# Digitize Pricing to Optimize Revenue and Margin

## Intelligently Manage to Key Performance Indicators


VENTANA RESEARCH

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# Price Smarter and Faster

Pricing is an ongoing source of anxiety for organizations because pricing decisions have a direct impact on sales volumes, revenue and profitability. Over the years, a variety of strategies have been in place to establish prices for products, depending on custom, the nature of a particular business and the degree of competitiveness in the market. Recently, the process has become more complex for companies that offer subscription- and usage-based services.

Organizations have found success in taking a data-driven approach to the process, as software has put modern microeconomic theory to practical use by enabling companies to optimize revenues and margin through more intelligent pricing. The importance of using software to manage pricing intelligently and with agility will increase in an era where two-to-three percent annual increases in price inflation become common. Ventana Research asserts that by 2024, 1 in 10 organizations will deploy a dedicated pricing optimization application to analyze, create and operationalize optimized pricing to reduce leakage and maximize revenues. Despite the benefits of digitizing pricing, companies have been slow to adopt software dedicated to this purpose. A primary reason is that software for managing pricing once required major effort to evaluate, procure and deploy. However, current offerings can accelerate time-to-value and reduce risk by simplifying implementation and enabling a step-by-step approach to adoption.


# Demand-Based Pricing to Optimize Revenue and Margin

The most straightforward approaches to price setting are a “cost-plus” calculation (cost plus some mark-up) and “follow-the-leader” (charge what competitors are charging). Recently, demand-based pricing has become more widespread as technology has made this approach more feasible. This method uses buyer demand—defined by an estimate of the good’s or service’s perceived value to the buyer—as the central element in setting price.

Pricing strategies are important because they can have a disproportionate impact on a company's bottom line. This is because the ability to add incremental revenue with no associated costs directly adds to pretax profits. More recently, how to set prices has become an even greater concern as internet empowerment has shifted the balance of power in price discovery from sellers to buyers. Once this was only a concern for B2C companies, but increasingly it is affecting B2B businesses. Consequently, by 2024, competitive pressures will force three-fourths of B2B companies to adopt technology-supported pricing strategies to achieve volume and margin objectives.

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Subscription and usage-based pricing models have gained popularity because of changes in consumption patterns (people and businesses preferring to rent rather than own some asset) and changes in go-to-market strategies that emphasize sustaining an ongoing relationship with customers to achieve a steadier income stream. These models offer a high degree of flexibility in pricing structures but also greater complexity in managing prices and presenting offers. Raising prices, offering discounts or managing offer bundles also are important considerations in achieving higher annual recurring revenue from a customer and limiting churn.

Deploying demand-based pricing requires using technology to enable the techniques of revenue and margin optimization. It is a business discipline that applies market segmentation techniques to achieve strategic objectives such as increased profitability or higher market share. The first demand-based pricing came into wide use in the airline and hospitality industry in the 1980s as a way of maximizing returns from less flexible travelers (such as people on business trips) while minimizing the unsold inventory by selling incremental seats on flights or hotel room nights at discounted prices to more discretionary buyers (vacationers). Today, it is a well-developed part of business strategy in the travel industry and increasingly is being used in others. Software plays an important role in supporting demand-based pricing, though it is just one of several factors on which companies must focus to use the technique successfully.

However, it remains the case that few companies outside those industries utilize price and revenue optimization techniques. According to our Office of Finance benchmark research, just 23% of organizations have adopted software for this purpose. The research also finds that only one-third use the associated analytical approaches of measuring customer profitability (34%) and product profitability (30%). Organizations without these approaches in place will find it challenging to optimize pricing because you cannot manage what you do not measure.

# Six Key Components for Price and Margin Optimization

There are six components that organizations must consider and manage well to be successful in using demand-based pricing: strategy, external factors, people, process, information and software.

## Strategy

An organization must have in place a realistic pricing strategy that is well aligned with its capabilities, product strategy and competitive position. In a scale-driven business, for instance, it may not make sense for a small player to try to be the low-cost provider in a commodity-type market. Instead, these organizations can choose an approach to maximize pricing in a price-conscious market by designing offerings with valued features and services that add margin.

## External Factors

A pricing approach also must account for external factors. In particular, different cultures and businesses have different attitudes toward fixed and negotiated pricing. In some cases—especially in consumer markets where fixed prices have been the norm—people may consider price optimization "unfair." Organizations that try to implement a demand-driven strategy thus may encounter resistance and so must approach pricing carefully. Also, there may be local or national legal and regulatory issues that impinge on pricing flexibility. That noted, people have grown accustomed to highly variable airline and hotel pricing, even if they do still find it annoying.

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## People

Management needs to ensure that all relevant parts of the organization are aligned with strategic pricing efforts. It is extremely important that incentives (especially sales compensation) are properly aligned with price optimization objectives and strategy. In many cases, organizations will require ongoing training to continually apply optimized techniques and deal with issues that arise. For some, a "center of pricing excellence" may be a useful way to build on experience and entrench a culture of price optimization. Exactly how this is handled depends on how an organization manages pricing and to what extent it is centrally managed.

### Process

The effective establishment and ongoing evaluation of price-setting processes requires a cross-functional team that includes all stakeholders. Initially these people will meet frequently (at least once a month) but as its revenue and margin optimization effort matures these policies may require only a quarterly review. There also must be a well-defined price analytics review process to ensure that methodologies remain sound over time.

### Information

Easy, rapid access to the historical deal data needed to support the use of pricing algorithms (including pricing, volumes, add-ons, cross-sales, and terms and conditions) is a prerequisite for successful implementation of a pricing strategy. This data is required to feed the analytics and facilitate rapid pricing decision cycles. Our research consistently shows that most organizations lack sufficient access to the appropriate data and this issue grows in proportion to a company's size.

### Software

An organization must have the right software—that is, software that not only enables the needed pricing controls but that is tailored to its needs and that is easy to deploy and maintain. And it must be implemented properly. Ventana Research asserts that by 2025, one-quarter of all organizations will have a non-spreadsheet-based standard pricing application to provide a uniform approach to support all revenue channels. When it comes to pricing, there can be subtle differences in the needs of different types of business, so prospective buyers should focus on vendors that have strong references in their specific industry. Moreover, the software must be able to simplify the handling of price lists for any type of pricing company management style—from highly centralized to highly decentralized—so that everyone is working from the same, up-to-the-minute pricing data. This capability is especially important in even moderately inflationary environments.


## The Path to Digitizing Pricing

While the above six requirements may appear daunting, there is a way forward. Software vendors have recognized the need to provide companies with an accelerated, lower risk approach to adopting a demand-based pricing strategy that optimizes revenues and margins.

Organizations can start small, develop the approach to a broader rollout that works best for them and then scale up at their own pace. Some vendors even offer a try-before-buy option to familiarize those considering a digital pricing approach with the basics.

Pricing has always been a critical issue for businesses and has become more challenging as the internet has shifted the balance in price negotiations to the buyer. In response, using technology for pricing and revenue optimization is now moving beyond travel and hospitality to become a practical technique for B2B commerce. Organizations can use pricing and revenue optimization technology to achieve and maintain a desired balance between market share and margin objectives.

Sales and sales operations groups in B2B companies must investigate how technology can make them more effective in pricing and quoting to intelligently manage to their key performance indicators. Furthermore, CFOs should support and even drive adoption of technology-supported pricing optimization. The benefits to an organization's key performance indicators are clear, particularly due to the outsized impact that optimized pricing can have on topline revenue and overall profitability.

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