OLIVER WYMAN

This piece was published before the May 2007 rebranding of Mercer Management Consulting, Mercer Oliver Wyman, and Mercer Delta Consulting as Oliver Wyman.

Oliver Wyman

Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

www.oliverwyman.com

MARSH MERCER KROLL
GUY CARPENTER OLIVER WYMAN

Finessing the Discount Price Challenge

How value engineering improves profitability

By Jacques César, Stephen Brien, David Trounce, and James Bacos

The rise of discounters has pinched margins and threatened the business model of many traditional retailers. There are ways to fight back, however, ranging from improving consumers' perception of a store's value to optimizing prices on the products that really matter.

Without doubt, the most successful retail format to emerge over the past fifteen years is that of discount retailing.

In the U.S., Wal-Mart, Costco, and Home Depot dominate their categories, and discount retailers have doubled their share of retail sales to almost 20%. In Europe, Aldi and Lidl outstrip their German competition in terms of growth and profitability and have successfully exported their hard discounting model to 16 other countries. Discount retailers in Germany account for over half the market. This trend is accelerating in France, Italy, Benelux, the U.K., and Scandinavia, driven mostly by new entrants.

Why is the format so successful? At one level, the answer is simple: Customers perceive that discount retailers provide better value than traditional formats, and price image is a crucial part of that view. There is a clear relationship between retailer profitability and positive price perception.

Why do discount retailers have such a strong value-for-money perception? Again, the answer is simple: Their value "reality" matches the perception. These retailers have an everyday-low-pricing strategy, consistently offering products and services of comparable quality and scope at prices far below those of traditional retailing formats. Everyday shelf pricing, much more than promotional prices or other marketing levers, is the single most important driver of value perception. Everyday low pricing has the added benefit of being an easily communicated, uncomplicated positioning.

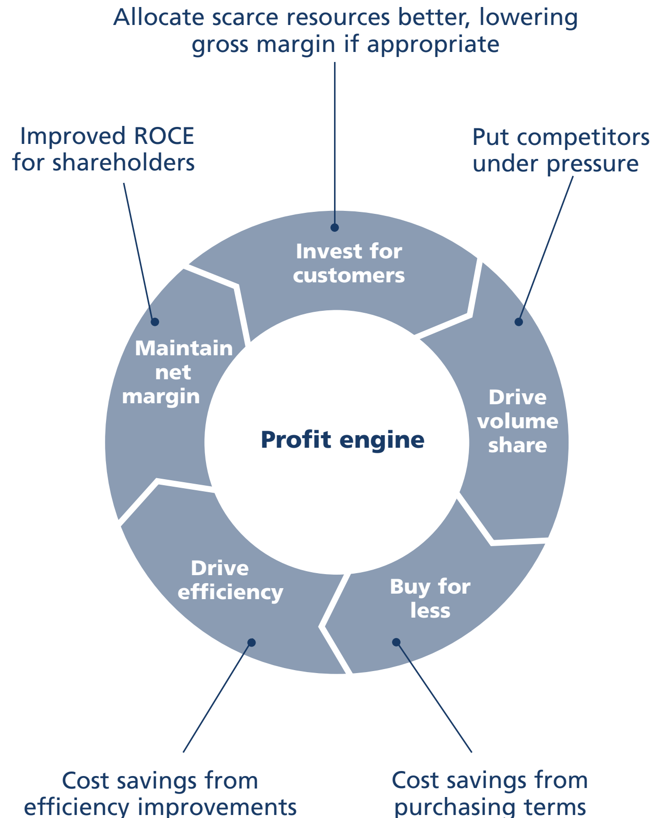
The challenge posed by low-cost players is formidable. Many of them use a profit-engine logic to increase both sales and profits through relentless price cuts (Exhibit 1). These discount offerings are combined with a powerful business model characterized by "big box" minimum-overhead stores, located in low-rent areas and backed up by sophisticated supply chain and management systems. They are increasing net margins even while squeezing their own and competitor gross margins, using their large volumes to buy for less and then reinvesting in price reductions to generate further market share gains.

Jacques César is a London-based managing director, Stephen Brien is a London-based director, David Trounce is a San Francisco-based principal, and James Bacos is a Munich-based director of Mercer Management Consulting. They can be reached at jacques.cesar@mercermc.com, stephen.brien@mercermc.com, david.trounce@mercermc.com, and james.bacos@mercermc.com.

How can traditional retailers respond?

Only a small number of traditional retailers have the option of repositioning themselves as value retailers. Most others find themselves constrained by their heritage of smaller stores, inferior economics, incompatible brand positioning, and an internal culture that would make such a change very difficult. For the vast majority, the only way to thrive, not to mention survive, is to stabilize the situation and claw back some of the perception advantage that has been gained by discount chains.

Exhibit 1 **The low-price steamroller**



Mainstream retailers must develop a strategy that creates value for the customer in a different way, while by necessity charging higher prices than value retailers (but not too high). The challenge is to find a position in the market that will generate sustainable value positioning and move the business toward that position. That is done through a combination of value levers that influence both perception and profitability. A good starting point is to determine what combination of offer and value perception improvements will serve to achieve the objective of reaching "fair value."

Our work helping retailers to do that in the U.S., U.K., and continental Europe has generated a highly effective approach for fighting back, allowing companies to regain share, at a profit. This approach has several elements:

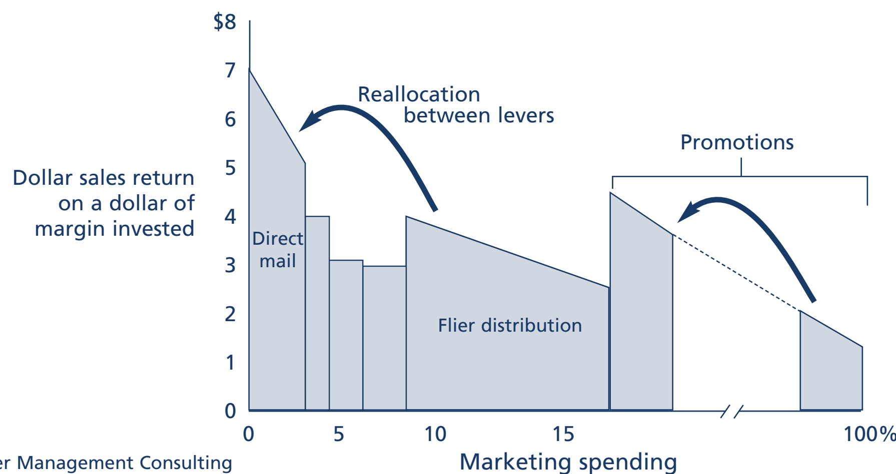
First, traditional retailers have no choice but to improve their value reality. The common response of raising prices in the face of defecting customers is not sustainable. Instead, retailers should adopt a continuous and hard-nosed focus on cost reduction, where a substantial proportion of the benefit is passed on to the consumer. Of course, cost reductions may not be enough to create a sufficiently competitive value reality, raising the issue of how to finance lower prices. We will discuss how companies can find internal sources of finance.

Second, traditional retailers must provide a depth of assortment that discounters either cannot or do not wish to provide, such as a paint store that carries more colors and finishes than does Home Depot and whose staff has deeper expertise. By adapting product ranges to the needs of specific customer segments and local demographic tastes, traditional retailers can attack the weakness of the standardized, high-volume, lowest-cost, low-differentiation value retailing model. For example, the U.K. grocer Tesco has maintained a strong position with a differentiated offer.

Beyond high-level repositioning of price and range, the most effective way for traditional retailers to respond is by mastering the discipline of *value engineering*. By that we mean reallocating investments toward those areas with the greatest return, both financially and in terms of value perception (Exhibit 2).

Exhibit 2 **Invest for the greatest return**

Reallocate marketing investment from low- to high-return activities, such as from flyers to direct mail, or from one type of promotion to another.



Source: Mercer Management Consulting

All companies make explicit allocation decisions with respect to value levers. An everyday-low-pricing player invests in value through only one lever, price. The investment takes the form of lower gross margins. Other players invest less in price and more in the form of promotional activities such as "buy one, get one free." Still others invest in a broader set of marketing levers including not only price and promotion, but also loyalty points, coupons, and direct marketing.

What's important for an individual retailer is to predict accurately how customers will react to changes in marketing levers and determine what that means for the retailer economically. The retailer must get a handle on all customers' elasticities for price, promotion, flier distribution, direct mail, and so on, at the granular levels of store, sub-category, and postal code. This way, it can predict how much volume it will gain or lose as a result of increasing or decreasing investment in a particular lever. In addition, the retailer needs to understand the complex cannibalization relationships within a product category, as well as indirect relationships across categories such as the one that exists between diapers and baby food.

At the most basic level, value engineering helps retailers decide what price, as well as what level of promotion or other activity, should be offered. At a more subtle level, it generates optimal decisions for pricing and promotion by product category. At its most powerful level, retailers can optimize their decisions store by store and regain not only a longer-term perception advantage, but also a shorter-term financial one.

There's a lot of flexibility to the value engineering approach. It can be used to help reposition retailers to compete more effectively against discounters; it can also be focused more narrowly to generate sales uplifts without sacrificing margins, or margin uplifts while maintaining sales growth.

Walking the fine line

Consider how a major drug retailer improved its position by finding the most effective places to cut prices, offset primarily by cuts in promotions that had minimal impact on volume. The company had faced aggressive price cutting by key competitors and had allowed some large differentials to open up on those product lines that staff did not explicitly price-check. As a result, the company's value perception was poor, despite offering an extensive promotions program.

Dramatically improving value perception to protect and strengthen market position over the long term then became a strategic imperative for senior managers. The primary vehicle for improving value perception and sales, without significantly altering the stores or product offer, was to initiate a program of high-impact, communicated price cuts. However, it takes time to change customer perception about such price reductions, which can significantly squeeze profits in the short term if the problem is not addressed.

Senior managers realized that their ability to invest in selective price cuts would be limited by the amount of funding that they could find from other sources to fill the profit hole that would be opened up. The inherent risks had left them in limbo for months.

In many situations, this financing would have been done through cost-cutting across the business; in this case, however, these funds were already accounted for and being used to counter more general price deflation in the market. Consequently, managers looked to other sources of funding.

Early improvements in price perception had the potential to make the program profit-neutral over the medium term. Hence, staggering the price cuts and their funding in waves was one way to manage the financial impact. Managers also knew that the potential benefits would vary widely depending on how price cuts were made and in what areas of the business. The key was to find the most responsive stock-keeping units (SKUs) in the product categories most likely to drive perception and sales, such as shampoo and hair colorants.

These moves still might not fully fund the price investment, so the firm made further shifts in price and promotion levers. In particular, it made selective price increases on product lines with low perception impact and made extensive changes to the promotional policy, based on a detailed understanding of product cannibalization and the mechanics of supplier funding to generate additional internal funding. The levels of cannibalization are often much higher than realized and are especially costly for promotions, as discounted products reduce sales of comparable products that otherwise would have been sold at full price and full margin. For this drugstore, diapers and wipes were found to be products whose promotions were highly cannibalizing.

A year after implementing these moves, the drug retailer has already seen excellent results. It has improved customer price perception against all major competitors, and the positive cash flow impact is on target to meet plans. It has been able to quantify both the medium-term perception benefits and short-term economic cost of cutting prices on each product line through an understanding of price elasticities, perception impacts, margins, and competitor price levels at a product and sub-category level.

The mechanics of driving price perception

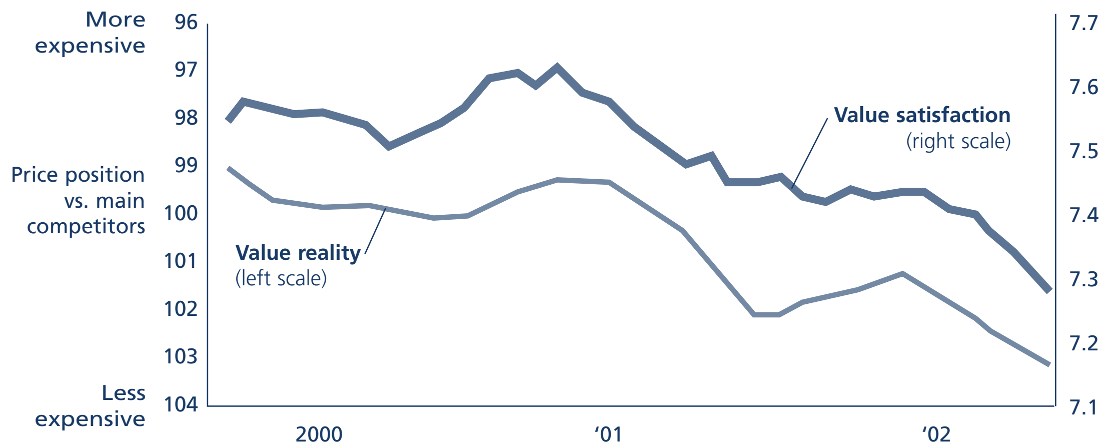
Price changes that improve profitability need to be balanced with a strong improvement in customer perception improvement in order to maintain customer satisfaction over the long term. The value perception of any offer to consumers is driven not just by price, but also by other fac-

tors including promotions, marketing messages, and broader customer touch-points, such as the range architecture (especially entry-level products) and store fit-out. Across retail sectors and companies, perception boils down to three things: the value reality of actual prices charged, value communication, and selective signaling elements of the offer.

Value reality

Typically, changes in value perception over time can be closely tied back to changes in value reality, and in particular to price (Exhibit 3). Indeed, price plays a significantly larger part in forming perception than do promotions, whose temporary nature and higher list prices are discounted by consumers.

Exhibit 3 **Perception closely tracks reality**



Source: Mercer Management Consulting client

Furthermore, certain categories and products are highly influential in driving value perception, namely products that are frequently purchased, directly comparable, and important to the consumer or the buying occasion. For example, in a drug store, core items such as toiletries and hair care are much more important than the non-core, grab-and-go food. For a supermarket, this relationship could be reversed, because core food products would drive perception. There are key value indicator products and they are more concentrated in some categories than others.

The lesson: Retailers should aggressively manage the pricing of categories and products that are strong drivers of value perception.

Value communication

Retailers with a disadvantage in customer value perception often discover that their communications to customers lack a clear value theme or emphasize products that have little influence on perception. The gap widens when consumers compare them to the continual messages by value retailers that reinforce everyday low pricing.

Different value messages have varying degrees of effectiveness. The highest impact messages feature the products that drive value perception, are reinforced within the store, and are appropriately positioned. For example, a product that is a key perception driver for a small segment of customers, such as diapers or cigarettes, should be communicated at the point of sale, whereas mass media advertising should be reserved for products that are widely bought, such as detergents.

The lesson here: Support the price management program with the right message and media plan, ensuring that each wave has sufficient mass so that the in-store impact is forceful.

Selective signaling elements of the offer

Two elements in particular can play a strong role in influencing value perception: range architecture emphasis and store fit-out level. Retailers that emphasize higher-end range architectures, skewed toward branded and higher-priced goods, face an immediate perception disadvantage. The lack of lower-end, entry-level products in the range can have a huge negative effect on perception, far beyond the actual offer reality.

The same holds true for store fit-out level. While the process of refurbishing stores to upgrade their feel can be a sound investment to attract and retain customers, retailers need to be careful. Too much visible improvement, or too high a standard, can have the perverse effect of eroding value perception in the eyes of some customer groups who feel that they are paying for the upgrade in the form of higher prices—which to some extent they are. Thus, it is critical to ensure that you have appropriate entry-level SKUs in all perception-driving categories and to invest only in those upgrades that support a value message.

While in the medium term it may be possible to influence value perception through changes to the range of products, in the short term value reality and the communication of value are likely to be the priorities. In particular, communicated price cuts probably hold the greatest potential to drive perception improvements.

The key to maximizing value perception for a given level of value investment is to prioritize sub-categories and lines for price cuts according to the return they deliver. To do so requires a quantitative understanding of the relative impact these drivers have on forming positive value perceptions.

Funding lower prices

As noted earlier, most of these investments in price perception have a significant short-term financial impact. The other side of value engineering is concerned with mitigation, the art of generating the required funding sources.

A U.S. regional grocery chain operating with very thin margins needed to improve its profitability without ceding ground to powerful competitors. It competed in a transparent market, where it appeared that margins were squeezed between the risk of a volume collapse if prices were raised and a price war if they were dropped.

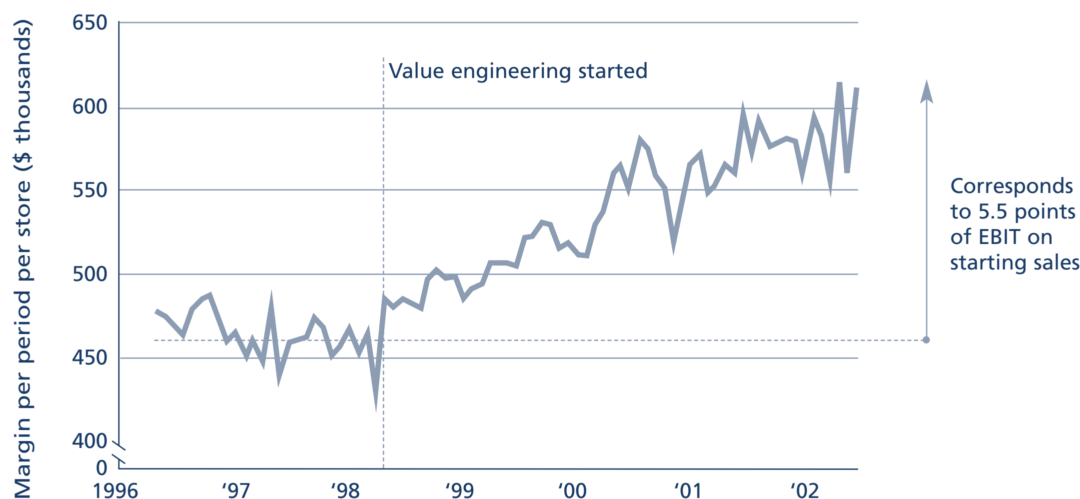
The effective response was to raise prices in some stores and categories and lower them in others. This meant extracting value by moving prices up in situations with low gross margins and low consumer responsiveness. For example, it was worthwhile raising prices on fruit such as apples and pears, particularly in stores without much competition, to increase cash margin. Then, the grocer could partially reinvest the cash into price cuts in high gross-margin, high consumer-responsiveness areas such as ready-made meals and sugar. The rest of the cash margin would fall to the bottom line.

The scale of the reallocation required meant that it could not be all done in one step. So the grocer made staggered and selected investments in waves. In the first year, prices were moved and the promotions program was redesigned. Subsequently, a direct marketing campaign was launched, focusing on the customers in battleground zones. By observing how both customers

and competitors reacted to all these initial moves, it was possible to identify several further moves and make changes with greater confidence.

As these actions produced a positive effect on the business, the organization and systems evolved to support a more sophisticated approach. This evolutionary yet systematic approach has meant that same-store sales and margins have increased substantially ahead of the competition over a multi-year period (Exhibit 4).

Exhibit 4 **Value engineering raises trading margin**



Source: Mercer Management Consulting client

Growing revenues without damaging margin

In another case, a do-it-yourself home retailer was being prepared to be sold by its parent company. Previously strong sales growth was slowing and it was imperative to jumpstart the sales engine again without sacrificing margin. The key was to identify those product categories where an investment in price would generate the greatest sales uplift, while finding an efficient source of funding for the investment.

A controlled price experiment gave the company key information on what these products were, how consumers would react to price cuts and affect volumes, and what the economic implications would be. Hence, managers could identify where it was most worthwhile to invest.

They funded this investment by pruning a significant portion of their promotions program, a rich source as the company in the past had underestimated the effect of cannibalization. Because there are diminishing returns to promotional activity, once a critical mass of well-communicated promotions have been achieved, there is little incremental store switching that will be triggered by increasing promotional participation. This is especially true of standard, long-shelf-life products. The do-it-yourself operator had a long "tail" of unprofitable promotions that could be cut.

* * *

Pricing strategy tends to be driven by the broad economics of the industry sector and each player's position in it. Value engineering tactics, on the other hand, are the most effective drivers of the microeconomics of the business. They should be based on a detailed understanding of how customers, competitors, and suppliers will react to changes in the way the firm operates.

Until recently, it was difficult to find a practical approach to determining price elasticities that could be used to make investment decisions among various value levers. Software-based approaches have tried to address this problem, but because software tends to oversimplify a retail environment, using software alone has frequently led to wrong answers or very short-lived gains.

Fortunately, a growing body of knowledge has been effective in understanding customers' price elasticities category by category and store by store. This detailed knowledge has provided the basis for many retailers to transform their profitability without transforming their enterprises, their infrastructure, or their underlying strategies. Companies have found ways to generate up to 2 percentage points higher sales margins and up to 4 points higher same-store sales, allowing them to counter the discount challenge. ❖