Performance Based Pricing – *A Case Study*
What the sales manager needed to know

By Louise Williams

With sales volumes and market share up, why was margin below budget? Trade spend was on budget, so where was the problem? This case study, based on real examples, has been translated into AdvisorBase's mythical Beer 'n' Chip company. In the real

Beer 'n' Chip Ltd: Beer category:

Freddy Smiles, Category Sales Manager at Beer 'n' Chip Ltd, was leaning over the newspaper, cup of morning coffee in hand, when a full page ad taken out by one of the major retailers caught his eye. One of his products held a key position on the page and it was at a price point that would only be possible with substantial contribution from the retailer themselves. Delighted he leaned in for a closer look, there was going to be significant uplift from this which would help him beat his sales target.

By the time the next exec. team meeting rolled around he was armed with the ad as well as his latest figures – market share, net sales and current volume – he was going to blow the others away with how well his segment was doing.

When he left the meeting however, he wasn't feeling nearly so buoyant. While the CEO had seemed pleased with Freddy's report the CFO had asked for confirmation that the numbers were going to improve because, he said, despite recent volume growth there was no improvement to the bottom line, which was still below budget. Freddy was puzzled, he was working his guts out to meet target and his team was working just as hard. Where were things going wrong? Freddy went back to his desk determined to take a closer look at the situation, finance had been known to get the numbers wrong before!

Enter the True Story

It took the rest of the month and much begging IT to run reports before a picture started to emerge – it had him worried – increases in sales were not being reflected in increased margin. Not only that but year on year the company's results fluctuated in a way that wasn't linked to the planned strategic change. Freddy leaned back and stared at the numbers on the screen. Last year when updating their terms of trade Beer 'n' Chip Ltd had undertaken a Cost to Serve analysis. As well as developing terms it had become apparent from the results that the chips and dips categories weren't pulling their weight. Thankfully they had caught the problem before it escalated and with some changes those two categories were recovering nicely. At the time Freddy had breathed a sigh of relief because the beer category showed a healthy profit. Now it was starting to look like he may have been complacent. Could it be that they had started to milk profits out of the beer category without realising it? Surely not, look at how well they had done with the drive for growth of Fruit Beer in the grocery channels – they had to be making money at that kind of volume. *Plus overall promotional spend was within budget*, so they weren't giving away too much.

Performance Based Pricing is about making sure you get value out of growth.

He pulled out a piece of paper and started brainstorming the issues he was facing. When he finished Freddy felt as if he was facing a machine gun barrage of questions starting with…

Why when we sell more does our profit percent of sales goes down?
Are we selling at the right price and/or in the right channels?
Why is a product targeted at grocery selling better elsewhere?
Will more promo spend help or hinder this brand?
We've invested a lot in this brand but how is it contributing?
How much money are we actually making from this product?

After talking to a few of his colleagues he realised that what he was trying to get his head around with all his questions was *Performance Based Pricing*. He took his concerns to the CFO and got permission to run a project to investigate. Freddy, a couple of key people from sales, account management and pricing sat down with the consultants who had helped on the Cost to Serve project and produced a plan of attack. With that in front of him he was ready to get his teeth into the numbers; find out why they were hitting sales targets and missing budget all at the same time. He was ready to start demystifying Performance Based Pricing.

> Performance Based Pricing is an analysis of brand and market segment economics.

There are three drivers of price performance…

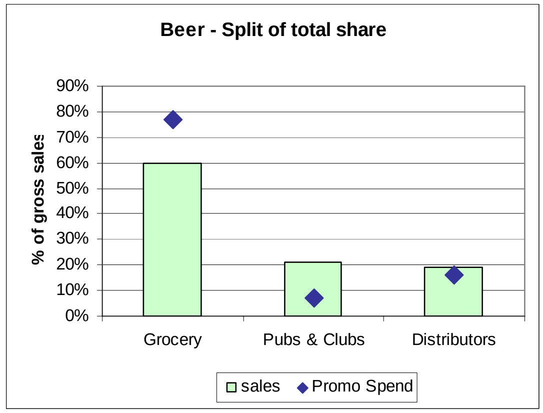
1. First, list price, it's the base from which discounts are taken. The key question is can the product cover is own production cost plus its related Cost to Serve out of revenue after discounts.
2. Second, efficiency terms, where pricing is an arrangement in which the retailer is charged based on their actual performance in achieving certain goals. This part of the problem Beer 'n' Chip Ltd had already dealt with when setting up their efficiency based terms. For example, they had introduced a full truck discount to retailers based on the saving they received from their freight carrier.
3. The third element of Performance Based Pricing relates to promotional pricing. Looking back at his list of questions Freddy knew this was the area, together with list price, that needed to be focused on. *Promotional Performance Based Pricing looks at the performance of brands within customers. It sets out to ensure that all customers perform, that all brands perform and to optimise performance of brands by customer*.

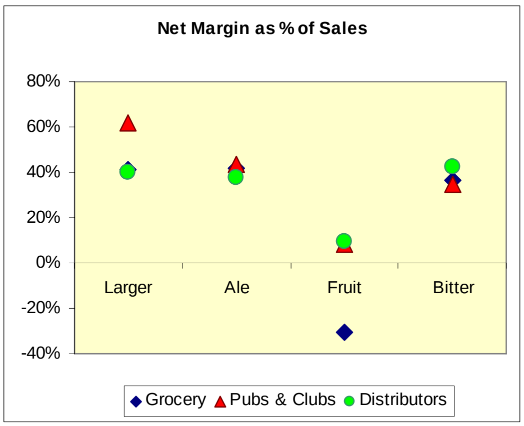
> Performance-based pricing is insurance. It insures that the seller does not undercharge the buyer.
> — Benson P. Shapiro (Malcolm P. McNair Professor of Marketing, Emeritus, at Harvard Business School.

The Analysis

Grocery was clearly their biggest customer group bringing in 60% of beer sales; it was also getting more than 60% of the promotional pie – should it? Pubs & Clubs and distributors were about the same size but there was a clear discrepancy in spend between them. Why?

The project team ran some more numbers breaking beer into brand groups to isolate the issues. It was clear that Fruit Beer which they had been pushing heavily in grocery was actually doing better for them in other channels. In fact, Fruit Beer wasn't even contributing in grocery at Net Margin level! Freddy bit his lip when he realised that 96% of Fruit Beer promotional spend was going into grocery. If he wasn't mistaken, he grabbed the newspaper, that was the very product advertised. He leaned back in his chair and groaned. The product line that was actually costing them money was the one getting a boost in sales. That certainly explained why sometimes it seemed the harder they worked the worse things got. Although Fruit Beer had a higher list price it was not high enough to compensate for higher COGS, not at the level of trade spend they had been throwing at it. As their premium line it should have been working better for them. Not only did they need to reconsider their promotional strategy but perhaps also their list price.





The deeper Freddy and the team went the clearer it became that they were going to have to change the way they looked at things. While as a category beer was profitable, at the detailed level individual groups were not delivering adequate returns. Right now for instance while they weren't overspending on promo what was being spent was on the wrong brand in the wrong channel. With the requirement of bundled promotional terms by some grocery accounts pressures on margin had increased, it was no longer good enough for achievement to be measured on market share and sales (volume and net sales). Trade spend, as one of the biggest single cost to serve categories, needed to be well understood and well managed, not lost in the day-to-day push for sales.

Performance Based Pricing identifies where promotional strategy has to change to realign product contribution.

Looking back at what he had learnt Freddy realised how important it was to know…

- customer performance (which customers return too little on the discount invested in their business);
- product performance (which products are selling at too low a price); and
- product by customer performance (the impact of customers on product profitability – which products work in which customers at what price).

With the results of the Performance Based Pricing analysis in hand he went and saw the CFO to talk through the results. He now knew what deal depth on which products he needed for each of his locked in promotional slots to make up the lost ground and hit budget. OK, Freddy had needed to recast his budget and promotional plan but his legendary smile is returning.

Louise Williams is a consultant with AdvisorBase. AdvisorBase has strongly focused expertise in developing business models to support decision making in areas such as Cost to Serve, Performance Based Pricing and the supply chain. We strive to help our clients in the FMCG industry make smarter decisions and do better business. www.AdvisorBase.com