Jumpstart Your Innovation Budget with Strategic Pricing Segmentation

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Many manufacturing businesses struggle to meet high demands for growth from innovation with limited cash and other constrained resources. Companies look to their existing product portfolios to fund innovative, “big idea” projects, but often feel powerless regarding pricing. Several challenges have contributed to systematic margin erosion in manufacturing industries including powerful, sophisticated buyers that dictate price, and foreign competition that threatens to commoditize existing product offerings.

So how can manufacturers identify “quick win” opportunities to generate cash and free up resources? Let’s explore several pricing strategies that companies can execute to drive incremental profit improvement and fuel sustainable growth.

Strategies that Utilize Customer Segmentation
Customer segmentation analysis can help manufacturers recognize differences in value perceptions, motivations and willingness-to-pay across groups of similar buyers. A simple and effective framework for segmenting customers plots customer priority against purchase behavior. Bucketing customers by relative strategic importance (e.g., A, B, C) along one axis, while classifying their key decision drivers along the other, helps define a manageable number of segments from which pricing and service tiers can be developed. Analytical tools such as value mapping can be used to approximate the right price for each segment.

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Let’s look at a real-world example. A Kalypso client, an automotive supplier, observed that one of its “big three” automaker customers did not value the array of services it provided – including engineering support, quote and order expediting, quality guarantees, short lead-times and a high-touch customer service relationship. This customer based its supplier selection solely on unit price, while for other customers, these services were important drivers of their supplier choice.

Through customer segmentation, this client was able to offer price-sensitive customers a lower price “no frills” service. When these customers required more services, they paid for premium services on an a-la-carte basis. Meanwhile, customers paying full price received a higher standard level of service. Customer service organizations often want to provide every customer with the highest level of service, but it is important to control this dynamic to prevent these price-sensitive customers from becoming less profitable.

As seen in this example, customer segmentation should match pricing and service offerings to customers on a cost-to-serve basis. Larger customers can have a lower willingness-to-pay, because they are generally more self-sufficient. Low priority customers (Segment 4 in Figure 1 above) should be managed carefully. The hidden costs of doing business with low volume customers, particularly those with limited growth potential, can be perilous.

**Strategies that Tune Prices across the Product Portfolio**

Portfolio profitability analysis can be used to identify clusters of product lines and transactions that should be re-priced or eliminated. Figure 2 below demonstrates how managers analyzing the profitability of the portfolio of products can formulate pricing strategies for each segment.

![Product Portfolio Profitability Grid](image)

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For a particular product line there may also be specific situations where the product offering is differentiated, for example when competitors cannot match lead times or quality levels. It is important to identify such factors in order to maximize price capture. Here again, value analysis tools such as value maps and value waterfalls can be helpful in quantifying non-price value drivers.

For manufacturers of custom products, small orders can be a significant source of organizational complexity. In one manufacturer client example, Kalypso found that 33% of total orders contributed only 5% of gross margin. Yet an equal or greater effort is often required to process orders below economic order quantities.

Enforcing a minimum profit threshold at the transaction level is a quick way to shed unprofitable business, reduce complexity and boost profitability. Manufacturers that provide customers with the convenience of ordering in small quantities or small release sizes must appropriately monetize this value-added level of effort and service. Policies such as multiple-release fees and annual volume commitments can also be effective in aligning pricing with the underlying economics of production and encouraging customer behaviors that maximize profit. Customers that are unwilling or unable to increase their order size might have the option of paying premium fees or they can be routed to purchase through a distributor.

**Institutionalize Commercial Processes that Enable Profit Maximization**

When diverted to innovation and “big idea” growth initiatives, the cash and resources resulting from these pricing initiatives can enhance the profitability of manufacturers’ portfolios. But to sustain success, it is critical that leadership is committed to investment in pricing systems, tools, and capabilities. Management and sales organizations should focus on (and be rewarded for) increasing profitability in addition to revenue, and must have the internal resolve to hold the line on rational price increases.