PRIVATE EQUITY PERFORMANCE IMPROVEMENT

SEALING OFF THE CRACKS IN THE LONG TAIL OF YOUR PRICING STRATEGY

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In our three-part series, "Show Me the Money, But the Right Money Please!" we discussed the framework for an effective commercial strategy that drives profitable growth and margin improvements.

In this article, we cover margin transparency as well as pricing and margin recovery, specifically as they relate to smaller customers that usually don't receive a lot of attention.

A&M COMMERCIAL EXCELLENCE APPROACH

Product Portfolio Optimization
Ensure the product portfolio and new product pipeline maximize profit opportunity

Pricing and Margin Recovery
Ensure that costs to serve are recovered and pricing captures maximum value

Segmentation and Channel Optimization
Understand the market drivers, how to differentiate by segment/channel to optimize the sales organization design

Sales Force and Market Coverage
Optimize the size and structure of the sales force and ensure it is properly incented to grow profitable business

Sales Process and Operations
Ensure leads are efficiently generated and converted into profitable sales, and sales is held accountable to KPIs and metrics

Margin Transparency
Determine where money is actually being made at the customer, market, channel, category, and SKU level by unpeeling margins and cost-to-serve

Market Transparency
Understand market trends, competitive dynamics, growth opportunities, and customer and end-user behavior and purchasing decisions

IMPACT OF COMMERCIAL EXCELLENCE:

- **Performance Improvement Plan:** Identified, quantified, and prioritized opportunities to improve performance and cost structure
- **Execution Roadmap:** Action plan to execute on the restructuring, e.g., finalization of detailed structure, selection, seperation, etc.
- **Cost to Serve Model:** Repeatable tool for clients giving visibility into customer, SKU, and product category profitability

Targeted Pricing Strategies for Low-Margin Customers

Pricing can be both the most powerful and the most dangerous tool in value creation. A 1% price increase for a company with a 10% EBITDA margin could improve EBITDA by 10%. However, excessive price increases can erode sales volumes, reduce overhead cost absorption, and initiate a vicious cycle of profitability erosion. These drivers can be further exacerbated by a dynamic market undergoing significant change and uncertainty. This means that targeted pricing adjustments, rather than one-size fits all price increases, may yield the most favorable results.

Firms often overlook pricing opportunities with their lower tier customers, which tend to have higher relative costs-to-serve, and focus too much attention to top tier customers, which account for the majority of revenues and margin. Careful analysis of the cost of serving different groups of customers and the values they assign to the company's products can reveal significant pricing opportunities for both smaller and larger customers.

Evaluating opportunities and addressing pricing leakage typically involves five steps:

- **Analyze the total cost to serve and true profitability of all customers.**
- **Assort customers falling through the pricing cracks by their strategic importance and degree of opportunity.**
- **Assess each customer's sensitivity to price increases based on the value the product creates for them.**
- **Action a specific price increase plan for the customers where value is being left on the table.**
- **Administer the systematic review of product portfolio profitability and complexity to inform price increase opportunities.**

ANALYZE

All repricing initiatives should begin with a cost-to-serve analysis. Even with effective cost systems, the total cost-to-serve for lower-tier customers tends to be understated, typically as a result of under representation of economies of scale and an overly simplistic application of the various drivers of cost-to-serve. Better understanding of costs should address fairness objections, as the unit cost to serve lower tier customers typically turns out to be much higher than expected. This should also allay fear of lost sales if those sales turn out to be unprofitable under scrutiny.

Margin Transparency

Material costs are usually well understood, even in industries with commodity inputs such as plastic resin or steel, which can change rapidly. However, it is common to see less rigor in the application of direct labor and significantly less rigor in the application of overhead costs to products. Overhead costs, in particular, are often applied as "peanut butter" across all products by a metric as simple as a flat percentage of revenues or some basic volume metric, rather than applied on a more granular level based on more sophisticated cost drivers. Basing overhead allocation on the underlying economic drivers of cost can lead to a dramatic rethinking of cost and profitability. In one example, a manufacturing company applied overhead costs, per pound, to its products. However, the production rates in pounds per hour varied by an order of magnitude across the various product lines. Reallocating overhead based on an hourly rate instead of a per-pound rate gave new insight into cost and profitability resulting in exiting of certain product lines and a variety of price adjustments.

Total Cost-to-Serve

Beyond allocating direct and indirect manufacturing costs to products, setup and changeover costs and scrap rates for small orders are often not applied directly to those orders but taken as averages. Similarly, the costs of selling and administering specific customers are rarely measured and often allocated as percentages of revenue to a customer, if at all. These costs can actually be quite sensitive to scale as the effort to take a $1 order, invoice it, and manage accounts receivable on it, could be the same as the effort on a $1 million order.

Even more pernicious are the various uncompensated costs of doing business with difficult customers. Typically, these pain factors include:

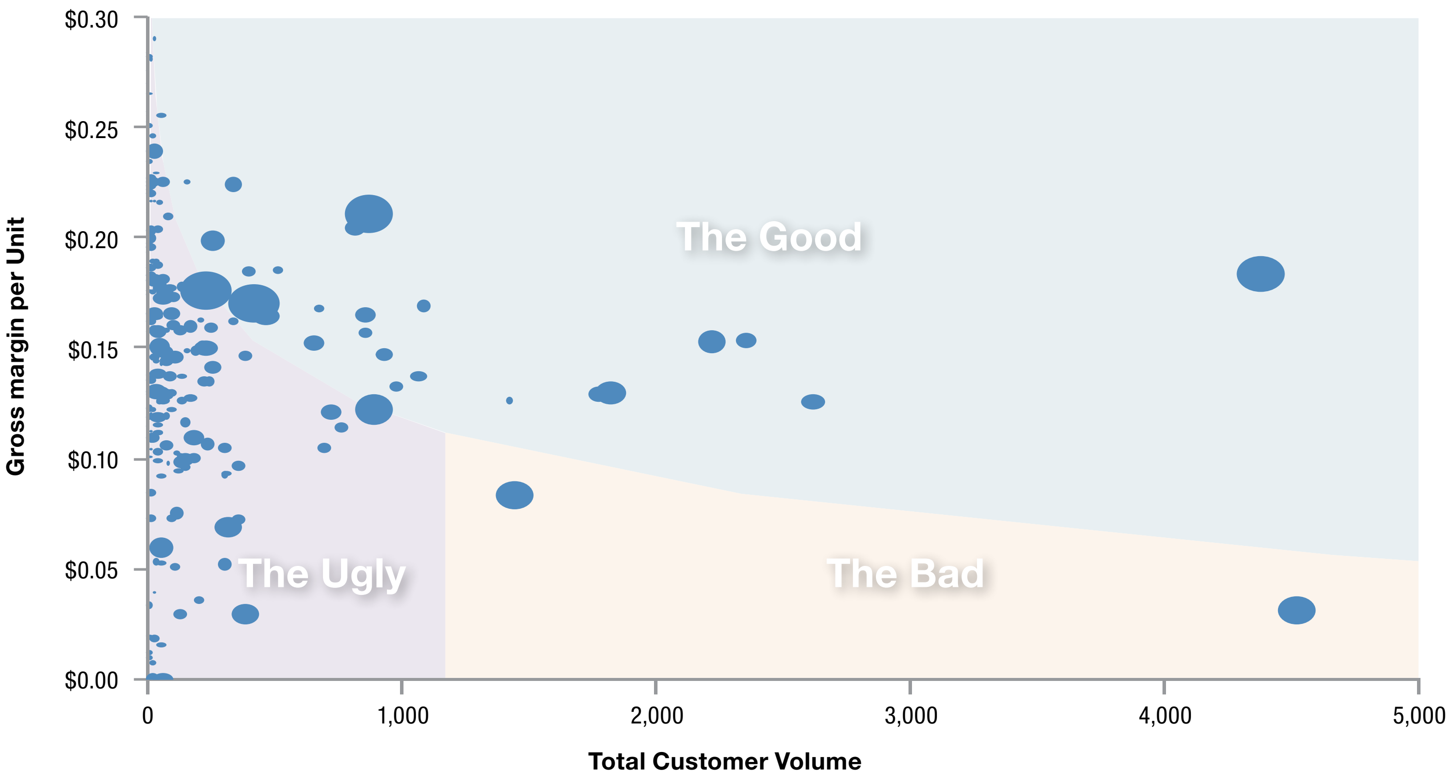
- Auxiliary orders (small orders tacked onto large orders that are costly and made-to-order)
- Uncompensated changes of scope on services
- Unique product customizations
- Special handling requests
- Rush orders
- Orders held in consignment indefinitely
- Slow payments
- Credit risks

As a result of implementing a more detailed application of these costs, unprofitable sales relationships can be identified and handled accordingly.

ASSORT

Even when significant rigor is applied in developing and implementing a pricing methodology, companies still frequently leave money on the table. Typically, the beneficiaries are underpriced smaller and infrequent customers ("The Ugly") that find themselves receiving prices designed for top tier customers. Also, problematic ("The Bad") are large customers with significantly lower margins than their peers after accounting for costs-to-serve.

TYPICAL UNIT GROSS MARGIN BY CUSTOMER



Size of bubble represents customer average order size
Source: A&M analysis

Typically, the smaller low-margin customers manage to fly under the radar and receive most-favored-customer pricing due to several factors:

- **Focus**: The company tends to spend its energy thinking about how to serve and price top tier customers which account for the majority of sales.
- **Fairness**: The company doesn't want to give lower tier customers what it mistakenly perceives to be an unfair higher price, failing to take into account the potential disproportionate costs of serving these smaller customers.
- **Fear**: The company is afraid of losing sales, especially when it perceives lower tier customers as already having a relatively high unit price.
- **Faith**: The company clings to the hope that treating a small customer like a large one will grow that customer into a top tier customer.

ASSESS

Understanding the value created by the product, especially for smaller customers, should further relieve fears of mass customer defections from a targeted price increase. Overcoming objections to raising prices requires evolving the understanding of what the customer values. All customers value specific features and benefits of the product as well as things like availability and service. However, these attributes can have a dramatically different value for low tier customers than they do for top tier customers. For example, a customer that needs a small quantity of an item may specifically value availability and convenience more than price because the item represents a minor spend category, and thus it is not worth it for that customer to spend time searching for an alternative vendor unless there has been an issue with a previous purchase to trigger the effort.

Customers with potential that are being treated as if they have already reached that potential should be carefully assessed. If such a customer truly presents a growth opportunity, specific action should be taken to exploit that opportunity rather than simply pricing them as a key account. The growth should be driven by an understanding of what creates value for that customer and leveraging that knowledge rather than just price.

ACTION

Pricing Paradigms

Pricing typically follows some variation or combination of one of a few paradigms such as cost-plus-pricing, market pricing and value-based-pricing.

The most basic, cost-plus-pricing applies what is perceived to be a reasonable or customary profit margin above cost. Money can be left on the table if this price does not reflect the value that the customer receives from the product. Conversely, high manufacturing costs with a margin applied can result in a price that is too high, resulting in lost sales. This leads to a vicious cycle of greater unit costs from lost scale economies resulting in further price increases and lost sales.

Market pricing is common in commodity markets, where each competitor sells a product that meets the same specification. If this method is used for non-commodities, value can be left on the table when a product exceeds the standard specification, creating incremental value that is not reflected in the price.

Value pricing is a combination of various techniques of splitting the market into segments, based on the value customers derive from the product. This enables capturing a larger portion of that value. One technique includes creating different versions of the same product, each value engineered to meet the needs of a particular segment and priced appropriately. Value pricing can also mean segregating the customers themselves by allowing them to self-select based on terms and conditions such as sales timing and pricing structure or on identifiable characteristics such as demographics or location. The problem with this approach can be a proliferation of SKUs created for increasingly smaller and smaller segments – down to the individual customer – which can ultimately cause complexity in the business and introduce significant cost.

Margin Recovery

The significant opportunity of a targeted pricing action should draw renewed focus to maintaining pricing vigilance across all customer groups. At one client, a significant price increase for certain groups of low-margin smaller customers and a smaller price increase for similarly unprofitable large customers increased prices in aggregate by more than 1%. This was done without harming the relationship with the most important and profitable top-tier customers.

Targeted Price Increase - Disguised Client Example

($ in thousands)

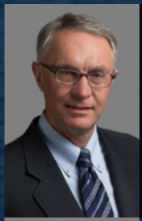
	Total Sales	Percent of Total	Percent Increase	Price Increase	Share of Increase
The Good	$80,000	50%	0.0%	0	0%
The Bad	$50,000	31%	1.6%	$800	44%
The Ugly	$30,000	19%	3.3%	$1,000	56%
	$160,000	100%	4.9%	$1,800	100%

Often, a price increase can actually be designed to directly relate to the original source of margin leakage. For example, if a customer is costly to serve because they frequently cause disruption to the manufacturing process by ordering items that are not made to stock, simply raising the base price of the product may not change the customer's behavior. Instead, a changeover fee, rush-order fee, or order processing fee can recapture the cost-to-serve while simultaneously creating an incentive for the customer to improve their ordering behavior. Implementing price increases as surcharges for high costs-to-serve also lessens concerns over price discrimination. By aligning pricing changes to focus on smaller, less-influential customers, a firm can realize significant incremental EBITDA gain without rocking the boat with strategic accounts.

ADMINISTER

To permanently seal off the cracks, refining the cost-to-serve model and reviewing customer profitability needs to be a part of the regular business cadence. In most cases, companies regularly review gross margin of their product lines, but do not have visibility to the net margin that is gained through the allocation of overhead and miscellaneous uncompensated costs. By regularly reviewing costing methodology and granular margins by product family, SKU, channel, and customer, additional opportunities and areas of margin leakage may be identified. Identifying opportunities and effecting change are never easy, but a careful approach that minimizes risk can be a great way to drive immediate EBITDA improvement and train the organization to use pricing as a tool for driving profitability.

KEY CONTACTS



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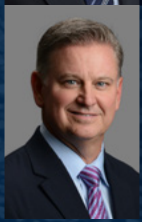

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