Fact-Based Pricing
How to maintain a healthy pricing strategy

Applied Value Knowledge
Revenue Efficiency

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Introduction

A variety of dynamics and decisions can negatively impact sales and profitability levels. From internal business errors to global slowdowns in growth, the causes of profitability losses are far-reaching. Regardless of the reason for low profitability, maintaining shareholder value by improving return in relation to invested capital should always be a top priority. Whether a company struggles with its strategy, profitability, or cash-flow, focusing on revenue growth is an expected and common survival response. In those instances, companies too often become overly top-line motivated, accepting any revenue regardless of its effect on a company's bottom line. This myopic focus on revenue and sales volume is understandable but also dangerous and can result in long-term harm to a business's profitability.

	Revenue	Operating Margin, %	Operating Margin, Absolute Value
Company 1	$100M	1%	$1M
Company 2	$10M	20%	$2M

Table 1: Revenue vs. Operating margin – Two alternatives

Table 1 illustrates two scenarios that highlight the peril in a revenue-only. At the first glance, Company 1 may appear more successful with 10x the revenue. However, Company 2 generates twice as much profit, and ultimately cash flow, from their operations.

The logic may seem simple, as 20% of $10M equals $2M, whereas 1% of $100M equals $1MUSD, but surprisingly, executives and middle management will typically select Company 1 as the more successful company, thinking about market share and customer base instead of true profit.

In order to help companies become and remain profitable, Applied Value helps companies understand and improve profitability with short-term and long-term impact. These strategies focus on "Commercial Excellence," a framework for measuring and establishing true and sustainable growth.

Consisting of three components – understanding true profitability, leveraging Fact-Based Pricing models, and using value-driven go-to-market strategies – the Applied Value commercial excellence model helps businesses improve their top-line growth without jeopardizing long-term profits.

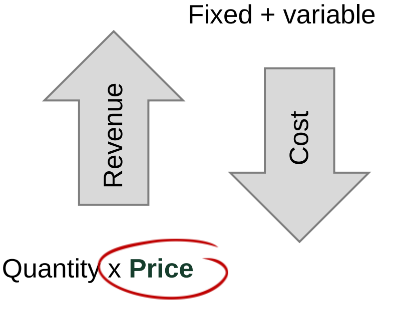


Figure 1: Functions of profitability

This paper focuses on **Fact-Based Pricing** as a component of achieving commercial excellence. By understanding the role that pricing plays in addressing decreased profitability and focusing on fact-based models, businesses can improve their outlook during periods of economic uncertainty while also creating business eco-systems for sustainable profit.

Pricing – A Critical Component of Commercial Excellence

Applied Value's Commercial Excellence strategy is a proven tool for sustainable growth. For all companies, identifying top-line levers that can impact profitability is crucial, and Applied Value's Commercial Excellence framework helps businesses narrow their focus, emphasizing 3 main steps for achieving success:

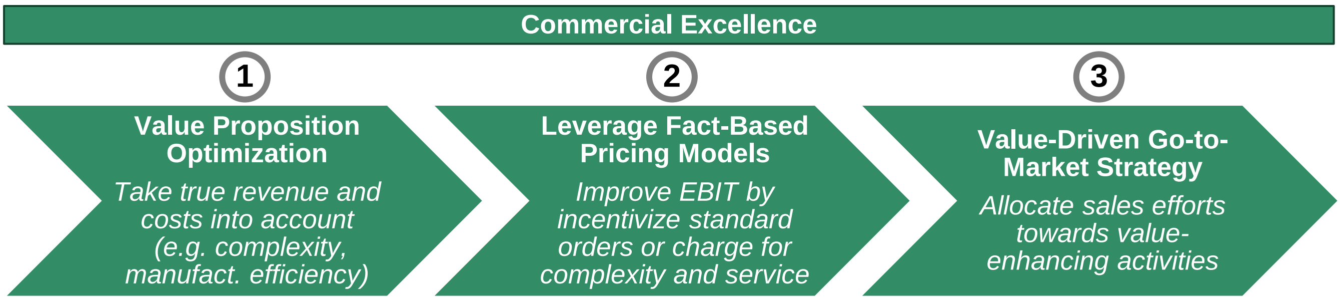


Figure 2: The three steps to achieve commercial excellence

1. A company must understand the true profitability of every product/service that they are offering. The true profitability of one product is the difference between its price and the cost of the component parts that support it including everything from research and development to sales and marketing. For more information about True Profitability, please see our Value Paper: "When less is more - the urgent need to prioritize customers and products."

2. After understanding profitability of different products and services, companies should leverage Fact-Based Pricing Models to ensure that all costs are accounted for in pricing and value-adding services and offers are properly factored into pricing. This paper focuses on this component of Commercial Excellence.

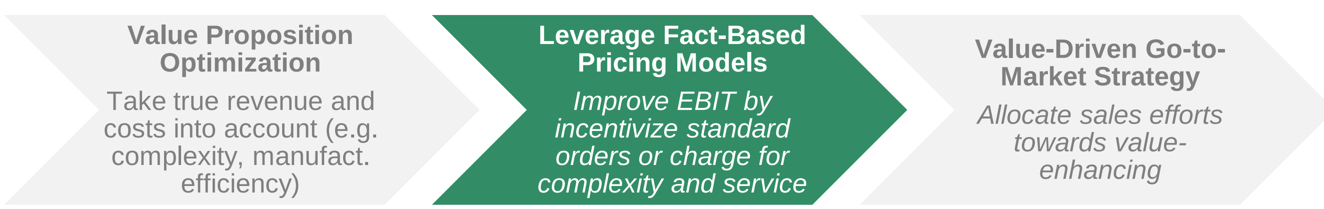


Figure 3: Leverage Fact-Based Pricing – Focus of this Value Paper

3. Finally, companies must also develop a Go-To-Market strategy that optimizes market coverage, sales channels, organizational structures, and ways of working. While Go-To-Market strategies are not covered in this paper, they remain an important element of Commercial Excellence.

The Power of Pricing

When sales volumes are down, price becomes the only revenue-lever that companies can address to maintain profit. While the thought of pricing changes can be overwhelming to many businesses, when approached correctly, price manipulations can have a significant impact on companies' bottom-line.

Applied Value uses EVA, Equivalent economic value-add, to measure true profitability. EVA measures the residual wealth of a company when its total cost of debt and equity is deducted from its net operating profit after tax, and it can be used to understand the clear value of pricing.

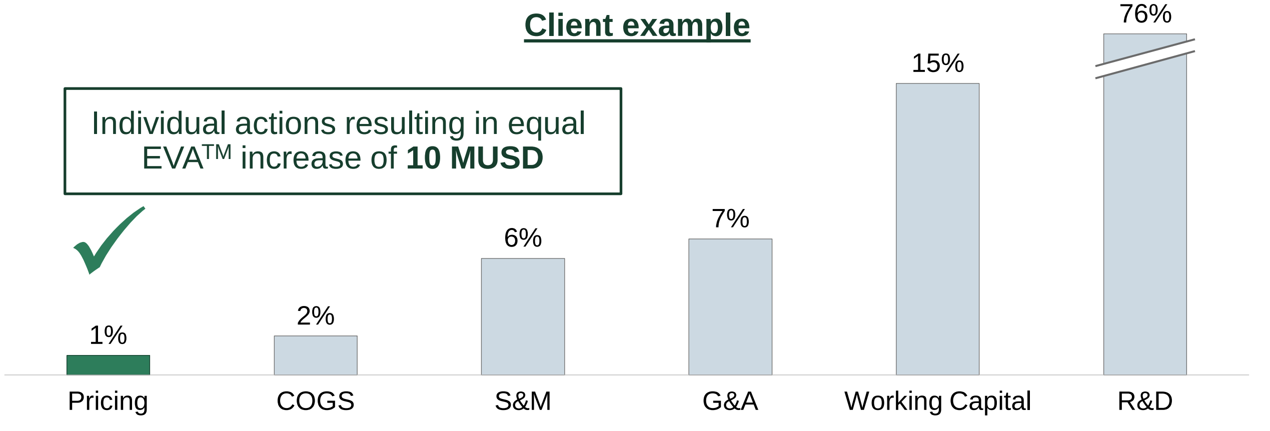


Figure 4: EVA (Equivalent economic value-add) between improvements across different areas

The client example presented in Figure 4 illustrates the change necessary per business function in order to achieve a 10 MUSD EVA impact. In this example, a 1% increase in price offers the same financial gain as a 2% reduction in COGS, 6% reduction in S&M costs or a 76% reduction in research and development costs, illustrating the power of pricing.

Nevertheless, despite these immediately visible benefits, management is still often hesitant to change price. Common concerns regarding price adjustments include:

- *Impaired retention of important clients*
- *Unawareness of customer's perceived value for given product/service*
- *Unexpected repositioning of your offering towards a different segment*
- *Falling demand for the product/service*

These considerations are valid reasons to interrogate the need for altering product pricing. Changes in price should not be made without careful consideration. If poorly executed, unthoughtful pricing changes can do more harm than good to a company's performance. However, a **fact-based approach can address concerns about price adjustments while enabling growth.**

Fact-Based Pricing

Pricing strategies should always be considered a key element of achieving profit goals. There are multiple ways to achieve profitable and consistent pricing across a company's portfolio, but historically, the most common strategies are market-based, value-based, and cost-based pricing. While market-based pricing sets prices by aligning them with similar products on the market, value-based pricing determines price based on perceived value for the customer. Cost-based pricing, where companies' influence is greatest, is set based on a determined product cost and desired markup.

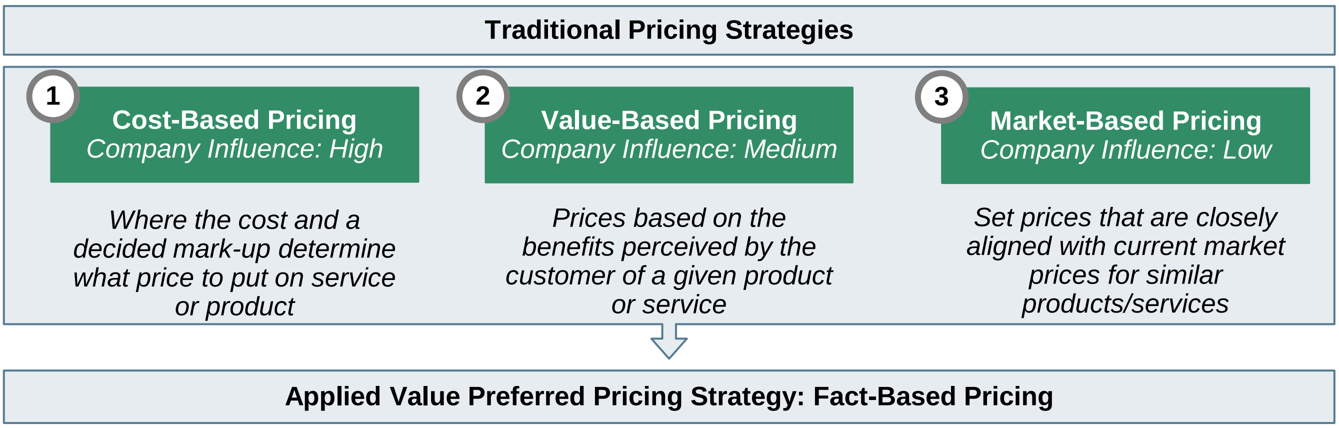


Figure 5: The Applied Value preferred pricing strategy as a combination of traditional pricing strategies

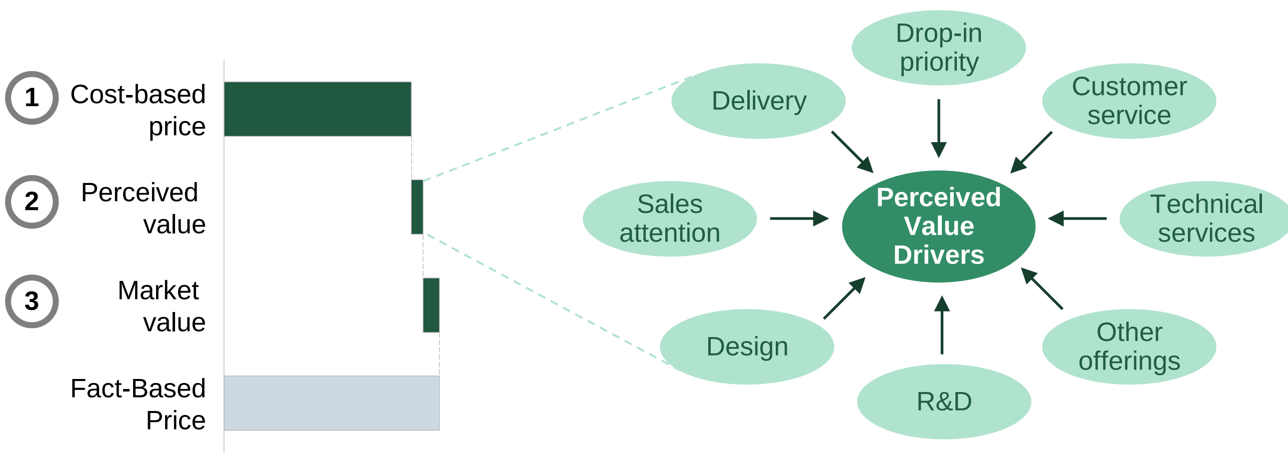


Figure 6: Illustration of preferred pricing strategy and perceived value

Fact-Based Pricing draws from the best parts of all of these methods to secure profitability on all products, whether standard or custom. To achieve this end, Fact-Based Pricing requires taking a multidimensional look at both cost and value. The following questions can help inform a company's pricing strategy:

- How does the market value our products and services?
- Are our products and services perceived as premium?
- Do customers properly understand the value that our products provide?
- Is the client willing to pay a premium for our brand?

Fact-Based Pricing allows businesses to supplement an understanding of their market with a comprehensive assessment of their customers' willingness to pay, as well as the impact a product has for customers. By evaluating all these factors, managers can find the sweet spot for optimal profitability that accounts for both consumer demand and companies' own portfolios. The Sweet Spot, where customer's willingness to pay aligns with profitable portfolio pricing and demonstrated demand, is the target that best allows companies to achieve truly profitable pricing.

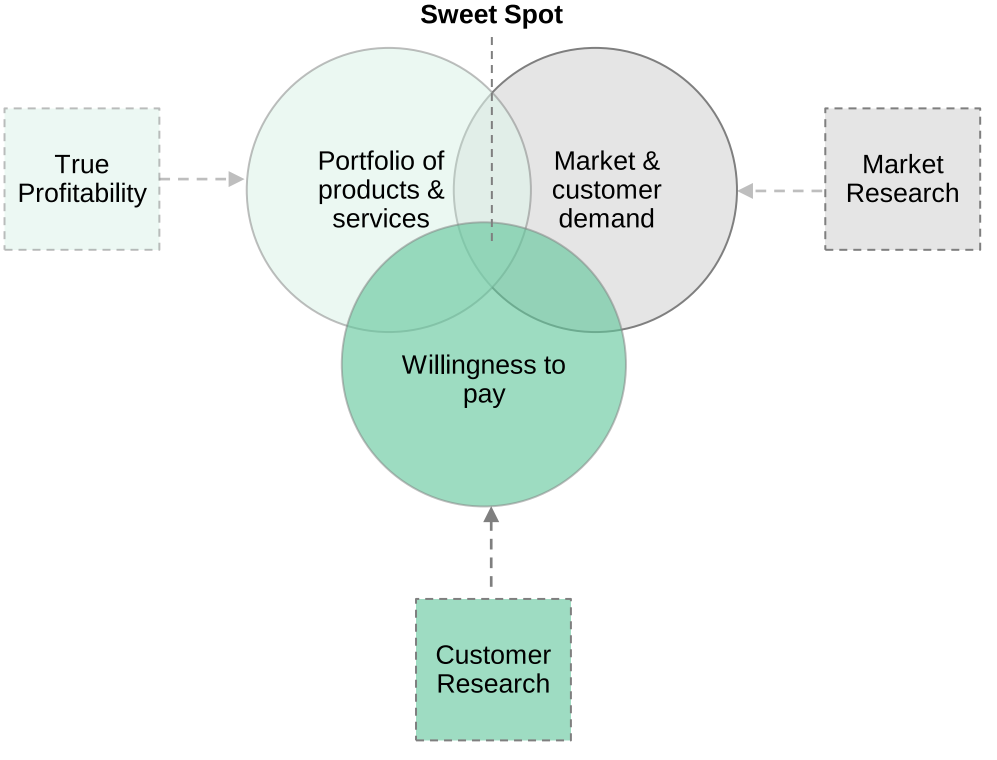


Figure 7: Sweet spot for profitability when matching portfolio with demand

Standard and Premium Pricing for Profitability

In traditional pricing models, allowing premium orders where customers customize based on their specific needs can result in lower profit margins. Fact-Based Pricing enables businesses to properly understand and up-charge for complexity and cost drivers that otherwise would dilute total profitability. Premium products can add value to a company's portfolio, but too often companies overlook complexity and cost considerations. Table 2 highlights several complexity and cost drivers that companies should be wary of when developing and pricing premium products or services.

Fact-Based Pricing outlines pricing methods that allow business to present **customers two pricing options without compromising profitability** on the premium product. The following pricing principles ensure standard offers maintain competitive and efficient pricing points while premium products are transparency up-charged for profit:

<u>Standard Products: Create standardized offerings with favorable cost base</u>

- Selling standardized orders in large quantities allow companies to properly control and improve the production efficiency and the standard cost base
- Standard products should be offered and a consistent market price
- By lowering R&D, production, admin, and other costs by offering standardized models, companies secure profitability through reduced costs that enable competitive pricing

<u>Premium Products: Charge higher prices for non-standardized and complex orders</u>

- Selling non-standardized, highly-complex premium products and services results in higher total costs in producing and delivering goods and services
- To avoid diluting Profitability margins, higher prices must be charged for all additional items that are not included in the standard offering

Giving customers the ability to choose between standard products and premium alternatives not only gives customers options but also establishes pricing transparency by making the value of customizations and additional upgrades clear. While some customer retention can suffer in the face of price adjustments, Fact-Based Pricing allows companies to endure short-term volume losses by building profitability into the structure of their portfolio, allowing for greater long-term success and sustainability.

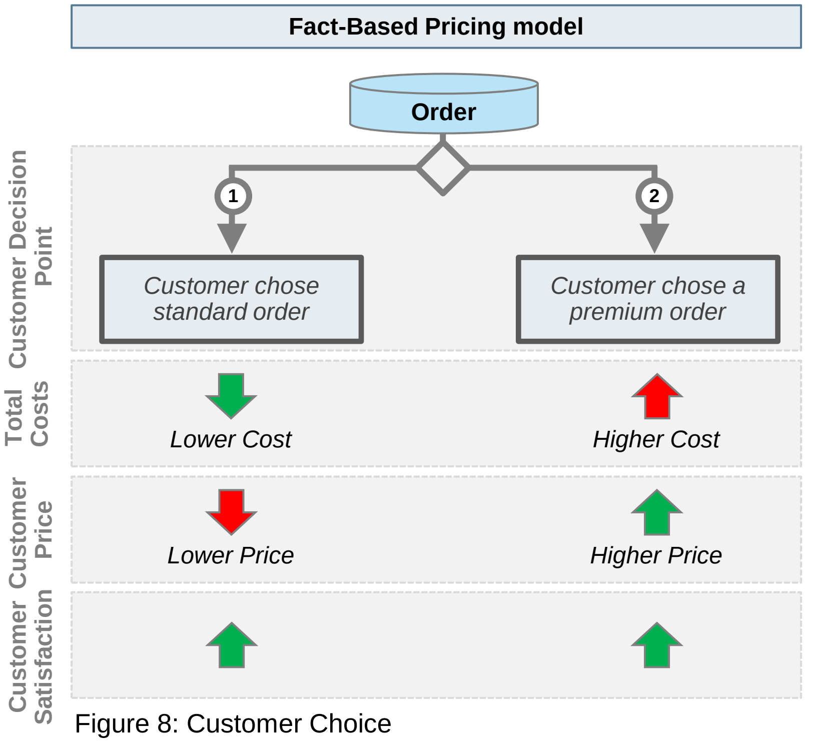


Figure 8: Customer Choice

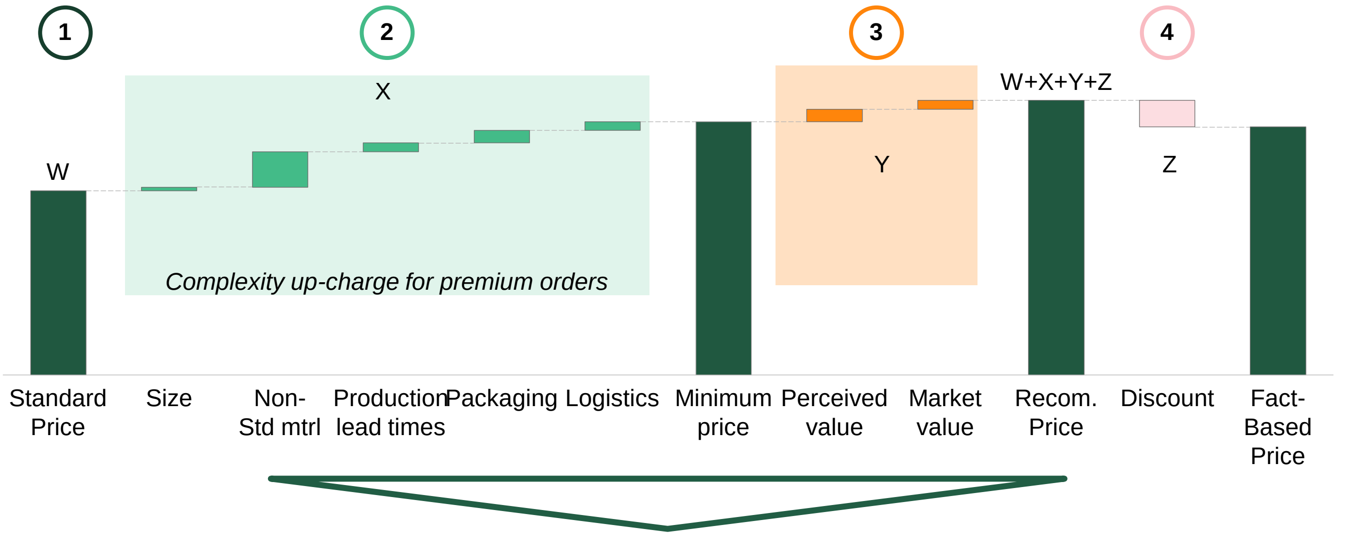
Example: Complexity and Cost Drivers

- Non-standard / premium materials
- Custom specification e.g. color, size
- Custom functionality
- Shorter production lead times
- Express delivery e.g. airfreight
- Specialist implementation support
- Non-standard services / premium SLAs

Table 2: Complexity and Cost Drivers

Determining a “Fact-Based Price”

In order to determine product pricing using this fact-based methodology, companies must consider several factors in order to determine a “Fact-Based Price,” which reflects *a standard price, complexity up-charge, perceived value, market influence and discount*. Figure 9 breaks down these considerations and illustrates the components of generating a Fact-Based Price.



Standard price + Complexity Up-Charge + Market Value + Perceived Value = Recommended Price
Recommended Price - Discount = **Fact-Based Price**

Figure 9: Break down of actual price for Fact-Based Pricing methodology

1 Standard Price: Scrutinize and develop a proper understanding of all costs related to the entire product and service portfolio. The standard offering spould be priced so that it covers all company costs at desired margins.

2 Complexity up-charge: Premium orders typically add production, sales, and admin complexities. For example, more expensive size, material, packaging, logistics, delivery, and lead-time drives cost extra and should determine the "complexity up-charge". The actual price for premium orders should cover the price of a standard order plus all additional costs related to the customization.

3 Market and perceived value: Benchmark against similar offerings on the market to find relevant prices. Understand what customers are willing to pay for your standard offering and potential premium solutions.

4 Discount: Discounts should only be given after careful considerations, although sometimes it can be a strategic move. Discounts are a good way to show appreciation to strategically important customers, e.g. key accounts and/or win market share e.g. when entering a new market.

Initiating Fact-Based Pricing

With an understanding of the value that Fact-Based Pricing can create, particularly in times of decreased volume, companies looking to achieve Fact-Based Pricing still must be willing to rigorously interrogate and potentially revise existing business practices. Although these processes can be difficult, the following implementation steps allow businesses to drive profitability with thoughtful changes to pricing:

> By **deciding a list price** on standardized orders, **adding up-charges** on the complexity, and giving **discounts to important customers,** you can **drive profitability** on every order accepted

1. **Evaluate and categorize your portfolio:** To recognize true profitability, it is critical to understand which products, services and sub-factors in your portfolio drive profitability and which do not. You need to understand the true cost of factors such as different sizes, packaging, logistics, delivery, materials, lead times, etc.

2. **Map customer, partner and portfolio impact:** Before making any changes to the prices or assortment, you need to understand how your key customers and partners would be affected.

3. **Pricing analysis:** Find out how much customers are willing to pay for different products and services. Surveys could be conducted and answered by either the clients or the internal sales organization

4. **Design your offering:** With a deeper understanding of your portfolio, customer impact and willingness to pay, the next step is to understand how to design your offering. Which products and services should be part of your standard offering and which should be classified as a complex or premium order. Where is your portfolio sweet spot?

5. **Determine prices, up-charge ability, and discount levels:** Decide the standard prices on your portfolio, how much the complexity up-charge should be for every type of sub-factor, and the discount levels for selected customer groups. Together they will contribute to the actual prices that you offer to your customers.

6. **Develop and communicate the new value proposition:** When prices are determined, it is time to create a new value proposition for both standard and premium offerings that reflect the new price points. The value proposition should be communicated internally as well as externally to customers and partners.

7. **Adjust standard pricing and up-charge continuously according to fluctuating market:** It is important to continuously monitor your standard/list prices, as market fluctuations may have an impact on various pricing factors.

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