

## How to Increase List Prices in Industrial Environments

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**The following article is written by Navdeep S. Sodhi, a practitioner of pricing strategy for over 10 years in various industries including airlines, medical devices, and industrial manufacturing. Navdeep is a recent winner of the PPS 2004 Award of Excellence for “Recognition for Bottom Line Impact Through Pricing.”**

There is plenty of expert advice and good discussion available for improving contractual or transaction prices<sup>1</sup> but there is little on hand to guide managers on how to increase list prices as a means for improving revenue and profits. In most industrial companies, list prices and discounts are used to derive the invoice or net price. While customers focus on net prices in their purchase decision, companies use discounts off of list to fulfill customer needs and to compete against each other. Thus discounts and list prices hold the key not only to increased revenues but also to profits. For increasing profits, a company can cut costs or increase prices. Many manufacturing companies have already cut costs drastically in the last few years of a down market through off-shoring, outsourcing, downsizing, squeezing vendors, and even switching to cheaper raw material. Any more push in these directions could reduce their ability to compete effectively.

Companies shy away from reducing discounts even in a period of economic recovery lest their customers defect to lower priced competition. The only recourse left then is increasing list prices provided their competitors raise list in lock-step but this possibility can hardly be taken as a given.

This article presents the case of Posit Industrial (fictitious name) to exemplify a situation where an increase in list prices was warranted and how this leading manufacturer of industrial

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<sup>1</sup> George Stalk Jr., “Organizing for Pricing,” *Professional Pricing Journal*, Quarter 3, 2003; Ron Farmer, “How to Fix your Pricing if it is Broken”, *Professional Pricing Journal*, Quarter 4, 2003

capital goods successfully implemented the increase. The main lesson from Posit and the process it followed is that price increases need to be thought through and processed in a logical and diligent manner.

### ***Why to Not Increase List Prices***

Companies, in general, are reticent about making and announcing list prices increases due to a number of reasons:

- **Regulators** watch for any attempt at price fixing. Although price signaling is usually legal, recent events in a market or past rogue behavior in an industry may invite close scrutiny<sup>2</sup>.
- **Competitors**, including companies operating in tight oligopolies, demonstrate complex gaming behavior and cannot be taken for granted in regards to following a list price increase even when an entire industry faces lean times. Although the outcome would likely be highly desirable, few companies are known to take their sole focus away from increasing volume to demonstrate clear price leadership.
- **Customers** may leave if there is a difference in price with respect to similar competitive products. Unlike transaction pricing which can be customized to micro segments, list prices increases do not differentiate between customers located in different geographies or by their purchase behavior.
- **Managers** remain unenthusiastic about the arduous meetings and consensus building or dealing with multiple IT systems that hold prices not to mention the uncertainty of market response.

### ***Why Increase List Prices***

In theory, companies can raise prices to increase profits but a successful price increase requires customer acceptance and competitors' willingness to comply with a new "going rate". Major reasons for increasing list include:

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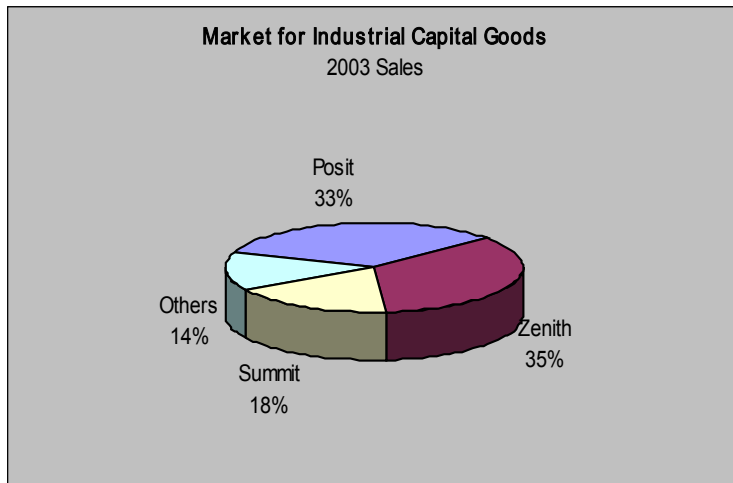
<sup>2</sup> John R Wilke, "Price-Fixing Investigations Sweep Chemical Industry," *The Wall Street Journal*, June 22, 2004

- **Inflation** from rising costs of raw materials or due to change in industry regulations unmatched by gains in productivity. The immediate action by companies is to reduce expenditure as much as possible and then rely on price increases to protect profits.
- **Increased industry demand** makes it difficult for companies to service customers at current levels of capacity. According to economic theory, companies in a free market would dynamically change prices to meet the supply-demand equilibrium. The market reality is not far from it: companies do raise prices and/or add capacity to meet the market opportunity.

### ***A Situation Warranting a List-Price Increase***

Posit Industrial anticipated demand growth after an extended lean period but was simultaneously being squeezed by a large unplanned cost inflation. In fall of 2003, Posit was finally emerging from a down market in which all companies in the industry had been cutting costs and competing on price. The good news of strong recovery in industry demand in 2004 came with the bad news of steel and petroleum price hikes. The increase in steel costs alone meant millions of dollars of unplanned incremental costs on the horizon for Posit. The rapid growth in China's industrialization alone was consuming half of the world's steel supply not to mention demand spurred by signs of economic recovery worldwide. Posit had already pared costs and there was little more they could do neutralize increased costs of steel and gasoline. Most of Posit's large steel suppliers refused to honor existing contracts asking for longer commitments at higher costs. So price increases seemed necessary but these had to be effected in a controlled manner to prevent loss of market share and profits: too much price increase would mean losing revenues and profits and too little would also mean losing profits by not being able to cover the increased costs.

All competitors in the Capital Goods industry (Figure 1) – mainly Posit Industrial, Zenith Corporation and Summit Inc (Figure 1) --were facing the similar cost pressures due to the



similarity of their product portfolios, location of manufacturing facilities and extent of unionization in the labor force.

Faced with sudden and sharp procurement cost increases, Posit had to choose

Fig 1: Posit is a major player in Industrial Capital Goods arena among the multiple ways to respond:

1. Reduce the extent of discounting and promotions but this was something that the company had already been trying to do for some time with mixed results. Posit had realized some margin improvement but competitive pricing practices allowed little consistency or control. Further reduction in discounts could lead to loss in market share something that was unacceptable in Posit culture.
2. Use surcharges as a means to alleviate the cost burden. Levying surcharges would be suitable and understood by customers if the inflationary force were temporary. However, the problem facing Posit seemed to be long-term with China's growing steel consumption with no alternatives to grow industry supply for several years. Customers could lose patience quickly and if competitors did not match surcharges the net benefit would be akin to the experience with reduction of discounts and promotions.
3. Increasing list prices immediately and letting the customers and competitors know the increase right away.

Announcing a list price increase was the option that could provide the fastest relief if implemented successfully. But there were inherent risks in raising list due to the uncertainty in the market and lack of in-house experience. The company decided to follow a plan of action suitable for their internal and external environment.

### ***Planning a List-Price Increase***

A list-price increase can be implemented in seven-steps:

Step I: Determine how much price realization will fulfill business need

Step II: Understand price sensitivity of products relative to life –cycle or other factors

Step III: Compare your products against those of competition

Step IV: Predict and prepare for competitive reaction

Step V: Predict and prepare for customer reaction

Step VI: Finalize plans and prepare Sales to execute list price increase

Step VII: Communicate list increase in the market

Most of these steps are used in companies but not necessarily followed in a concerted manner to execute major price actions. Posit carried out these steps as follows:

#### **Step I. Determine how much price realization will fulfill business need**

The requirement for Posit to preempt margin erosion was to raise price by at least 2 percent. Even if the company succeeded at passing along costs to customers, it seemed impossible to extract the full potential of the list-price increase. As one manager said, it was important to aim slightly higher because the actual transaction prices (list price less discount) might not increase by the same proportion for all customers. Hence, the list-price increase in discussion was around 3%.

One idea was to refine this by having different list price increases based on product but this posed a problem. Posit management did not want to "leave money on the table" by not increasing the list price adequately for some products just to retain simplicity in the discount structure. The sales department at Posit had always been vocal about having "too many" discount

rates in the market. Moreover, Posit's pricing environment is highly transactional where invoice prices can be order-specific. Also, the management realized that implementing different rates of price increase for different products would further complicate the discount structure, a possible hurdle for a smooth and quick implementation. As such, Posit was leaning towards to a simple increase as it started analyzing its products individually to determine what kind of increases could be viable.

**Step II: Understand price sensitivity of products relative to life cycle or other factors**

Analysis of Posit's product line (Figure 2) showed large variation in margins, sales and maturity in the company's offering. At one end was ES30, its biggest sales generator, a mature

| Product     | List Price (\$) | Avg Unit Price (\$) | Avg Unit Cost(\$) | Margin | 2003 Sales (\$MM) | Sales Mix | Product Life cycle Phase |
|-------------|-----------------|---------------------|-------------------|--------|-------------------|-----------|--------------------------|
| ES30        | 3,000           | 2,700               | 2,430             | 10%    | 524               | 43%       | Maturity                 |
| GS40        | 4,000           | 3,200               | 2,560             | 20%    | 270               | 22%       | Growth                   |
| LS40        | 5,500           | 4,125               | 3,094             | 25%    | 201               | 17%       | Growth                   |
| RX30        | 6,500           | 4,225               | 2,113             | 50%    | 90                | 7%        | New                      |
| Accessories | 500             | 200                 | 90                | 55%    | 130               | 11%       | N/A                      |

Fig 2: Posit's product profile based on 2003 sales results

product labeled as commodity owing to aggressive pricing practices in recent years. According to Posit's sales personnel, price sensitivity

was high for this product and an inappropriate price increase could hurt market share.

At the other end was RX30, just a year old, fulfilling specialized needs while enjoying relatively high prices but not growing as fast as planned. Posit did not want to raise the price of RX30 so much as to lose the opportunity of making higher margins from loyal customers.

The analysis also revealed that customers were more sensitive to changes in prices of core products than those of accessories. Posit decided to frame the question regarding which products to include in list price increase relative to ES30 and RX30 since every other product fell between these two in every aspect.

**Step III: Compare your products against those of competition**

Posit considered price value maps<sup>2</sup> based on feature-set comparisons to see how Posit products were perceived in the market vis-à-vis the competition. For simplicity, it was assumed that average transaction prices would increase in proportion to list price increases (for most customers this was a good assumption).

ES30, a product known to have the highest price sensitivity, became pivotal in deciding

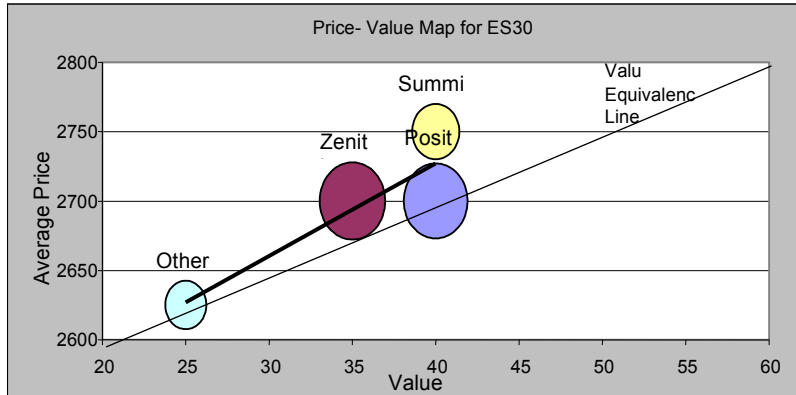


Fig 3 ES30 is value advantaged with respect to equivalent competitive products by \$50 than the equivalent Summit product that offered the same value.

the minimum list price increase. ES30 feature set (Figure 3) offered more value than competitive products but it was priced at par with the equivalent Zenith product and was cheaper

Taking a pessimistic scenario (Figure 4), if Posit raised prices 2% (roughly \$50) and none of

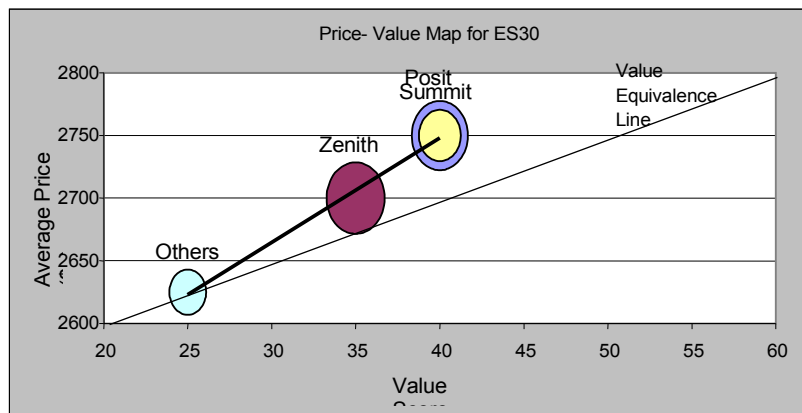


Fig 4 Scenario of Acme matching Summit Price

competitors followed, it would be at par with Summit as regards to this product and therefore would be acting within reasonable bounds.

In an optimistic scenario (Figure 5), all competitors could follow with a \$50 list price increase. This would position all competitive products in the industry in better alignment with the Value Equivalence

<sup>2</sup> Ralf Leszinski and Michael V. Marn, "Setting Value, Not Price, The McKinsey Quarterly, 1997 No 1

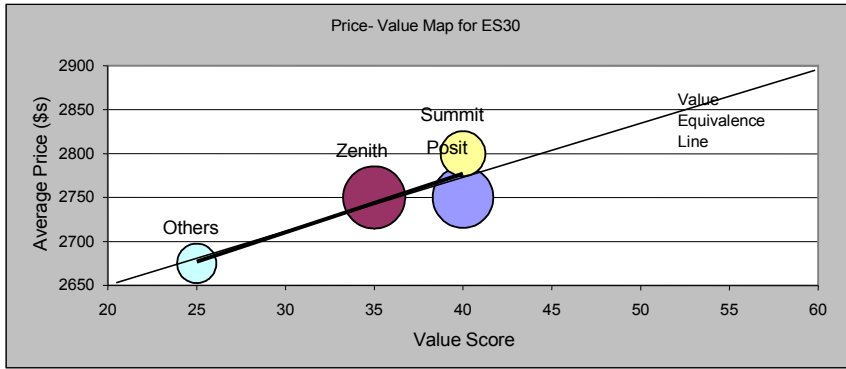


Fig 5 Scenario of all competitors raising prices \$50 to reach new equilibrium

line – something that would be desirable for Posit. The company did similar price value analyses with all major products.

**Step IV: Predict and prepare for competitive reaction**

It was difficult to predict how the competition would react to a list increase, as there had been no such action in the industry in the past several years. The only clues available to predict

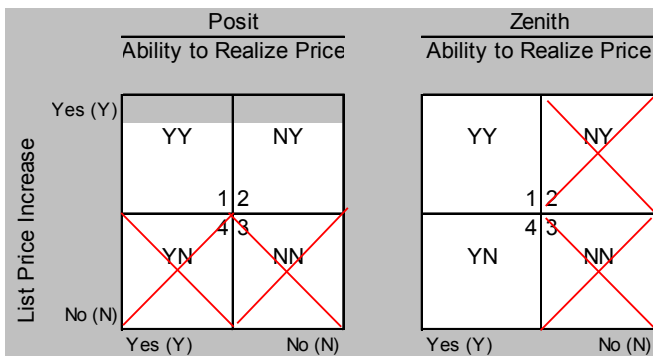


Fig 6  
 Box 1 : Implement List price increase and realize benefits  
 Box 2 : Implement Price Increase but unable realize benefits  
 Box 3 : Do not implement List increase and do not realize benefits  
 Box 4 : Do not Implement List Increase but prices go up

competitive behavior were reactions at the time of new product launches.

Posit had launched a high end product in spring 2003, RX30, with novel features and a price to skim the early adopter market. Zenith stayed away from attacking RS30 using price and the reason for that became apparent when they launched a similar product

three months later. This allowed Posit to stay the course in its pricing strategy for RX30 with Zenith aligned at a slightly lower price with its new product. Summit had tried to compete on price with its existing products but found itself disadvantaged by the feature benefits offered by RX30 and Zenith’s new product.

Based on the price-value mapping described earlier, it was clear that Posit’s market share would be threatened most by Zenith if all competitors decided against taking list price increases. Posit carried out an informal game-theory analysis to review different scenarios of competitive reaction (Figure 6). If Posit chose to announce a price increase, the outcomes could only be that

they are able to successfully realize price or they do not (boxes 1 and 2, Posit, Figure 6). The ideal scenario entailed Posit realizing the desired price increase without changing its discounting policies (box 1, Posit, Figure 6). Inability to realize price increase (having to raise discounts along with list prices) was possible (box 2, Posit, Figure 6) but even this option was not any riskier than “do nothing”.

If Zenith’s cost pressure were anything like Posit’s, they would want to avoid price erosion (boxes 2 and 3, Zenith, Figure 6). The ideal scenario for Zenith would also be able to realize benefits of a list price increase (box 1, Zenith, Figure 6). A less optimistic scenario entailed Zenith not increasing list prices but instead just improving transaction prices by offering fewer discounts to its customers (box 4, Zenith, Figure 6).

Posit felt it was more than likely that Zenith and others would follow their price leadership and pull up the pricing levels if they perceived Posit to be "serious" about price increases. Therefore, speed and clarity in announcing the price increase would be vital in communicating the seriousness of Posit’s intent.

#### **Step V: Predict and prepare for customer reaction**

Posit expected that customer reaction regarding list price increase would vary by segment such as transaction volume and geographic location among several other factors. Some customers might be more conscious of steel and petroleum price hikes and acquiesce in Posit's list price increase while others who often bought high-ticket items in large quantities would likely find the price increase undesirable.

Posit decided to focus on its top 300 customers comprising of 65-70% sales volume and segmented them as – Economic, Value, and Loyal. Some of the largest customers had contracts with anywhere between one half to three years remaining although quite a few of these contracts did not have clearly defined price escalation clauses. Posit management felt that some of the Economic customers would require persistent persuasion and continue to resist a price increase while Value and Loyal would be more accepting. While speed to act remained important, Posit

was sensitive to its relationships with customers and wanted to provide a small yet adequate time window so that sales people could clear outstanding commitments.

### **Step V1: Finalize plans and prepare Sales to execute list price increase**

Posit decided to take a price increase of 3% on all products across-the-board and up to 5% on accessories. Using 3% rather than a 2% increase would also help the company cover cost increases and establish clear price leadership to ensure that competition did not view this action as a guarded gesture but as true intent to raise prices.

Conservative price-realization estimates showed that Posit would be able overcome cost pressures and bring in incremental profit. In preparation, senior managers at Posit asked for analysis of sensitive national accounts, opportunity markets and any large transactions in final stages of negotiation. A monthly review meeting was set up with representation from Marketing, Sales, Finance and Pricing to track the actual price realization and any hurdles in the process. Also, in case the transaction prices did not improve in proportion to the list price increase of 3%, they might still increase by an amount adequate to prevent margin erosion as noted earlier.

The next step was to explain the price action to its sales force before making an announcement in the press. Posit followed a communication approach it had used when RX30 was launched.

The senior management forwarded a detailed memo to all the sales managers outlining current cost pressures, urgency of implementation and an action plan that included time-line and selling message. Sales managers were instructed to start training the sales personnel in how to initiate conversations with customers to prepare them for the price increases. Pricing and Product marketing led phone and web meetings with major sales offices for training purposes and hear objections in order to refine the message. In doing so, it became clear that with the exception of a few reluctant sales people, there was general support throughout the organization.

An important feedback from sales calls were how important it was to manage customer relationships. Sales people wanted a window of at least a month to clear pending negotiations. It

was decided that the company would retain a high level of price flexibility for a month before completely switching to price increase on the date announced.

## Step VII: Communicate List increase in the market

Posit announced a list price increase (Figure 7) in "Industrial Capital", a respected and

**Posit Company Announces Off-List Price Increases for  
all Products**

**Goodspport, CA, July 5, 2004** – Posit Industrial (PSI: NYSE) today announced off-list price increase of 3% for all its products and up to 5% for select accessories effective July 15, 2004. The price increases will be valid in the United States, Canada, Puerto Rico and Mexico.

The price increases are due to significant upward shift in cost of steel and transportation. Pricing for raw materials such as steel is not expected to return to previous levels due to strong increase in demand and inadequate growth of supply.

Headquartered in Goodspport, CA, Posit manufactures Widgets for commercial use. The company has 10000 employees in 10 countries. For more information about Posit and its products, visit [www.posit.com](http://www.posit.com).

widely followed industry journal that brought to light latest innovations and significant news about industrial manufacturers and distributors. The announcement was made on July 5, with effective date as July 15 with an understanding that all pending customer

Fig 7: Announcement made by Posit in "Industrial Capital"

negotiations would be cleared by August 15, 2004.

## **Results**

Zenith announced a 3% price increase on the very next day and Summit followed suit a week later. The other smaller players in the industry seemed more cautious and took up to a month to announce smaller list-price increases. Zenith's announcement brought immediate relief and managers at Posit were glad at having gone through the exercise of effecting a list price increase. It soon became apparent that most of Posit's customers were expecting a price increase like they had seen from vendors from other industries. Senior management at Posit not only felt they solved the problem of margin erosion due to steel and petroleum price increases but that they could also get back to the original annual operating plan.

## ***Lessons***

### **I. Analyze diligently**

The quality of answers around which products and how much price increase are key to a success of a list price increase. There is never complete information and therefore a pricing practitioner must stay tuned to market signals no matter how faint. Posit used feedback from the sales department, price-value maps, and its experience with different competitors pertaining to new product launches.

### **II. Communicate clearly**

And that is both inside and outside of your company. Every decision-maker, whether customer or competitor, looks for ways to reducing uncertainty. Posit used a clear message to convey the reason and scope of price increases to their customers. They also successfully signaled to competitors that they did not expect pricing for steel to return to previous levels.

### **III. Act quickly**

Once a decision is made, speed in establishing price leadership or becoming an early follower can bring major gains. Posit conducted situation analysis, scoped the price increases, made an announcement and set up a tracking mechanism. Companies should set up these processes so that they can rely on routine steps for analysis in case strategic decisions such as list-price increases need to be made. On the other hand, companies must keep in mind that they will have to give their customers time to adjust to new prices.

#### **IV. Proceed with preparation**

Posit could have foreseen a situation of having to “grandfather” pricing due to weak escalation clauses in contracts but this alone would not have helped them with price increases. Posit did a good job at getting agreement from and in training sales personnel. They were also well prepared with knowledge of customers and what to expect from them.

#### **V. Monitor carefully**

It would be worth little if a company could not measure price realization and pinpoint opportunities to harvest price. Posit management started by evaluating responses from its top customers and set up monthly review meetings to discuss success of the list price increase.

### ***Conclusion***

Despite Posit's success, one should not forget that although list price changes can help raise the level playing field, they should be used with sound justification and should appear fair to customers. Implementing increases in list may entail revamping discount guidelines and a company's internal processes that would take time to stabilize. Posit's success came from a well-thought action plan supported by diligent analysis that was implemented systematically. In similar situations, other companies can follow a similar path and replicate Posit's success.