Developing an Effective Pricing Strategy for a Troubled Economy

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Outline

- **Introduce frameworks for diagnosing the impact of a recession on the four C's with prescriptions for dealing with the changes**

  – **C**ustomer demand
  – **C**ompetitors and their behavior
  – **C**ompany's costs, capabilities and performance
  – **C**ontributors (such as suppliers, resellers and strategic partners) and their behavior

- **Diagnosing the impact of a recession on the four C's with prescriptions for dealing with the changes**

A Perspective on the Weak Economy

"The economic crisis doesn't represent a 'cycle' it represents a 'reset.' It's an emotional, social, and economic reset . . . Those who understand that will prosper. Those who don't will be left behind."

– Jeff Immelt
CEO, General Electric

Speech to Business for Social Responsibility Conference
November 6, 2008

How Do We Respond to a Weak Economy?

- **A declining economy implies that there is a decreasing margin of error in pricing decisions**
  - In a strong economy companies can "afford" pricing mistakes in that is possible to achieve financial objectives even with suboptimal pricing policies
  - In a weak economy pricing mistakes can threaten a company's survival

- **The "Four C's" that influence the success of a business have changed and need to be reassessed**
  - Pricing strategies and tactics need to account for those changes

The Recession's Impact on Customer Demand

- **Impact on demand will depend how customers perceive the product or service and its attributes**
- **A classification scheme based on how customers perceive products, services, and attributes:**
  - **Extravagance** – Affordable by a small percentage of the population
  - **Luxury** – Affordable by a significant proportion of the population but requiring a substantial expenditure that may require sacrifices of other goods, services or activities
  - **Discretionary** – Not necessary but affordable by most of the population
  - **Necessity** – Needed and affordable by most of the population
  - **Investment** – Not needed but may lower the cost of common activities or increase productivity or future consumption opportunities

The Recession's Impact on Customer Demand

- **Examples of Product/Feature Classification**

	Consumer	Business
Extravagance	Expensive home or vacation home, lavish vacation in an exotic location, expensive wine with dinner, Maserati	Plush offices in prime locations, private jets
Luxury	High end home remodeling, vacations staying in higher-end hotels, Lexus	Corporate boxes at sporting events, company retreats, large offices with expensive furnishings
Discretionary	Home theater components, Basic restaurant dinners, movies, optional equipment in a car, Camry	Employees that perform non-essential services, employee lounges, non-essential business travel
Necessity	Food, shelter, home maintenance, clothing, basic transportation, Chevy (or used car)	Basic office space and equipment, employees the perform essential services
Investment	Education, energy efficient appliances, Prius	R&D, advanced computers, software or networking equipment, equipment that automates manufacturing or other business processes, conferences

The Recession's Impact on Customer Demand

- **Perceptions and Purchase Intentions**

	Perceptions	Purchase Inclination or Budget Allocation
Extravagance	↑	↓
Luxury		
Discretionary		
Necessity		
Investment	?	?

Investment perceptions and purchase inclination will be influenced by the upfront cost, perceived risk or uncertainty, and the time it takes the investment to pay for itself

General pricing prescriptions

Rx

- **Reassess your market**
  - How have the size and composition of your target segments changed?
  - What changes have there been the customer’s willingness to pay for your product and its unique features?
  - How will it affect their desire to seek deals and other competitive offers?
- **Build a market model that can assist in evaluating the impact of those changes**

The Recession's Impact on Customer Demand

- **A Recession's Impact on Demand – Gross Generalizations**

	Target Market Size	Category Price Sensitivity
Extravagance	Decreases – Fewer people are (or feel) wealthy	None or modest increase in price sensitivity
Luxury	Decreases – Slight growth due to trading down from extravagances – Significant decline due to cuts in discretionary spending	Noticeable increase in price sensitivity –Need more inducement to indulge
Discretionary	Depends – Some growth due to trading down from luxuries – Some decline due to cuts in discretionary spending	Higher end - Significant increase in price sensitivity (unless trading down from luxury) – Will shift to less expensive indulgences or seek deals Low end – Depends
Necessity	Stable – Possibly some growth due to "sticking to basics" and cuts in discretionary spending	Little change, perhaps a decrease in price sensitivity – A reduced incentive is needed to get customers to trade down
Investment	Depends – Perceived value of cost savers increases, but the number who can afford or finance them decreases	Depends – Ability to afford or finance them decreases implying a higher required "ROI"

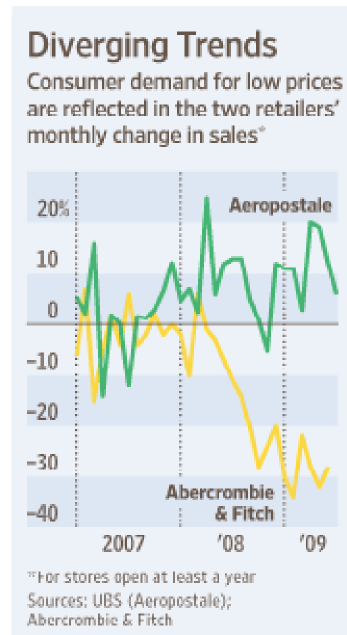
The Recession's Impact on Customer Demand

Examples:

- **Extravagances**
  – 2008 Sales of large recreational boats were down approximately 50% from the previous year - the worst decline since the Great Depression

- **Luxuries**
  – Abercrombie and Fitch vs. Aeropostale:
    - Aeropostale has lower prices and has offered discounts while A&F have avoided discounts

  – Saks Fifth Avenue's sales have been down 15% in spite of greatly increased discounting



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The Recession's Impact on Customer Demand

Examples:

- **Discretionary**
  - Movie box office sales are up 7% tear-to-year
  - Combined video sales and rental revenue is down 4% year to year
    - The adoption of the Blu-Ray standard and over-pricing it has probably contributed to this trend
    - People are finding the purchase option less attractive: Blu-Ray is often viewed as overpriced and DVD's are expected to become obsolete so people are moving to rentals or doing without
- **Necessities**
  - Wal-Mart and Dollar Stores have posted sales increases
  - Procter and Gamble has seen sales decrease as people shift to lower cost brands

General pricing prescriptions
(Based on demand factors, ceteris paribus)

Rx

– **Extravagance**
  - Try to maintain price unless a volume target is a high priority Price reductions will have limited success in attracting new customers and may jeopardize image of exclusivity
  - Perhaps (temporarily) offer lower end options with fewer frills

– **Luxury**
  - Lower price to reflect new perceptions of product or feature value
    - Price discounts may be announced as temporary to help maintain a higher reference price
    - Care should be taken to not train customers to be price or deal sensitive
  - Maintain price but unbundle luxury components or features that are costly to provide unless doing so compromises the quality image or performance
  - Maintain price but reposition as an extravagance

General pricing prescriptions

(Based on demand factors, ceteris paribus)

Rx

– Discretionary
- Determine if you are a “trade down” or “can easily live without” discretionary
  - If a “trade down” maintain price and features
  - If a “can easily live without” unbundle costly extra components or features and/or lower price

– Necessity
- Try to maintain prices
- Demand should not decrease substantially and may actually increase as customers trade down

– Investment
- Account for any changes that the recession has had on the return or risk of your offerings and adjust prices accordingly
- As necessary, try to provide assistance with financing (which requires assuming additional risk and may not help cash flow)

Quality brand names may now be considered discretionary even if the category is a necessity!

General pricing prescriptions

(Based on demand factors, ceteris paribus)

- **You should still price to capture the value of your product, but you need to realize that what customers are willing to pay for "luxury" or "discretionary" products or features has probably declined for many, if not most, customers!**
- **Changes in price sensitivity may make it necessary to redefine your target markets**

The Recession's Impact on Competition

- **Weak demand creates a big temptation to cut prices due to declining market performance**

- **Defensive competitive pricing strategies**
  - Defending Share – Cut prices as necessary to maintain share
  - Retrenching – Selectively yielding less profitable segments

- **Aggressive (Offensive) competitive pricing strategies**
  - Defending Sales – Cutting prices to maintain sales volumes
  - Opportunistic – Selectively cut prices to capture sales or share from weaker or less alert competitors

- Aggressive pricing policies run a high risk of triggering a price war!

General pricing prescriptions

(Based on competitive factors, ceteris paribus)

Rx

- **Monitor competitor prices and product offerings because they are likely to change as may their strategies**

- **Defensive pricing strategies often are wise**
  - Prompt responses will signal to competitors that aggressive pricing will lead to minimal short run benefits

- **If implementing an aggressive strategy, keep in mind that competitors are likely to respond**
  - An aggressive strategy may be successful if
    - You are better off even after the competitors respond
    - Competitors are very slow to respond
    - You can win a price war and competitors will leave

The Recession's Impact on Your Company

- **Unit sales and cash flow likely suffer**
  - Cash reserves will tend to be depleted
  - Access to credit will be more limited

- **Input costs probably have changed**
  - Commodity prices generally have dropped from their peaks in 2008, making lower input prices possible
  - Some vendors may be more willing to negotiate or discount price although probably less so than six months ago due to declining inventories and reduced capacities

General pricing prescriptions

(Based on company factors, ceteris paribus)

Rx

- **Cut production and volume targets to reduce unnecessary pressure to lower price**
  - Trying to maintain volume may trigger a price war
- **Try to reduce your costs so that you can maintain margins at lower prices**
  - Prune product lines to reduce the number of low volume products (product variety will have less value)
  - Seek out discounts or lower cost alternatives

General pricing prescriptions

(Based on company factors, ceteris paribus)

Rx

- **Provide offerings that cut out expensive extra features**
  - Features should be kept if
    - The target customer's willingness to pay (which is likely to be reduced in a bad economy) is greater than the cost
    - The feature is central to the product's performance or image
  - Example: Procter and Gamble's "Basic" lines

- **Delay the launch of new features until customers will value them more and be able to pay for them**

The Recession's Impact on Your Company's "Contributors" Ability/Willingness to Contribute

- **The consideration of "contributors" is important if the successful sales of your offerings depends on the activities of others, particularly suppliers, resellers and strategic partners**
  - Suppliers
    - They may have had their cost structure change
    - They will have increasing cash flow challenges
    - They will experience greater pressure to retain business
  - Resellers
    - They will want to cut costs and reduce exposure to risk
    - They will have reduced cash reserves and access to credit
  - Other strategic partners
    - They will be more inclined to negotiate deals that will benefit them in a weak market
    - They will tend to cut back on costly deals

General pricing prescriptions

(Based on "Contributors," ceteris paribus)

Rx

- **Dealing with suppliers**
  - When possible, renegotiate prices and terms since market pressure will tend to make them willing to work harder to keep your business

- **Dealing with resellers**
  - Encourage risk taking and forward buying through quantity discounts and possibly more generous return policies
  - More trade deals may be appropriate
  - Provide financing options that will enable them to hold more inventory or product variety

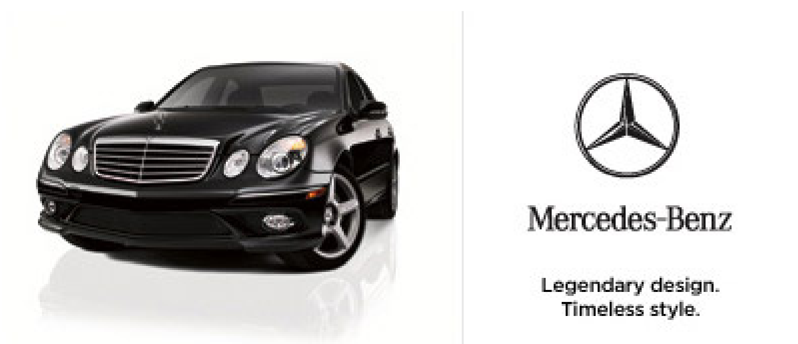
General pricing prescriptions

(Based on “Contributors,” ceteris paribus)

Rx

- **Work with strategic partners to develop offers for which the perceived value of the offer is significantly greater than the cost**
  - Customers are encouraged to consider discretionary items they might not consider otherwise
  - Doing so may give the perception of a price deal without necessarily having to cut price

- **Example:**



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Where Will Our Economy Go From Here?

- **Consumer spending will probably continue to decline over the near future**
  - They will continue to pay down debt
  - The ability to fund purchases though borrowing will be limited
  - Job losses will probably continue, leading to a greater incentive to build saving and reduce spending
  - Some of these effects may be offset by
    - Increases in expected net worth coming from improvements in the equities and housing markets
    - New high value products, primarily in the technology industries
- **The recession will likely end in a formal sense in the next 3 to 6 months if it hasn’t done so already**
  - Inventories have been reduced and production will need to be increased to replenish them or maintain them at reduced levels
  - Government spending from the fiscal stimulus should offset reductions in consumer spending

Where Will Our Economy Go From Here?

- **The longer term health of the economy will be highly dependant on fiscal, monetary and trade policies**
  - Since most consumers will probably need several years to deleverage, fiscal stimulus will probably still be needed to avoid a second dip
  - The Bush tax cuts will expire next year which will exert downward pressure on spending unless they are renewed or replaced with other tax cuts
  - Monetary policy will need to remain loose until the banking system starts lending again or else tighter money and high interest rates will choke off growth
    - The Fed will need to move rapidly to raise its interest rates when banks start to lend or we run the risk of inflation
  - Improving our balance of trade will speed the economic recovery
- **The economy will be in a precarious condition over the next several years and price policy should account for that fact!**

Pricing When the Market Recovers

If you're serving a market that is recovering:

- Realize that "unfair" price increases will motivate customers to seek out alternatives
  - Be careful about raising prices unless you are confident competitors will match!

- The psychological effect of a price increases can be ameliorated by:
  - Adding value along with the price increase
    - Introducing "new and improved" versions of the products and perhaps offer temporary incentives to encourage trading up
    - Dropping low end products from the line or deemphasizing them
  - Making the price increase less noticeable
    - Change the unit of measure
    - Drop subtle "free" value-added features without commensurate price drops
    - Reduce the frequency and depth of discounts
    - Require larger quantities to qualify for quantity discounts

QUESTIONS??

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