Pricing ist Chefsache

42. Congress der Controller

München, 16. Mai 2017

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www.simon-kucher.com
Simon-Kucher & Partners at a glance

Best consultancy in marketing and sales

<table>
<thead>
<tr>
<th>Manager Magazin</th>
<th>Brand Eins Thema</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketing and sales</td>
<td>Marketing and pricing Sales and CRM</td>
</tr>
</tbody>
</table>

1 Simon-Kucher & Partners

2 Boston Consulting Group

3 McKinsey & Company

Source: Manager magazin survey of top managers in Germany, August 2007 and 2011/IMB
Source: Brand eins Thema/Statista survey of approx. 1,500 partners and project leaders from consulting firms and approx. 1,500 C-level managers from German companies, May 2014, 2015 and 2016

World leader in pricing

"World leader in giving advice to companies on how to price their products"

BusinessWeek

"The world’s leading pricing consultancy"

The Economist

"Pricing strategy specialists"

The Wall Street Journal

"In pricing you offer something nobody else does"

Professor Peter Drucker

Global presence

33 offices worldwide, 1,000 employees, €240m revenue in 2016

Strategy | Marketing
--- | ---
Growth and competitive strategies | Product portfolio (re-)design
Pricing excellence | Customer relationship and customer value management
Sales strategies and sales channel optimization

Top Line Power®
There’s not much in the world we haven’t priced

<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Porsche</td>
<td>Price strategy and pricing for models like Cayenne/Cayman/Panamera</td>
</tr>
<tr>
<td>DHL</td>
<td>Worldwide price-/product optimization (across divisions)</td>
</tr>
<tr>
<td>Nokia</td>
<td>Pricing for Virtual Reality</td>
</tr>
<tr>
<td>Brown-Foreman</td>
<td>Pricing strategy for Jack Daniels and other brands</td>
</tr>
<tr>
<td>Bayer</td>
<td>Launch of Levitra (competitive product to Pfizer's Viagra)</td>
</tr>
<tr>
<td>secret.de</td>
<td>Pricing and product strategy for &quot;casual dating&quot;</td>
</tr>
<tr>
<td>LinkedIn</td>
<td>Monetization of premium services</td>
</tr>
</tbody>
</table>
Agenda

**Why Pricing matters**

- Importance of the CEO
- The Best and the Rest
- The root evils in Pricing
- What the CEO should do
Price is the most effective driver

– and destructor –

of a firm’s value
Firm Value and profit

Firm Value = f(Profit)

Revenue

Volume
Price

Costs

Variable costs
Fixed costs

Only price, volume and costs have an influence on profit!
Value destruction through bad pricing
Praktiker (DIY): "20% discount on everything"

Aggressive price strategy
Slogan: "20% discount on everything"

Slogan aired for the last time

Source: www.onvista.de
Value creation through high pricing
Hermès International outperforms JB EF Luxury Brands

“Hermès bets on higher prices while others even cut their prices.”*

Source: www.onvista.de
Value destruction through high pricing
J.C. Penney: How the CEO (ex-Apple) ruined the company

End of promotions and special offers

Announcement: Ron Johnson appointed CEO

Ron Johnson becomes CEO

Source: www.onvista.de
Agenda

Why Pricing matters

**Importance of the CEO**

The Best and the Rest

The root evils in Pricing

What the CEO should do
What is the ultimate CEO responsibility?

Increasing the Value of the Firm
"The single most important business decision in evaluating a business is pricing power."

Warren Buffet

Creation of Pricing Power

Share of companies with high Pricing Power

- without CEO-Engagement: 26%
- with CEO-Engagement: 35%

Source: Simon-Kucher Global Pricing Studies 2012 and 2014
Successful price increases

Share of successful price increases

- without CEO-Engagement: 37%
- with CEO-Engagement: 50%

Source: Simon-Kucher Global Pricing Studies 2012 and 2014
EBITDA-Improvements after successful price increase

without CEO-Engagement: 37% improvement

with CEO-Engagement: 48% improvement

Source: Simon-Kucher Global Pricing Studies 2012 and 2014
Agenda

Why Pricing matters

Importance of the CEO

The Best and the Rest

The root evils in Pricing

What the CEO should do
GPS 2016: Increasing price pressure on a global scale

82% report increasing price pressure!

Why?*

- Stronger competition from low-price suppliers: 60%
- Increasing negotiation power among customers: 37%
- Greater price transparency: 34%

* Multiple responses possible
Source: Global Pricing Study 2016 (n = 2,186)
Every second company is engaged in a price war

49% are currently engaged in a price war!

Who started the price war?

- 86% Competitors
- 6% We did – on purpose
- 8% We did – accidentally

Source: Global Pricing Study 2016 (n = 2,186)
Innovation does not help either!

72% of all new products miss their profit targets
The outcome?
Four out of ten companies fail to improve their margins

39% did not improve margin percentages last year!

Why?*

- Variable cost inflation offset price increases: 32%
- No price increases: 20%
- Shift to lower margin sales (mix effect): 19%

* Multiple responses possible
Source: Global Pricing Study 2016 (n = 2,186)
The Best in pricing substantially outperform the Rest

- **EBITDA margin of last 3 years**
  - The "Best": 16%
  - Rest: 12.8%
  - +25% higher EBITDA margin

- **Average price implementation rate**
  - The "Best": 51%
  - Rest: 36%
  - +41% higher pricing power

- **Share of new products fulfilling their margin goals**
  - The "Best": 39%
  - Rest: 27%
  - +45% higher share of successful new product launches

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1) The "Best" classification comprises 10% of all companies participating in the study.
Source: Global Pricing Study 2014
Agenda

- Why Pricing matters
- Importance of the CEO
- The Best and the Rest
  - The root evils in Pricing
- What the CEO should do
The root evils in Pricing

1. Commoditization and Innovation failure
2. Cost-Plus Pricing
3. Controlling & Accountability deficiencies
The root evils in Pricing

1. Commoditization and Innovation failure
2. Cost-Plus Pricing
3. Controlling & Accountability deficiencies
R&D investments higher than ever

Global R&D investments 2015
~ $1,700bn

Companies with highest innovation expenditure

<table>
<thead>
<tr>
<th>Company</th>
<th>R&amp;D investments 2015 in bn</th>
<th>Share of turnover</th>
</tr>
</thead>
<tbody>
<tr>
<td>VW</td>
<td>15.3 (5.7%)</td>
<td></td>
</tr>
<tr>
<td>Samsung</td>
<td>14.1 (7.2%)</td>
<td></td>
</tr>
<tr>
<td>Intel</td>
<td>11.5 (20.5%)</td>
<td></td>
</tr>
<tr>
<td>Microsoft</td>
<td>11.4 (13.1%)</td>
<td></td>
</tr>
<tr>
<td>Roche</td>
<td>10.8 (20.8%)</td>
<td></td>
</tr>
<tr>
<td>Google</td>
<td>9.8 (14.8%)</td>
<td></td>
</tr>
</tbody>
</table>

1 Source: Battelle, R&D Magazine 2016
Despite high investments poor innovation performance

72% of all new products do not achieve profit target

In 25% of companies all products fail to meet profit target

New products: "flop rate"

<table>
<thead>
<tr>
<th>Region</th>
<th>Flop Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>76%</td>
</tr>
<tr>
<td>USA</td>
<td>74%</td>
</tr>
<tr>
<td>Globally</td>
<td>72%</td>
</tr>
<tr>
<td>DACH</td>
<td>69%</td>
</tr>
</tbody>
</table>

Source: Global Pricing Study 2014; n=1,615
Failure category #1: "Feature Shock"

Source: Simon-Kucher & Partners

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Feature Shock
FirePhone: Hundreds of $m "burned"

From the iPhone hunter to a cheap phone
From $199$^{1)} to $0.99 in 4 months
$170 million in inventory write-downs

$^{1)}$ incl. contract
Failure category #2: "Minivation"
**Minivation**

**Automotive supplier/VW: ParcAssist**

Cost plus pricing towards VW and other OEMs: approx. €100

OEMs understand full customer value

VW's customer price: €670
Failure category #3: "Hidden Gem"
Hidden Gem
Kodak – did not recognize they had it

1974
Kodak's Steven Sasson invented the digital camera technology

1995
Kodak introduced its first digital camera; only in 2001 they got serious about that business

2012
Kodak declared bankruptcy
The root evils in Pricing

1. Commoditization and Innovation failure
2. Cost-Plus Pricing
3. Controlling & Accountability deficiencies
Why Cost-plus pricing doesn’t work

- Simple and cheap solution
- Required data is usually readily available

- Cost improvements are passed on to the market immediately
- High willingness to pay not fully extracted

Source: Simon-Kucher & Partners
What we often see at cost-plus clients

Gross margin

<table>
<thead>
<tr>
<th>SKU</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>SKU 1</td>
<td>57%</td>
</tr>
<tr>
<td>SKU 2</td>
<td>57%</td>
</tr>
<tr>
<td>SKU 3</td>
<td>56%</td>
</tr>
<tr>
<td>SKU 4</td>
<td>54%</td>
</tr>
<tr>
<td>SKU 5</td>
<td>57%</td>
</tr>
<tr>
<td>SKU 6</td>
<td>53%</td>
</tr>
<tr>
<td>SKU 7</td>
<td>56%</td>
</tr>
<tr>
<td>SKU 8</td>
<td>58%</td>
</tr>
<tr>
<td>SKU 9</td>
<td>55%</td>
</tr>
<tr>
<td>SKU 10</td>
<td>57%</td>
</tr>
</tbody>
</table>
Value is key

Customers pay a price because they want to get a certain value. They never pay a price to cover the cost they incur.

"Customers don't buy products. They buy advantages that those products offer to them."

Peter F. Drucker
One of the greatest management thinkers of all times

It is the key job of management to create as much value for the customer as possible – and charge according to that value, not according to the cost to maximise profits.
A look at the Roman Empire

Pretium = Price = Value
Value pricing for car options

<table>
<thead>
<tr>
<th>Option</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metallic paint</td>
<td>&gt; 90%</td>
</tr>
<tr>
<td>Rain sensor</td>
<td>&gt; 80%</td>
</tr>
<tr>
<td>Leather</td>
<td>&gt; 50%</td>
</tr>
<tr>
<td>Electric sun roof</td>
<td>&gt; 40%</td>
</tr>
</tbody>
</table>

With pure cost plus pricing many car manufacturers would not have survived.
The five tasks in value-based pricing

Value-based pricing

- Extract the value
- Differentiate your offerings
- Measure willingness to pay
- Configure your products
- Sell the value

Value-based pricing
Differentiate your offerings:  
When segmentation goes wrong

<table>
<thead>
<tr>
<th></th>
<th>Two customers: Seemingly alike...</th>
<th>...but very different</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGE</td>
<td>68</td>
<td>68</td>
</tr>
<tr>
<td>BORN</td>
<td>UK</td>
<td>UK</td>
</tr>
<tr>
<td>MARRIED</td>
<td>✔</td>
<td>✔</td>
</tr>
<tr>
<td>HOME</td>
<td>Castle</td>
<td>Castle</td>
</tr>
<tr>
<td>INCOME LEVEL</td>
<td>Wealthy</td>
<td>Wealthy</td>
</tr>
</tbody>
</table>

Source: Simon-Kucher & Partners
### Differentiate your offerings: Segment based on value desired by the customer

<table>
<thead>
<tr>
<th>Needs/Features</th>
<th>All customers</th>
<th>Segments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&quot;Want the best&quot; (30%)&lt;sup&gt;1&lt;/sup&gt;</td>
<td>&quot;Want it now&quot; (40%)</td>
</tr>
<tr>
<td>Price (+/-10%)</td>
<td>21</td>
<td>12</td>
</tr>
<tr>
<td>Service programs</td>
<td>15</td>
<td>19</td>
</tr>
<tr>
<td>On-time delivery</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Product performance (end user)</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td>Product quality (converter)</td>
<td>13</td>
<td>17</td>
</tr>
<tr>
<td>Speed of delivery</td>
<td>13</td>
<td>8</td>
</tr>
<tr>
<td>Tech support</td>
<td>9</td>
<td>9</td>
</tr>
</tbody>
</table>

* Segment size (value)

- **Basis:** WTP/needs data – always!
- **Early on task**
- **Statistics and common sense**
- **Less is more**
Measure willingness to pay: Customer desire is not enough

<table>
<thead>
<tr>
<th>Features</th>
<th>WTP in $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Free ground shipping</td>
<td></td>
</tr>
<tr>
<td>Communicate on-line with seller over chat</td>
<td></td>
</tr>
<tr>
<td>24x7 customer support</td>
<td></td>
</tr>
<tr>
<td>Early access to special deals</td>
<td></td>
</tr>
<tr>
<td>Price guarantee</td>
<td></td>
</tr>
<tr>
<td>Membership sharing</td>
<td></td>
</tr>
<tr>
<td><strong>Highlight connections from Facebook</strong></td>
<td></td>
</tr>
<tr>
<td>Ability to place a video call with seller</td>
<td></td>
</tr>
<tr>
<td>$10 off first purchase</td>
<td></td>
</tr>
<tr>
<td>Message with friends</td>
<td></td>
</tr>
</tbody>
</table>

Source: Simon-Kucher & Partners

Project example 2-sided marketplace

- From 25 to 10 features
- Clear ranking of these 10
- Principle: Focus on winners, get rid of losers early

Project example 2-sided marketplace

- From 25 to 10 features
- Clear ranking of these 10
- Principle: Focus on winners, get rid of losers early

Source: Simon-Kucher & Partners
Configure your products: Product configuration is more science than art!

% of respondents with high value for the feature

% of respondents with no value for the feature

Features

1 2 3 4 5 6 7 8 9 10 11 12

Leader

Filler

Killer

91% 82% 82% 68% 59% 59% 32% 25% 20% 19% 14% 5%

43
Sell the value: IoT massively reduces maintenance cost at Caterpillar

- Predictive maintenance almost eliminates down time
- Repair cost are down as well
- Specific case in mining: Cost decrease by 90%
- Typical cost savings across industries: 30%
Extract the value:
Two thirds of the companies work on new price models

Do you think about changing your revenue model because of higher price pressure?

- Yes – actively planned
  - 37%
- Yes – vague initiative
  - 29%
- No – never thought about it
  - 12%
- No – thought about it but declined
  - 22%
Extract the value: Debundle

- Analysis: PE of base price much, much higher than that of surcharges
- Model: Debundling; low base price + lots of surcharges
- Reinvented the whole industry
- Revenue/market capitalization (2014/15) (€bn)
  - Ryanair: 5.6/18.7
  - Lufthansa: 30.0/5.5
Extract the value:
...and optimize the pricing components

**2006:**
price for 20kg = €3.50

**2014:**
price for 20kg = €35.00
### Extract the value: Influence the customer’s decision

<table>
<thead>
<tr>
<th>Option</th>
<th>Price in USD</th>
<th>% of people choosing option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Online</td>
<td>59</td>
<td>68</td>
</tr>
<tr>
<td>Print + online</td>
<td>125</td>
<td>32</td>
</tr>
</tbody>
</table>

**Average revenue per subscriber:** $80.12

---

### Option 2

<table>
<thead>
<tr>
<th>Option</th>
<th>Price in USD</th>
<th>% of people choosing option</th>
</tr>
</thead>
<tbody>
<tr>
<td>Online</td>
<td>59</td>
<td>16</td>
</tr>
<tr>
<td>Print</td>
<td>125</td>
<td>0</td>
</tr>
<tr>
<td>Print + online</td>
<td>125</td>
<td>84</td>
</tr>
</tbody>
</table>

**Integrate intelligent price anchors**

**Average revenue per subscriber:** $114.44

*Source: Simon-Kucher & Partners*
Extract the value: Let price speak for quality

In an experiment, participants were asked to estimate the effect of a painkiller after being treated with electrical impulses.

<table>
<thead>
<tr>
<th>Group</th>
<th>Price</th>
<th>Pain-killing effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1</td>
<td>$2.50</td>
<td>~100¹)</td>
</tr>
<tr>
<td>Group 2</td>
<td>$0.10</td>
<td>~50¹)</td>
</tr>
</tbody>
</table>

Pain-killing effect confirmed by

Source: Ariely, 2010

¹) Index

Schmidt-Gallas_Pricing ist Chefsache_42. Congress der Controller
The root evils in Pricing

1. Commoditytization and Innovation failure
2. Cost-Plus Pricing
3. Controlling & Accountability deficiencies
Deficiency:
Too many product margins too low

### Project Example

<table>
<thead>
<tr>
<th>Margin</th>
<th>Product ABCD Classification</th>
<th>A Product</th>
<th>B Product</th>
<th>C Product</th>
<th>D Product</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;0%</td>
<td></td>
<td>9%</td>
<td>1%</td>
<td>1%</td>
<td>1%</td>
</tr>
<tr>
<td>&gt;10%</td>
<td></td>
<td>31%</td>
<td>13%</td>
<td>10%</td>
<td>6%</td>
</tr>
<tr>
<td>&gt;20%</td>
<td></td>
<td>27%</td>
<td>17%</td>
<td>15%</td>
<td>14%</td>
</tr>
<tr>
<td>&gt;30%</td>
<td></td>
<td>17%</td>
<td>30%</td>
<td>24%</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;40%</td>
<td></td>
<td>12%</td>
<td>31%</td>
<td>40%</td>
<td>41%</td>
</tr>
<tr>
<td>&gt;50%</td>
<td></td>
<td>4%</td>
<td>8%</td>
<td>10%</td>
<td>17%</td>
</tr>
</tbody>
</table>

"No-Go" Zone

Sales share in the no-go zone

- Area A: 5.2
- Area B: 8.3
- Area C: 9.0
- Area D: 10.5
- Area E: 11.9
- Area F: 12.1
- Area G: 13.2
- Area H: 14.3
- Area I: 15.4

Source: Simon-Kucher project work
Deficiency:
Customer prices inconsistent

The pricing freedom is too large for sales reps. There are no price limits that cannot be overstepped.

Status quo vs. target in warehouse business

"This happens when the sales rep knows what the lowest prices possible are."

Project Example

Source: Simon-Kucher project work
Deficiency:
Discounts peak at escalation limits

How approval thresholds drive the pricing execution of sales

<table>
<thead>
<tr>
<th>No approval required</th>
<th>Discount approval by:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sales Director</td>
</tr>
<tr>
<td></td>
<td>VP Area Sales</td>
</tr>
<tr>
<td></td>
<td>SVP America Sales and VP Product Line</td>
</tr>
<tr>
<td></td>
<td>SVP America Sales and VP Global Accounting</td>
</tr>
</tbody>
</table>

Source: Simon-Kucher project; data altered to protect confidentiality
Deficiency: Rounding off of discounts

Discounts should look like this:
7.23%
5.14%
3.18%

And they should get smaller in each negotiation round!
Deficiency: The opposite of good is good intentions

- The CEO of one of the largest logistics enterprises loved visiting the CEOs of his key customers himself.
- The CEOs of his customers often demanded higher price concessions – to which he gave in.
- This undermined the many preceding negotiations and frustrated his sales team.
- We advised the CEO to stop his visits which in turn led to one percentage point increase in margin (which is a lot in this industry).
Agenda

Why Pricing matters

Importance of the CEO

The Best and the Rest

The root evils in Pricing

**What the CEO should do**
"Price is really really important but a lot of people under-think it through"

Steve Ballmer,
former CEO Microsoft
Clarify your price position

„Premium products and discounts don‘t go together well.
That‘s why we have decided to not defend our market share at any cost.“

Norbert Reithofer, former CEO BMW
Take over price leadership

“We are by far the market leader. It is the task of the market leader to help prices up.”

Johan Molin, CEO Assa Abloy
(World market leader door opening solutions, EBIT-Margin 16.3%)
Organize the pricing process

„Margins rise significantly and sustainably if you have a well-defined pricing process and clear rules for price decisions, price implementation and price controlling.

If the CEO delegates pricing responsibility or even worse, leaves it to the market, there is no way you can shine against your competitors. "

Albert Baehny, Chairman Geberit
(World market leade in behind the wall sanitary systems, EBIT-Margin 27.5%)
Enforce price discipline

“We have carried out a pricing analysis and revealed that about 5 bn Dollars are at stake. If you take into account all decisions, sales staff can make themselves then it’s about this enormous amount of money.

On the cost side we would never allow anything like this. If it’s about our purchasing prices, we analyze, compare and bargain them down. But with our selling prices, we are sloppy.”

Jeffrey Immelt,
CEO General Electric
Summary

- Price is the most effective driver – and destructor – of a firm’s value: Play it right and your benefit is massive, play it wrong and you’re doomed.

- The CEO’s job is to increase the value of the firm. If pricing gets his attention or not has a ~30% impact on important KPIs.

- Companies see themselves under enormous price pressure. Every other firm is entangled in price wars – which they claim others have started.

- There are three root evils in Pricing
  1. Commoditization and Innovation failure
  2. Cost-Plus Pricing
  3. Controlling & Accountability deficiencies

- To fix these evils, the CEO can help with five actions
  1. Make pricing a key topic in the organization
  2. Clarify your price position
  3. Take over price leadership
  4. Organize the pricing process
  5. Enforce price discipline

All this requires the determination, stamina and relentlessness of the CEO.
"Costs are a matter of facts ... Pricing is a matter of guts"

Jack Welch
Profile

Dr. Dirk Schmidt-Gallas is a Senior Partner at Simon-Kucher & Partners and Member of the Board at Simon-Kucher. Furthermore, he manages the company's Frankfurt office.

Dirk looks back at more than fifteen years of consulting experience, all in the field of pricing, sales and strategy. His projects have covered more than 40 countries across the globe. His clients seek his advice on strategy, pricing, sales and product optimization.

Dirk has authored and co-authored numerous books and articles on the topics of strategy, pricing and sales and is a regular speaker at leading domestic and international conferences.

He studied business administration at the University of Mainz focusing on marketing and finance/risk management. In collaboration with Deutsche Bank, he wrote his dissertation on strategic product design. For this he was able to use the knowledge he had gained from a research assignment at Yale University (USA).