

In Pricing, Success Breeds Success

A.T. Kearney's Pricing Full Potential (PFP) Analyzer does the heavy lifting when it comes to pricing. The more market power you have, the more you can still gain from your pricing strategy.



In the summer of 2013, A.T. Kearney surveyed more than 1,600 businesses in five countries to get an “outside view” and answers to two fundamental questions:¹ How much money can a business realistically gain from better pricing? Is there a simple, reliable way to predict these gains? The short answers are “much more” and “yes.”

This study, which includes major companies in various for-profit industries, has yielded three compelling and practical insights on how companies can make significantly higher profits from better pricing.

- **Know what’s at stake for your business.** Improved pricing increases gross profits by 15 percent on average over a three-year period, often multiplying net profits and raising market capitalization by hundreds of millions of Euros.
- **Don’t stop. There is always more to gain.** The more market power a company has, the more profits it can still gain from further pricing improvements.
- **Go deep, not broad.** The best pricing performers succeed by focusing on a small number of pricing improvement efforts rather than broad-based pricing programs.

These findings not only illustrate what factors separate the pricing outperformers from others, but also paved the way for development of a new tool, the Pricing Full Potential (PFP) Analyzer. The PFP Analyzer provides simple, reliable estimates of how much profit is at stake.

Know What’s at Stake for Your Business

The PFP Analyzer estimates the size of the prize for any given company by looking at the actual achievements of companies or business units with similar market positions (measured by a combination of market share and gross margins). For example, a global automotive powerhouse based in Europe with 8 percent market share and 20 percent gross margin can add almost three points on gross margin through better pricing within three years. This translates into more than \$275 million in additional profits. An innovative high-tech leader with 60 percent market share and 45 percent gross margin in a niche market can add on average 10 points to its margin.

Of course, market power can vary significantly within a company, especially in large conglomerates. Metro, for example, is very strong in the cash-and-carry wholesale segment in its home market of Germany, but weaker in France where Carrefour is the long-established leader. It is essential to look at business units and markets at the right level in order to identify the pricing potential.

Two other questions helped us validate our belief that better pricing drives higher profits. We asked half of our study participants how much their suppliers could still capture from them in price negotiations. In other words, how much money were suppliers leaving on the table? We asked the other half how much they themselves were leaving on the table in price negotiations with their customers. The assessments were almost identical, at 5.2 and 5.1 percent of the deal size. Needless to say, these amounts would make a substantial difference to profits. The average EBIT margin for Europe’s top 300 companies was 9.9 percent in 2012. Adding another 5 percentage points to the top line would have increased EBIT by about 50 percent. Even if companies captured only a fraction of that potential, it would still be a substantial increase in profits.

¹ The “outside view” is from Daniel Kahneman and Amos Tversky’s concept of reference-class forecasting discussed in their book, *Choices, Value, and Frames*.

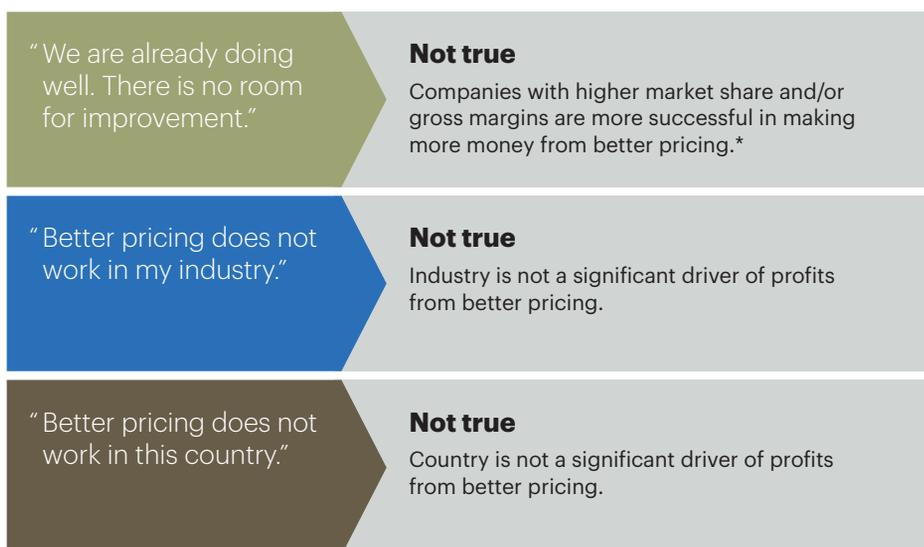
Don't Stop. There is Always More to Gain

Our findings reveal that a company's market power—measured by gross margins and market share—is a reliable predictor of its potential gains from better pricing. The more market power a company has, the higher the profit improvement potential. What's more, the relationship is linear. Profits gained from pricing continue to rise as market share and gross margins rise. In other words, there is more, and then there is still more to gain.

This finding refutes the typical arguments heard when an organization thinks it has done enough or is already good enough when it comes to pricing. The main arguments are: "Why? We are already doing well," "Better pricing does not work in my industry," and "It does not work in this country." The fact is, industry and country of origin turned out to have little influence on the profit improvement potential from pricing (see figure 1).

Figure 1

A.T. Kearney study debunks three classic arguments against better pricing



*Significance: $p < 0.01$

Source: A.T. Kearney survey in UK, France, Germany, Italy, Spain with $n = 1647$, summer 2013

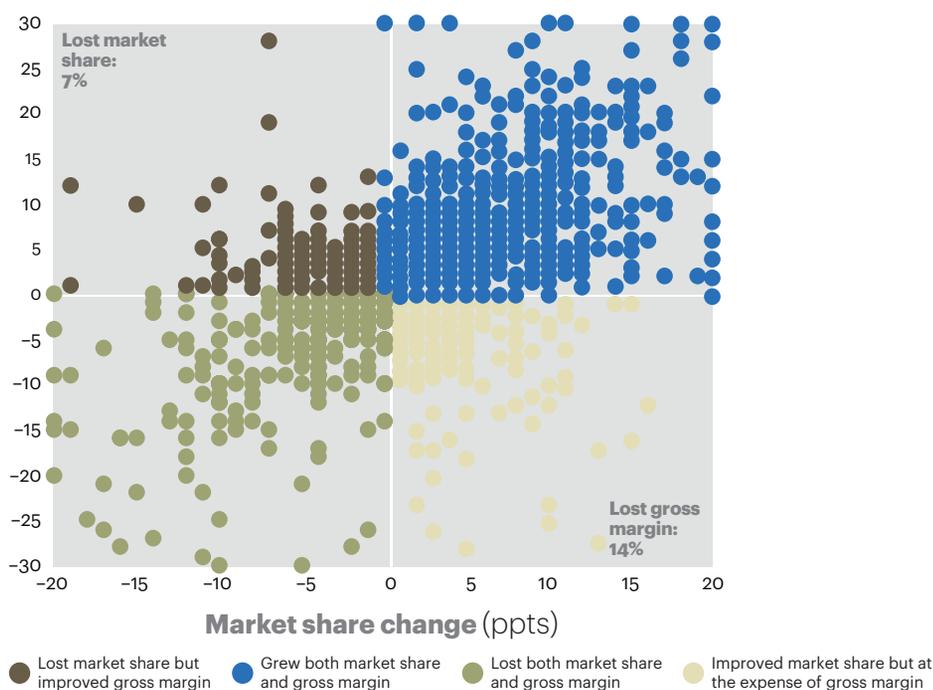
The three typical arguments above are dangerous, because they lead to behaviors that hinder pricing efforts and harm profits. A company that manages to lower its costs tends to pass along the cost savings to customers, which means there is a preference to preserve gross margins rather than improve them. In fact, our findings demonstrate that when cost of goods sold (COGS) rise, gross margins are almost three times less likely to change than when COGS fall.

Such companies are also prone to sacrifice profit to preserve market share, rather than the reverse. An obsession with market share is still very much alive. Looking at the laggards in our sample—companies that improved either share or profitability—the share of companies that gave ground on gross margins is almost twice as high as those that lost share (see figure 2 on page 4). So when in doubt, laggards sacrifice profit to preserve market share, rather than sacrificing market share to preserve profits.

Figure 2

Companies are twice as likely to sacrifice gross margins instead of market share

Gross margin change (percentage points)



Source: A.T. Kearney survey in UK, France, Germany, Italy, Spain with n = 1647, summer 2013

Go Deep, Not Broad

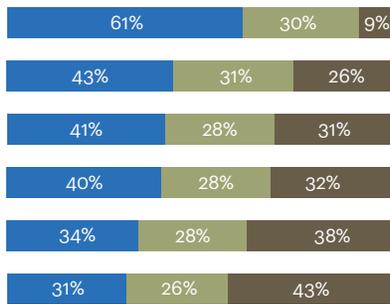
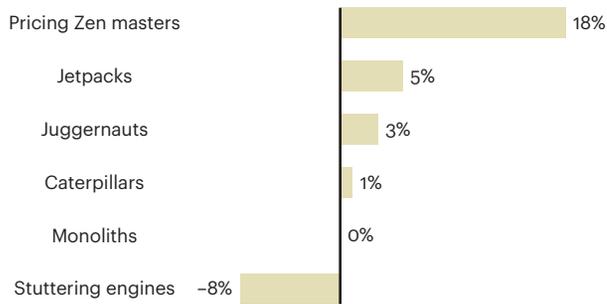
Having market power is clearly important. It is no surprise that companies with high market share also enjoy high margins. Consider Apple in smartphones, BMW in cars, and Coca-Cola in soft drinks. What a company does with its market power is perhaps even more important.

The top performers in our analysis, an elite group that we call the Zen masters of pricing, have three things in common. They enjoy very high market share and gross margins, they have spent the past three years expanding their market power, and they attribute the majority of their profit improvement (more than 70 percent of it) to their pricing strategies. In other words, their market power, which is already high, continues to rise as their pricing improves.

The Zen masters differ from the other businesses in two ways: First, they are much more likely to undertake at least one initiative to improve pricing. Second, almost two thirds of the Zen masters focus on one or two key pricing actions rather than a major program addressing more than five price actions (see figure 3 on page 5).

Interestingly, firms that possess better overall pricing skills (or think they do) have higher market share and gross margins. Yet these firms still invest to deepen their skills even more. Unlike price promotions, which are not applicable to many business-to-business firms, pricing training is an opportunity to change not only how people think about pricing but also how prices are managed. And it is essential to every industry.

Figure 3

Learn from the pricing Zen masters how to unlock profits from better pricing**Pricing improvement actions****Share of respondents****How the actions paid off****Gross margin improvement from better pricing**
(in percentage points, over three years)

- Successfully implemented **one or two** key pricing improvement actions
- Implemented a **major program** addressing more than five different actions
- Took no action or other actions

Source: A.T. Kearney Pricing Improvement Survey, performed in the UK, France, Germany, Italy, Spain with n = 1647, Summer 2013

Beyond training, other possible pricing initiatives include improved price-setting process, more-targeted discounts and promotions (if applicable), better sales force price execution, and tighter price monitoring.

Success, and More Success

What we know intellectually is that success breeds success. A company that understands the mechanisms of smart strategy, and uses them to its advantage, is bound to succeed. Nowhere is that more true and pertinent than in pricing. Smart pricing leads to increased profits and market share. Our study proves it.

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