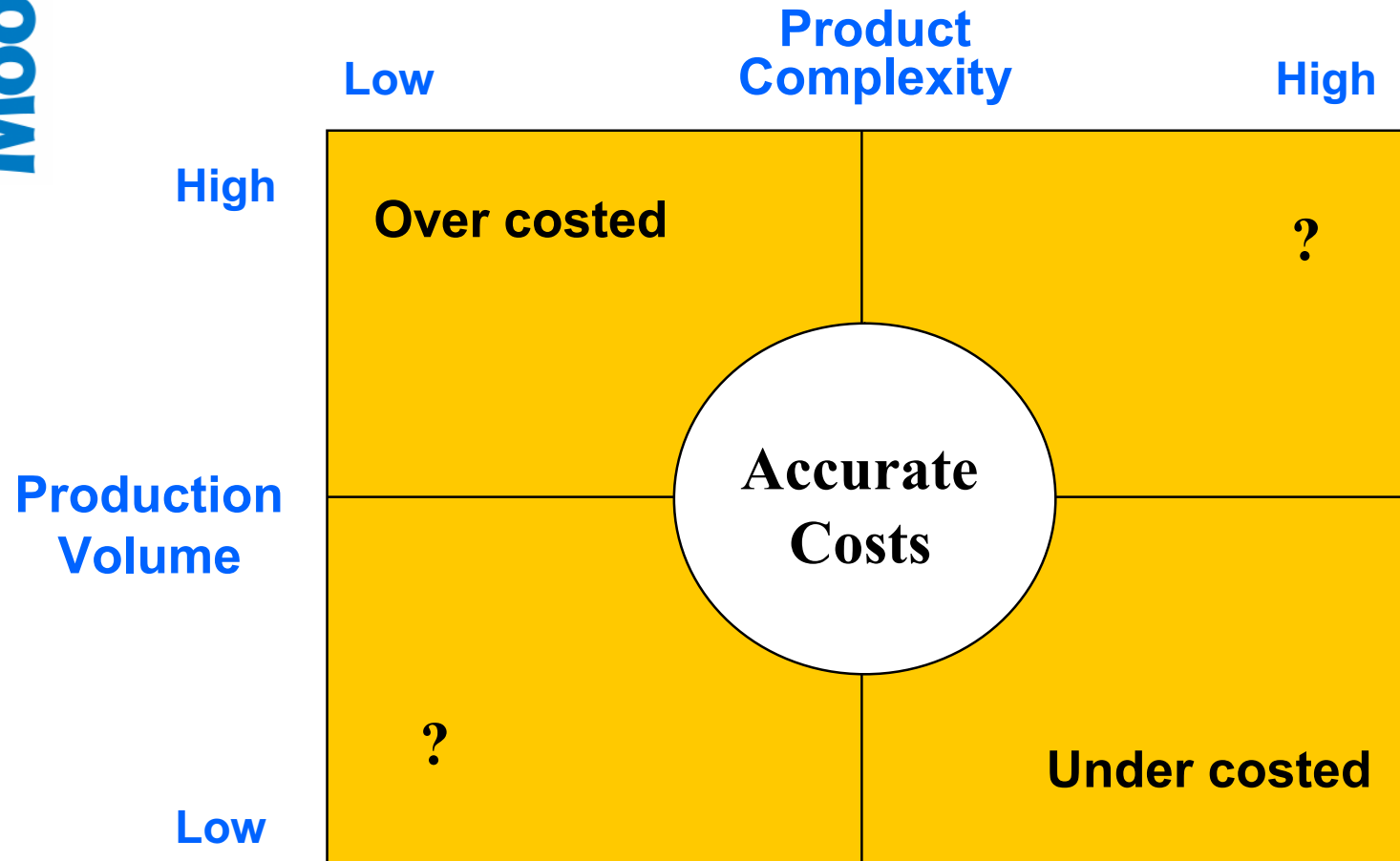
Issues with traditional cost practices

- Management not confident output reflects reality

- Cost reductions fail to achieve expected results

- Increased sales fail to achieve profit projections

- Improvement initiatives not recognised, eg, TQM

- System generated variances difficult to explain

- Performance measures not used by all managers

- Financial performance difficult to explain

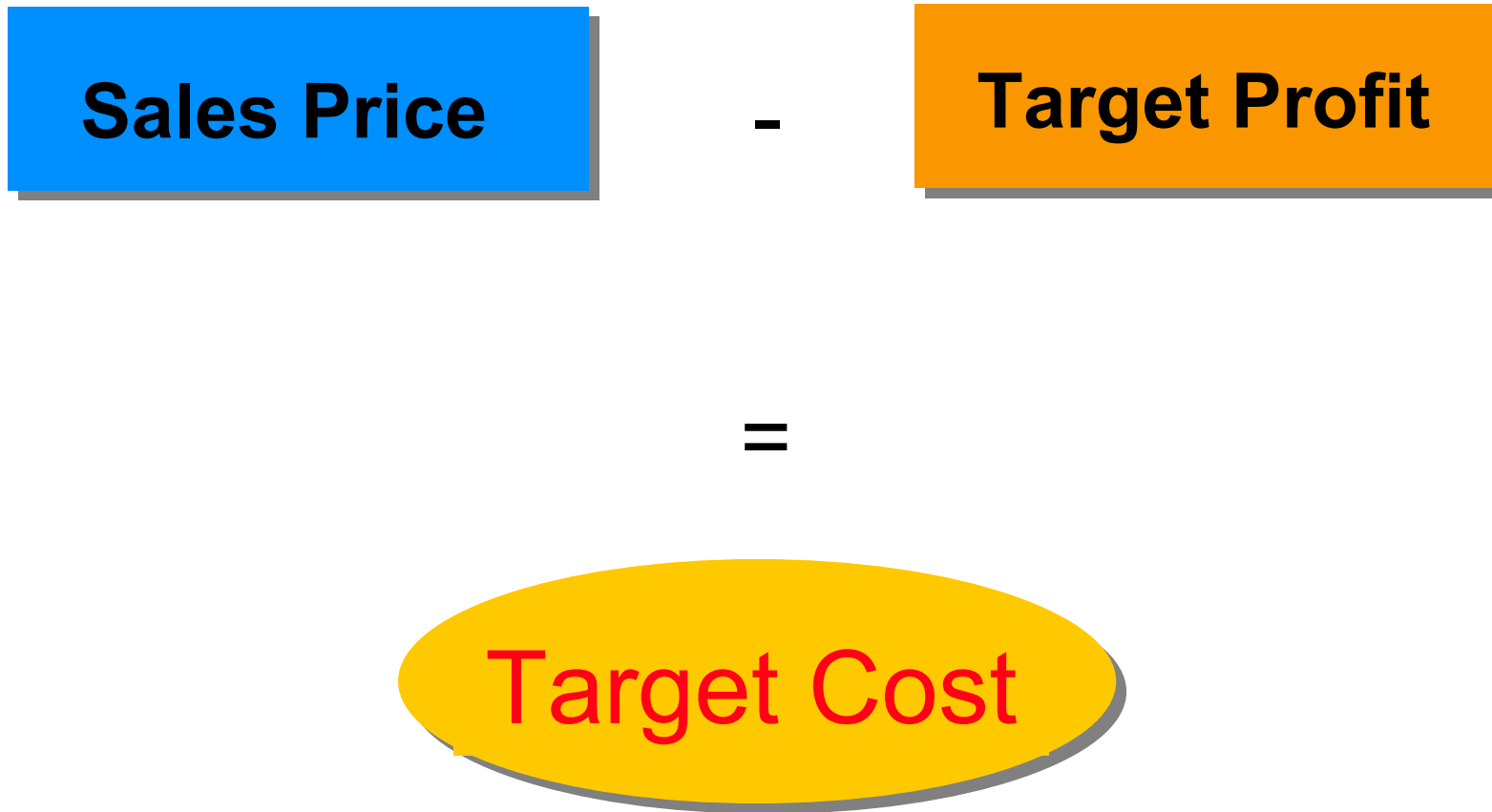# Issues with traditional cost practices (contd.)

- Sales/Marketing do not use cost information

- Increased sales fail to achieve profit projections

- Investment cost/benefit difficult to analyse

- Customers are selective across product lines

- Cost based pricing is inconsistent with competition

- Only some products or services are costed

- Cost based pricing margins are small

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Traditional systems distort product, customer and segment costs

Product Complexity

Low   High

Production Volume

High — **Over costed**   **?**

Accurate Costs

Low — **?**   **Under costed**

Target costing

Sales Price - **Target Profit**

=

Target Cost
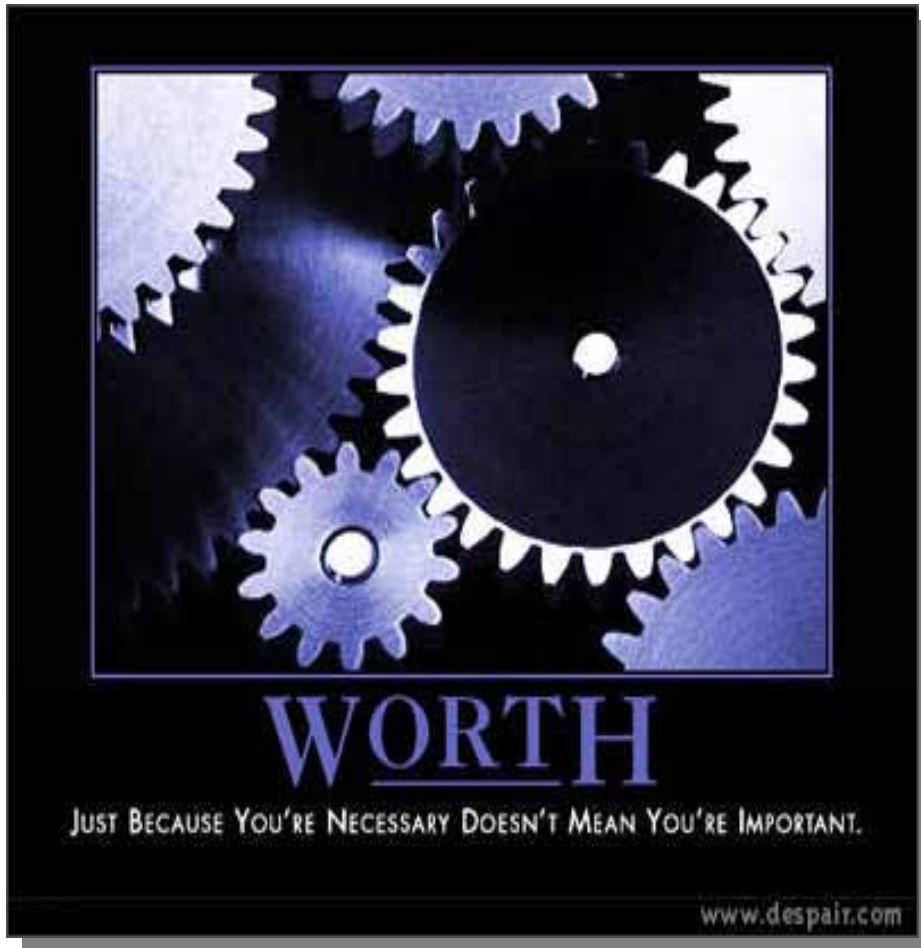
Discount vs. Premium Pricing

Discounting

Easiest strategy to copy and the hardest strategy to defend

- Very few businesses improve profitability by discounting
- Most effective discount range is 15-30%
- Should be used as a tactical tool rather than ongoing – frequency kills advantage
- Reflective of the business
- Impact on image
- Financial metrics do not stack up – can lead to cannibalisation
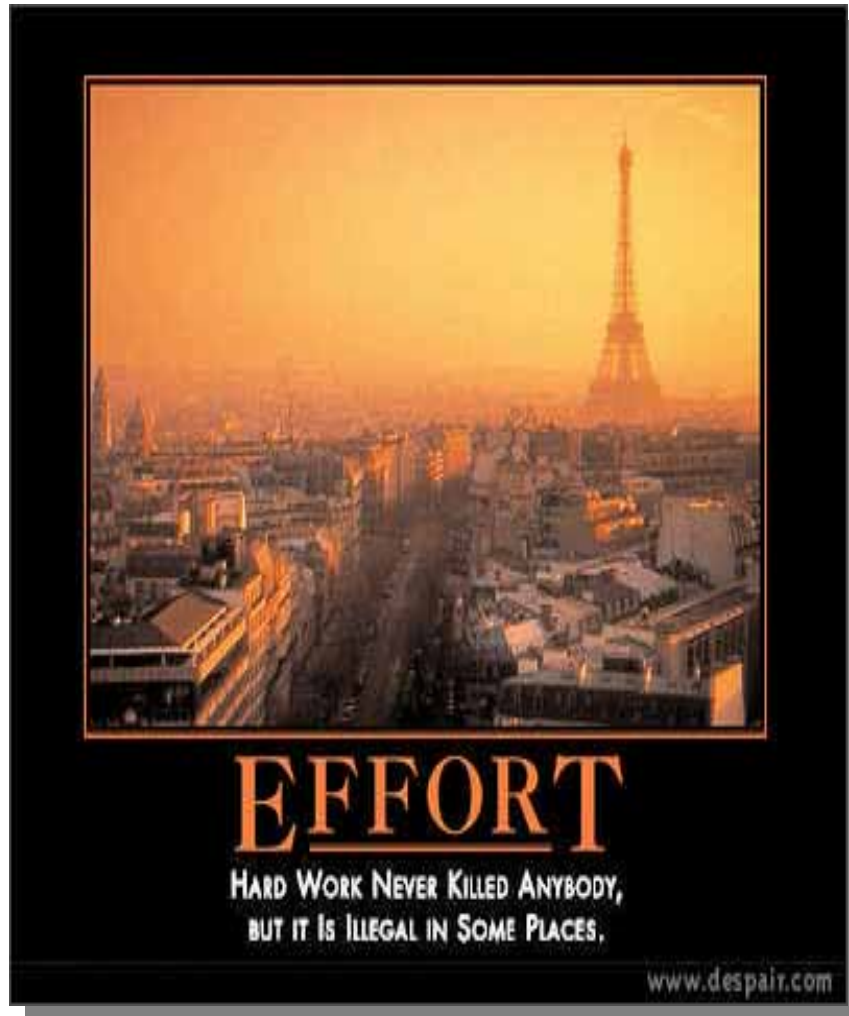
Discount vs premium pricing

- Discount focuses on price – Premium focuses on value

- Price too high lose potential sales – Price too low lose profitability

- Discounting relies on volume to compensate – are assumptions realistic?

- Premium requires to be in touch with customer and product value – need to adapt to shifts in buyer sentiment changes

Case study - ALDI

- **Clearly identified target market**
- **Entrenched competitors offering extensive range and services**
- **Limited product range and variety**
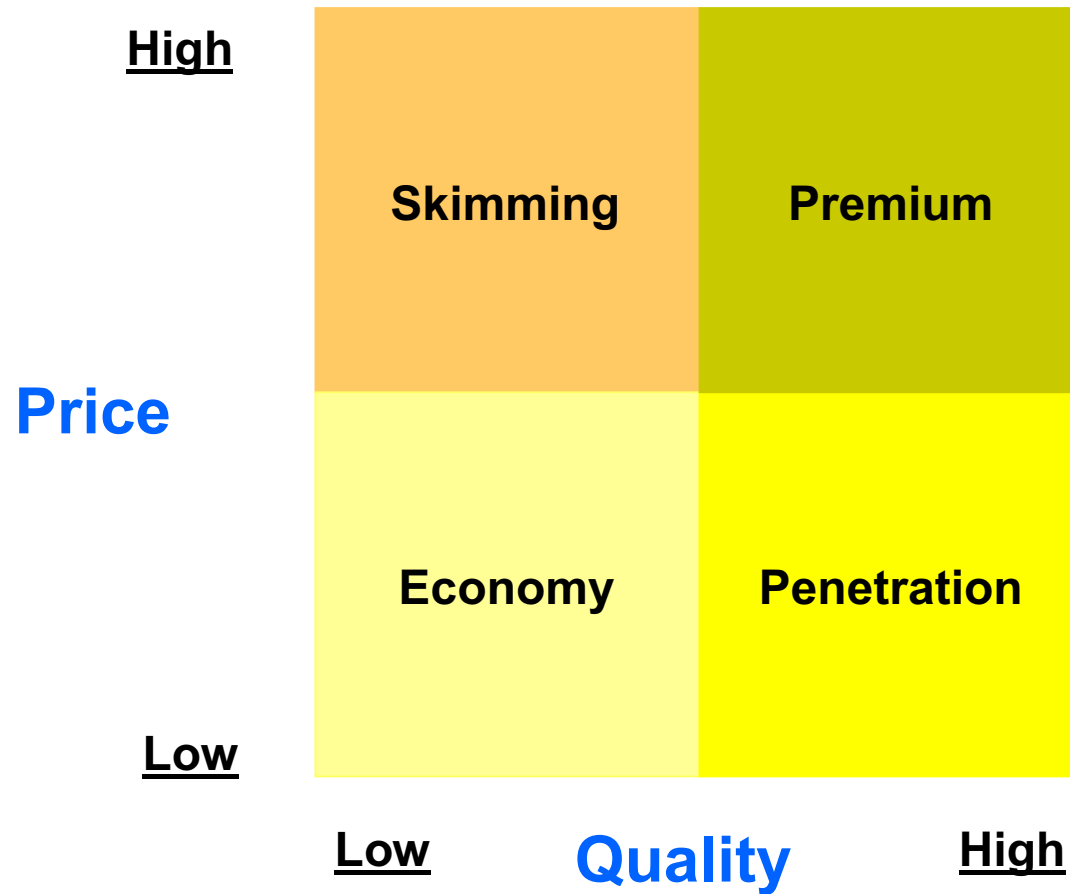- **Extensive use of own branded products**
- **User pay charges policy**

Discussion

The introduction of Costco into the Australian retail market

Contemporary Pricing Strategies

Pricing strategies matrix

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	Low Quality	**High** Quality
High Price	Skimming	Premium
Low Price	Economy	Penetration

Price

Quality

Different strategies

- Psychological
- Line
- Optimal
- Captive
- Bundle
- Promotional
- Geographical
- Value
- Etc…

Masstige pricing

Hook cost conscious consumers & buyers of premium-priced products /services by offering cheaper options that are perceived to offer a premium

Examples

- Virgin Blue
- Zara
- House brands over 'no frills'

Surcharges

Pricing by default

- Direct marketing have used them for years now being adopted by other industries

- Tend to be highly profitable

- Can be used to avoid across the board price rises

- Seen as more acceptable than straight price increases

- Effective in short-term to win price increase acceptance

Surcharges (contd.)

Pricing by default

- Credibility is lost if continually increased and maintained

- In longer-term need to realign prices

- Should be used to differentiate between low value sales/orders that incur similar costs to high value/orders

Resizing

Pricing by stealth

- Has been the domain of consumer markets for years but is gaining momentum in other markets
- Buyers are less sensitive to quantity changes than price
- Frequency is on the increase
- Way of reducing costs to maintain margins
- Subtle – not so noticeable by buyers
- Sifting into services by drumming down support functions

Resizing (contd)

	Existing Product 24 x 375 ml bottles	New Product 24 x 375 ml bottles	
Retail Price	$40.00	$42.00	5.3% reduction in size
Cost to retailer	$36.00	$37.80	
Taxes	$14.00	14.80	
Manufacturers Margin	$2.00	$3.80	90% increase in margin
O/H Costs	$5.00	$5.00	
Var. Manuf. Cost	$15.00	$14.20	

Menu pricing

Example: The Dell Model

Mass Marketing	→	Individual Specifications	→	Menu Pricing

USP – Pay only for what you value

Multi-dimensional pricing

For every product / service in the world, there are at least two people who are willing to pay different prices:

- Sell the same products/services to different customers at different prices (Differentiating)

- Sell similar products/services to different customers at different prices (Versioning)

- Price to activate dormant customers (Segmenting)

Discussion : Paris Cafés

Strategies for changing price

- **If Increasing Price**
  - Increase the 'perceived value'

- **If Reducing Price**
  - decrease the value offering

- Condition customers for a price increase

- Educate customers why the change

- Introducing new products/services – do so at the top of the range rather than at the bottom

Consider

"Better the loss of a sale, than a sale at a loss"

Don't under price your offer - customers won't think it a bargain: they will be suspicious

Don't overprice your offer - customers may fall for it once or twice then look elsewhere for a cheaper/alternative offering or not purchase again

Concluding

Comments

Concluding thoughts

- Price is important but not everything

- Need to focus more on price management – it should not left to the realm of marketing/sales

- Smarter price & revenue management will deliver increased profitability and cash flow than better cost management practices

- Pricing is a complex issue that needs careful consideration and planning

- Cost based pricing has its limitations

- Pricing and cost management should not be viewed in isolation

Finally

The Challenge

Will you maintain the status quo and muddle through or exploit pricing for the leverage potential it offers?

THANK YOU

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