THE PROACTION℠ GROUP LLC

Identifying Operational Opportunities to Improve Pricing During Due Diligence

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This is the sixth article in our series on Identifying Opportunities to Improve Operations. We have divided the opportunities to increase the market capitalization of a company into seven value lever buckets. For each area we describe the signs we look for that indicate the company can improve their financial performance. In other words, we are highlighting points you want to know BEFORE you buy the company; things that expose opportunities to increase EBITDA, capacity and asset utilization.

The Seven Value Levers include:

1. Throughput. Can we increase the output of a plant, office, service location, or other facility?
2. Variable Costs. Can we reduce the costs directly tied to our volume and revenues?
3. Fixed Costs. Can we reduce the costs that do not change in the short term, based on customer demand?
4. Order to Cash Cycle. Can we shrink the time between investment on our part and collection from our customers?
5. Pricing. Can we collect more revenue for the services we are providing?
6. Asset Utilization. Can we increase inventory turns, the use of plant equipment, or the use of facilities?
7. Risk. How can we reduce risks related to running our business?

In this article we share with you the signs we look for that indicate a company may be able to effectively increase their revenues and EBITDA through pricing. From a results perspective, we are looking for indications that our client can:

- Increase overall pricing levels, often from 1-3% of total revenues
- Reduce or eliminate “leakage” from designed pricing strategies or plans
- Identify price elastic and inelastic items
- Address any issues related to the gap between gross and net sales
- Collect more revenue in the current market

This is a powerful topic; finding opportunities to get paid more for what you do. Effective pricing strategies and practices lead to designed increases in margins where customers are willing to pay more. The following indicators demonstrate that a company is not consistent in the pricing approach, is leaving money on the table, or is allowing the company to execute policies that are out of alignment with company strategy and direction.

Indicator	What it can mean
Does the company monitor margins by product and customer segment?	If the management team doesn't have reports showing trends and variation in actual transactional prices, then there is opportunity; if they can't measure it, they can't manage it. The best practice here would be to not only track trends and variation in margins, but to do so by customer and part / SKU ("stock keeping unit") segment.
When a price increase is decided, is the actual yield monitored?	One effective approach we use in performing due diligence is to interview managers and workers on how they address various functions and duties. Then, we also look at history, at actual numbers. This allows us to triangulate people's perception of how pricing is managed with real history. Fortunately, if a company keeps their sales history, we can retroactively track pricing change yield. If, however, management doesn't have access to this data and does not monitor performance, then the company is vulnerable to pricing "leakage".
Can a sales rep or inside sales person change the price for an item based on their judgment?	Sales people only lose a portion of their commission if they reduce the price of an item. They stand to lose the entire commission, however, if they miss the sale. This can provide an unbalanced motivation. Proper controls limit the ability for any sales person or manager to provide a discount or price reduction outside of designed parameters. If these controls are not formal and discrete, there is likely a meaningful opportunity to investigate.
Decisions on prices and near-price discounts, deductions and incentives are made independently of each other – rather than in an integrated fashion	When decisions are made based on the total cost of ownership, we often find that well balanced choices are made. There is no opportunity to squeeze one end of the balloon and simply move the problem to another department or budget. When determining how we will treat various customer segments and sku's, if we do not address all components (pricing, discounts, freight, accessorial charges, etc.), then there is a meaningful potential that one group of customers or products are subsidizing others.
People paid as a percentage of revenue or gross margin dollars (e.g. salespeople and sales managers) make some or all pricing decisions	Whether we are talking about selling standard products off a price list or complex designed services off a quote, if the people that get paid on making the sale have a say in the price charged, there is a danger that we are allowing personal goals and motivations to supersede company strategy and goals.
Can a price in the system be changed by someone not specifically authorized to make a pricing decision?	When we conduct our diligence work in the field, we start with the historic data. We look for any variance in prices charged; we look for actual compliance with company policies. When we do find a gap or a meaningful variance, we then look to see who can change a price or discount in the system. Often, executives and managers are surprised to find that many people within the system have the ability (even if they are prohibited from doing so) to change or set pricing levels.
Margins on lower volume sku's and higher volatility sku's aren't differentiated from high volume or stable products	Low volumes and high volatility drive higher costs. Providing the desired quantity of low volume and volatile parts to customers when and where they want them adds value. Largely speaking, these items should have a higher margin than products that drive high levels of steady demand. If the company does not segment their products by volume and volatility and monitor margins, there is an opportunity.
Margins by sku and customer segment are not tracked and monitored by the executive team	Similarly, providing goods and services to smaller customers when and where they want them creates value. Smaller customers do not have the scale to evaluate other options as larger ones do. A company should have a designed policy or pricing approach that differentiates how we price different customer segments. If margins are not tracked by customer and product segment, then we need to investigate.

Indicator	What it can mean
Is there a structured set of rules, controls and baselines in place to address one-off or job shop type quoting?	For custom and designed products and services, companies need to provide specific quotes during the sales process. If the same item would be quoted differently based on who in the company completes the quote, there is an opportunity to improve pricing. Even more so, if the same person might quote an item differently on two different days, there is an opportunity. There should be pricing tables, consistent component costing, rates, rules and worksheet tools to support a consistent and designed quoting process.
Are margins on projects or jobs tracked and compared to the quote?	For custom projects and services, we need to provide a quote during the sales process. High performing companies can show how completed projects and services compare to the original quote. Further, the company should be able to show what actions they take to improve the quoting process based on actual performance. If any of these pieces are missing, there is an opportunity to improve.
Cost plus pricing	If we find evidence that "cost plus" pricing plays a meaningful role in setting pricing levels, then we see opportunity.
Elastic and inelastic pricing is not evaluated	Retailers have found success in setting low prices on items that drive consumer behavior. If the grocery store sets a low price for milk, then customers flock to the store and they never check the price of snack items, for example. The same relationship holds true for companies selling to other companies (B2B). If a company does not analyze and track elasticity by part, then there is opportunity.

Recently, we worked for a company that had hundreds of sales people in a dozen regions. The company retained us to find out what was causing a double digit gap between gross and net sales. While there was a companywide, executive driven mandate to hold firm on pricing, we found that sales people were routinely providing discounts. The sales people had good intentions and wanted to close the sale, but the executive team had developed their pricing strategy on sound principles and needed their mandate to be carried out. The company's regional controllers were aware of the mandate, but lacked conviction that it was truly in the best interest of the company. After uncovering the issue, we were able to design simple reports that tracked compliance and allowed management to monitor pricing levels. Within a short time management's strategy was carried out throughout the company and net margins increased by over 3 points. Because this company had a 10% EBITDA margin to start with, this increase generated a 21% increase in EBITDA.

Another client, a consumer packaging company, recognized that low volume and highly volatile sku's did not carry any premium pricing over high volume and stable items. Correcting this added $500,000 in margin, an increase of 8% in overall EBITDA.

There are many examples like these. Look for these indicators. When you find them, it is time to investigate and take action!

In our next article we will look at indicators that a company can reduce the risks related to operating their business, serving their customers and providing returns to their shareholders. Our other articles focused on ways to reduce costs, increase throughput or reduce the working capital required by the company. This next article will focus on how we identify ways to take the risk that our cost structure will change, that we will not be able to sustain our growth and margins, or that we will produce product that does not live up to our specifications.

If you have any questions or requests, please feel free to contact me at tvm@proactiongroup.com.

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