

P R E S S R E L E A S E

**Oliver Wyman "Value Pricing" study
The unfounded fear of price rises**

- **The capital goods industry lags behind other sectors when it comes to pricing**
- **Only around seven percent of companies systematically apply value-based pricing**
- **Modern pricing models can vastly increase the profitability of the capital goods industry**

Munich, April 17, 2007 – Even though they recognize the need for a better pricing process, only around seven percent of the manufacturers of capital goods have used sophisticated pricing methods to date. These are the findings of a recent study by Oliver Wyman. Profitability can be enhanced more effectively by raising prices than by cutting costs or increasing revenue alone. But the pressure on prices is high and is growing further, which explains why many manufacturers are hesitant to raise their prices. In practice, however, it is evident that price rises have a far smaller impact on sales than many companies fear. Innovative pricing models play a key role in ensuring customer acceptance of price increases. They are based on systematic approaches backed by solid market research. Oliver Wyman's "value pricing" approach replaces the traditional pricing concept based on the manufacturer's cost and expense with a model built around the value created for the client. This pricing method makes it possible to identify the customer's needs with a view to optimizing both offerings and prices to the benefit of both parties.

At four percent of revenue, the profitability of capital goods manufacturers has remained at a dangerously low level over the last ten years. Up until now, companies have for the most part tried to improve their dissatisfactory profit situation by cutting costs. According to a new study by Oliver Wyman, 39 percent of Europe's capital goods manufacturers are applying cost-cutting programs today; 36 percent are trying to achieve lower unit costs by raising sales volumes; 25 percent of companies are optimizing their prices, although a mere seven percent are employing modern pricing instruments. Prices in the capital goods industry are still being set mostly by instinct and experience instead of on the basis of structured customer analyses. Nevertheless, more and more companies are recognizing the profit potential of pricing. In the Oliver Wyman study, they expressed their intention of putting a greater emphasis on pricing in the future.

The pressure on prices is increasing

"Most manufacturers of capital goods view prices as a parameter set by the market, over which they have little influence," says industry expert and Oliver Wyman consultant Thomas Kautzsch. "But even small price increases already have a huge impact on the profit situation." For the average revenue margin in the industry, a one percent rise in prices yields a 25 percent hike in EBIT, whereas a one percent reduction in fixed costs boosts pre-tax profit by a mere ten percent, calculates Kautzsch. In addition, the cost-cutting potential has already been largely tapped in the industry and in many cases can only be realized by making painful cutbacks on the personnel side. Consequently, price management has become top priority for company executives in many sectors.

The Oliver Wyman study shows that the prices for classical capital goods like machines are under strong pressure these days – and that this pressure is set to increase further over the next few years. The factors affecting price pressure cited most frequently by the companies surveyed are mature technologies without opportunities for differentiation together with industry consolidation and the competition from low-price vendors. Added to this are growing price transparency, the increasingly efficient purchasing functions on the customer side, the dwindling number of customers, and shrinking markets.

Oliver Wyman calculations indicate that the 500 biggest European manufacturers of capital goods alone are today missing out on a profit potential of a billion euros each month as a result of poor pricing. Oliver Wyman consultant Kautzsch sums up: "Companies are giving away up to 25 percent of their profit potential by making too little use of the price lever."

From traditional pricing to value pricing

Which pricing method is the right one depends on the company's situation. "The range of pricing models is very broad," explains Kautzsch. "Some companies simply need to use the possibilities for increasing prices to best effect. Compared with low-price vendors, though, what often matters more for western premium vendors is to fundamentally redefine their market position using prices and the products and services they offer. The key question is: what products and services for which customers at what price? In this context, pricing models can deliver the right answers in individual cases and help to underpin the company's survival."

The classical approach to pricing in the capital goods industry states that cost plus profit margin give the selling price, which, where necessary, is adjusted to match the price level of the competition. The next stage is "competitive pricing." This method employs intensive market research to compare competitor offerings with proprietary offerings. Recognized market gaps are systematically filled with customer-specific offerings and priced in accordance with the identified willingness of the respective customer group to pay. Competitive pricing is suitable primarily for markets with standard products and large volumes, in which customers tend to make direct cost comparisons, such as computers or standard tools.

Only new solutions permit new prices

The value pricing approach goes much further, being particularly suitable for customized products and services. Here, too, intensive market research needs to be carried out first. Value pricing is detached from the classical list price and tries instead to find new profit models, such as payment by production performance or machine availability, royalties for

new production processes or profit-sharing from benefits achieved by the customer. Under value pricing, the manufacturer of capital goods targets a genuine solution partnership with the customer – and bases his prices on the economic benefits achieved for the customer.

Where, for example, a company has developed an innovative manufacturing process that is clearly distinct from existing competitor offerings, the value pricing approach can be applied. This is all the more applicable the less transparent payroll costs and the cost of materials are. "Many companies pass up profit potential by basing their prices as usual on the 'cost-plus' approach. This gives rise to amortization periods of less than six months in some cases. There is quite evidently potential for raising prices here, since payback times of up to a year can generally be accommodated without the slightest problem," states Sebastian Frankenberger, Oliver Wyman expert and co-author of the study. In figures, this means that a machine that gives the customer a value contribution of €250,000 and is currently offered for €125,000 with a 25-percent markup, can also be easily sold for €200,000. This would put the profit per machine at €100,000 instead of €25,000, and it would still represent a good deal for the customer.

For value pricing to work, the sales force must also strongly support this effort. To be able to sell complex solutions, the salespeople require detailed argumentation aids that can be used to better win over customers. But the incentive structures must also be geared to the new pricing system. "Up until now sales commissions in the capital goods industry have depended more frequently on revenue than profit," says Oliver Wyman consultant Frankenberger. "This makes it impossible to implement creative pricing models."

Fears of price rises are widespread

Alongside such wide-reaching pricing models, the possibilities for classical price increases also need to be systematically examined and exploited in the future. "The fear of declining revenue resulting from price rises is widespread among manufacturers of capital goods," says Oliver Wyman consultant Sebastian Frankenberger. "Yet these companies very rarely have data on price sensitivity among their customers." He cites the example of a U.S. mechanical engineer, which raised the price of its service hours by 20 percent in several steps over a very short period of time, and doubled the profit contribution from its service operations, without having to suffer any lost revenue – the customers were far less sensitive to price than originally expected. "The importance of price as a criterion of decision is often overestimated," comments consultant Frankenberger. "In reality, other criteria like product performance, previous experience, image, or service quality decide the deal."

Even minor declines in revenue can and should be accepted, however, if the company's profitability can be increased as a result, as a worked example demonstrates: for an averagely profitable manufacturer of capital goods, a price rise of five percent can lead to a decline of 10.6 percent in sales without eroding profitability. If sales fall by just a few percent, the price increase would be beneficial.

Ten steps to value-based pricing

1. Understand the customer's economics

All pricing is based on an understanding of the customer, built on facts. What drives the customer's profitability? What role does the company's product play in generating value for the customer? What causes problems for the customer?

2. Communicate findings within the organization

The understanding of the customer that has been gained must be communicated to sales, marketing, development, and service, and implemented in everyday activities.

3. Differentiate pricing more clearly

Not all customers are the same. A few customers benefit more from in-house products, others less. Consequently some can pay more and the others less.

4. Create value-based offerings

The offering for the customer should enhance his profitability and remove the things he considers problems or irritants.

5. Analyze price elasticities

Pricing requires a factual base. A precise analysis of the purchase-decision chain and price elasticity of various customer groups forms the basis for all sound pricing.

6. Build value argumentation

The value of the company's offering for the customer must, wherever possible, be used as argumentation with the customer. This gives rise to a new, shared perspective.

7. Draw up alternative profit models

Selling machines and systems is not the only way of earning money. There are more than 30 profit models, many of which are also suitable for manufacturers of capital goods.

8. Switch sales incentives

Sales commissions must be geared primarily to profit in the future – and not exclusively to revenue, as before.

9. Introduce profit controlling

Detailed profitability analyses, such as "profit by customer" or "contribution margin by sales assistant", facilitate timely, profit-based sales management.

10. Take pricing to the next level

If all the steps work, it is time to apply the knowledge gained for further product development.

Contact

Pierre Deraëd
Head of Corporate Communications
Oliver Wyman
Marstallstraße 11
80539 Munich
Tel.: 089.939 49 599
Fax: 089.939 49 515
pierre.deraed@oliverwyman.com
www.oliverwyman.com

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