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PRICE EROSION CHALLENGES FOR TECHNOLOGY COMPANIES

Realize Your Potential

INTRODUCTION

Pricing professionals at technology companies constantly struggle to create and maintain a consistent pricing strategy over the product lifecycle. But, the lack of control over a coherent pricing strategy often results in an inability to deliver proper pricing guidance to field sales. This leaves sales to request pricing based on customer demands, perceived competitive responses, intuition and emotion.

This lack of a disciplined price-setting approach generates too many price approvals via exception. The exception process typically becomes an emotional internal struggle that ultimately results in the approval of some very low pricing in the name of competitive matching. This greatly increases the risk for an acceleration of price erosion due to inconsistent price approvals and confusion between the pricing team and field sales.

To help take back control of pricing, technology companies need better insight into list price setting and automated methods to determine price guidance targets for negotiated deals. Fortunately for technology companies, pricing software can help create a consistent pricing framework based on objective measures. This, in turn, leads to logical price band ladders for a product group, a slower rate of erosion and ultimately higher revenues while protecting market share.

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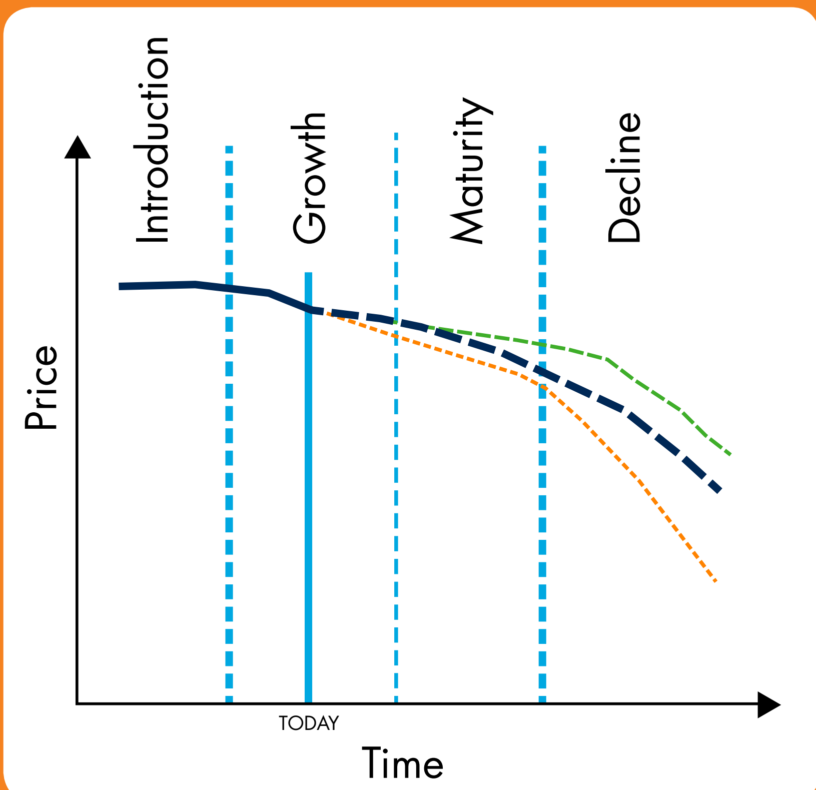
Figure 1: Use pricing to move the Product Lifecycle Maturation curve to the green line

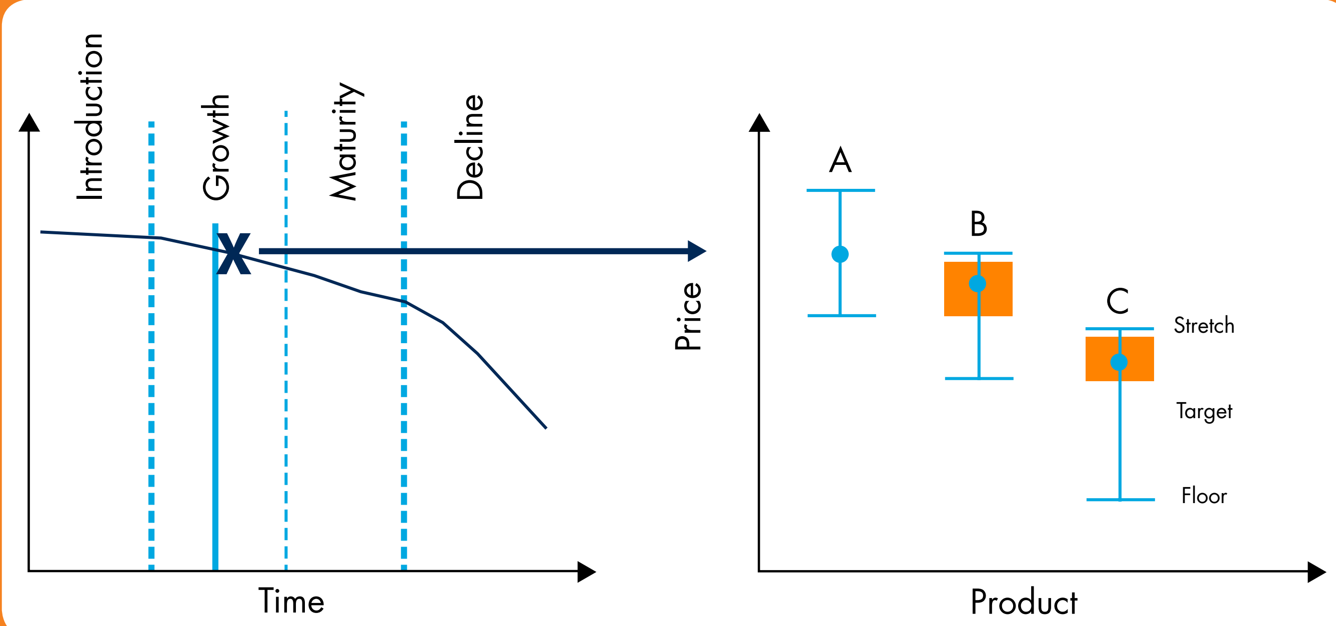


FORECASTING PRICE EROSION

To illustrate the advantages of pricing software, it's helpful to use a hypothetical technology products company called Benson Tech. At the macro level, Benson Tech pricing managers want to be able to forecast price erosion so they can decide whether or not their pricing strategies are working as planned. Through their current business intelligence tools, they can see how much pricing has dropped historically, but they have no ability to forecast future declines. Without this kind of insight, they have no idea if their current tactics and strategies are optimized and as effective as possible in slowing the rate of price decline.

They may believe that they are giving too much in the way of discounts during deal negotiations but they do not have a yardstick by which to objectively measure their performance. The graphs in Figure 1 illustrates Benson Tech's situation with regard to price erosion across the product lifecycle. The blue line represents Benson Tech's price decline assumption plugged into their five-year plan for each product line. The company derived the rate of decline based on guesstimates by experienced sales, marketing and pricing team members.

Figure 2: Managing good, better, best product line pricing to identify and quantify exposure risk



The orange line represents the possible risk of losing control of pricing due to a price war, underestimating the product's value in the market, or being out negotiated by the customer. At PROS, we are seeing quite a few technology companies experiencing accelerated price erosion among their products due primarily to shorter product lifecycles, an increasingly sophisticated buyer and overall economic malaise—a major cause of concern in executive management suites. The green line represents an ideal situation whereby Benson Tech would be able to slow the rate of price erosion and protect its profits as the product moves through its useful life.

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Deriving these price decline scenarios based on subjective measures is not a best practice and provides only a general direction of trends at best. However, by using sophisticated pricing software to forecast price changes based on objective inputs, the company can give the pricing, sales and finance groups much more confidence in accurately predicting future price assumptions for strategic planning purposes.

INFLUENCING THE SHAPE OF THE PRICE CURVE

Better forecasting of price erosion has another more tactical benefit: Benson Tech gains the ability to target shift the curve toward the green line. Assume that Benson Tech has a significant number of product lines with a good, better and best option for quality and value. Sales people at Benson Tech, however, find themselves in too many situations where their customers are not willing to pay what they consider a reasonable premium for the additional value derived in the better and best products. For fear of losing the business, they routinely offer all three products at the same price point or at only a marginal premium.

What they don't realize is by taking the easier route of offering all three products at or near the same price, they are creating a huge exposure risk not only within this specific product segment but also across the entire marketplace. This lack of pricing-to-value insight has the unintended consequence of driving down prices on Benson Tech's higher end products due to customer benchmarking. The diagrams in figure 2 below illustrate this situation. In the diagram 2, the product curve represents a typical product line curve from Benson Tech.

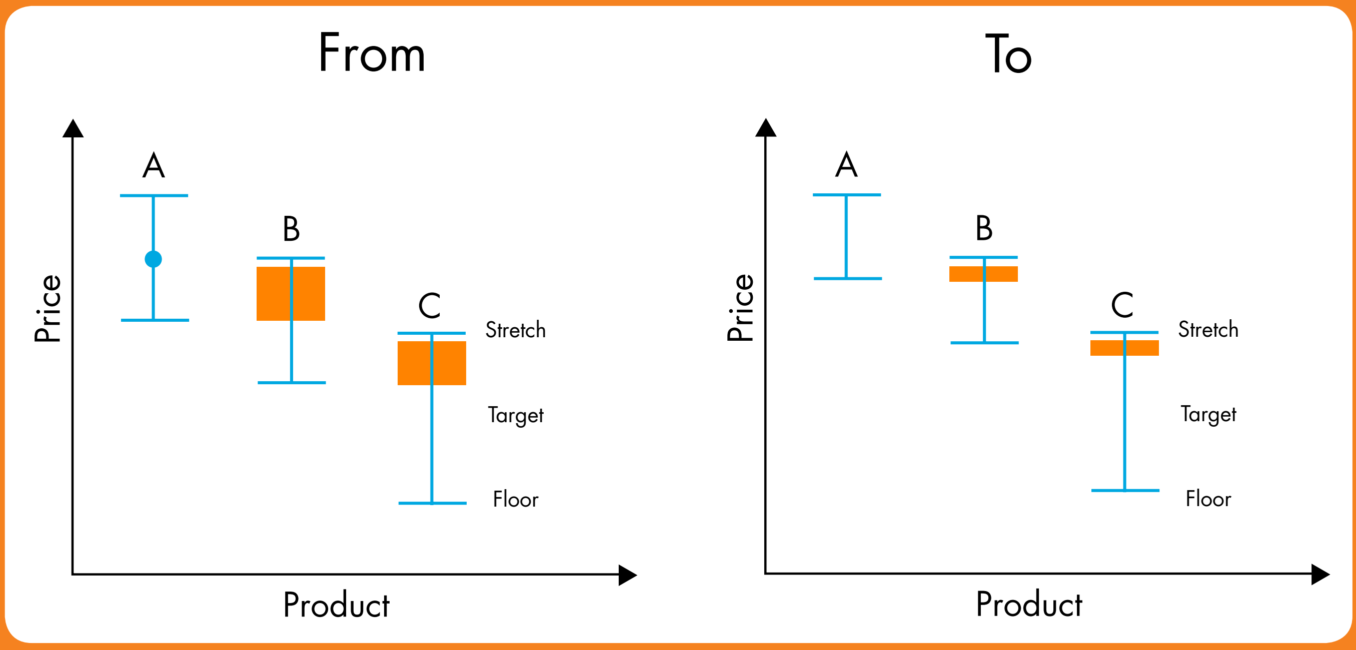
Diagram 3 shows the three products in the line. A is the "best," most advanced product and thus priced the highest. B is the "better," workhorse product and C is the "good," least price-sensitive product. Each product has a price band bound by floor and stretch prices and a target price that lies somewhere in between the two. The blue dots represent the invoice prices for Johnson Manufacturing, one of Benson Tech's bigger customers. The area in orange is the exposure risk Benson Tech faces when determining final negotiated prices. For example, there is a clear risk that Johnson Manufacturing might want a price for Product B closer to Product A's floor assuming they performed a benchmarking study and learned what similar customers were paying.

Pricing software can help create a consistent pricing framework based on objective measures. This, in turn, leads to logical price band ladders for a product group, a slower rate of erosion and ultimately higher revenues while protecting market share.

To avoid the risk of having to lower the price of Product A unnecessarily, Benson Tech needs to properly segment the market so they can isolate the true exposure risk and decide when a price is truly too low to approve. With that knowledge, Benson Tech can employ pricing strategies that will shrink exposure risk and slow the rate of price erosion as illustrated in Figure 3.

Using science-driven segmentation techniques, the floor price for Products A and B can be raised as shown in the right-hand graph and the risk exposure in orange can be significantly reduced. This is possible because the segmentation process classifies customers by their willingness to pay and their key drivers for price. Product C, the most mature product in the line, still has a relatively wide price range between stretch and floor because there is little if any exposure risk associated with Product C's pricing.

Figure 3: Narrowing price bands with pricing software segmentation



PROS provides the insight and control to develop and track pricing strategies based on scientifically based segmentation and help you correctly set floor, target and stretch pricing by product and segment.

NEW METHODS FOR TIGHTENING PRICE BANDS TO RESIST PRICE EROSION

Based on using pricing software to forecast, properly segment customers, and provide price guidance delivered to field sales at the time of contract negotiation, Benson Tech should be able to execute a three-part pricing strategy to improve profitability and margins.

First: Set more accurate floor, target and stretch prices for all products and minimizing exceptions. Benson Tech was approving too many deals through the exception process because they thought by reviewing a majority of deals, they were in control of their pricing. In reality, it was just an illusion. By reducing the number of exceptions, management can devote more time to focusing on deals that genuinely need a greater level of scrutiny.

Second: Reduce the price band variance by not offering the "better" or "best" products during a contract negotiation if a customer is unwilling to pay for the additional value. The more products found within a product line or group, the more complicated it can be to manage prices but also the greater the opportunity to influence the slope of the price decline. With more products available, there is greater flexibility to offer only the lower end of the line to a customer that values lower pricing over product attributes.

Third: Effectively launch new products. If Benson Tech were to launch a new product without proper customer segmentation for pricing, there would be no fact-based way of determining each customer's true willingness to pay for a new product. Proper segmentation would enable Benson Tech to set variable, acceptable dollar uplifts and drive tighter price bands while minimizing price erosion exposure over the lifetime of the new product. Moreover, Benson Tech can now stage the release of the new product by targeting those prospects and customers with the highest willingness to pay. If Benson Tech decides to offer the new product to a customer at a sub-optimal uplift, they will at least understand how much exposure risk they might incur.

PROS OFFERS A PRESCRIPTIVE PRICING SOLUTION

Achieving more profitable pricing requires an investment in systems and software to collect accurate pricing and profitability data, identify profit-improvement opportunities, and optimize price levels to stem the tide of price erosion. Most technology customers today are using more sophisticated procurement tools and negotiation training aimed at reducing the price of their products and accelerating price erosion over time. Thus, manufacturers need to also employ software tools to improve price management and move away from giving up price points based on "gut feel" or the threat of losing an account.

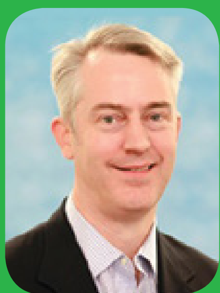
PROS provides the insight and control to allow your organization to develop and track pricing strategies based on scientifically based segmentation and correctly set floor, target and stretch pricing by product and segment. This enables you to weigh the risk of approving prices below floor and assess the impact that decision might have on price erosion management.

LEADING PRESCRIPTIVE PRICING SOLUTIONS FROM PROS OFFER:

- Scientific segmentation algorithms to ensure customers are properly segmented.
- Pricing analytics to improve full profit visibility and reduce price leakage.
- Price optimization capabilities to generate prescriptive pricing guidance for the field sales force.
- Deal management software to ensure consistent pricing rules are efficiently applied.

By employing tools that use scientific analytics to improve pricing decisions, technology manufacturers have a better chance of offering a price point that's relevant to the market with less risk of "following the competition" or relying on emotional pleas to make pricing decisions.

Bottom line: You can take back control of your price concessions and proactively shape your price erosion curves through automated price analysis and guidance. Reducing price erosion at even a slightly slower rate than currently being experienced has a huge payback when you consider the length of most product lifecycles.



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Phil Holladay is a Strategic Consultant at PROS
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To learn more about PROS pricing solutions for technology
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