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Beyond the Price Waterfall

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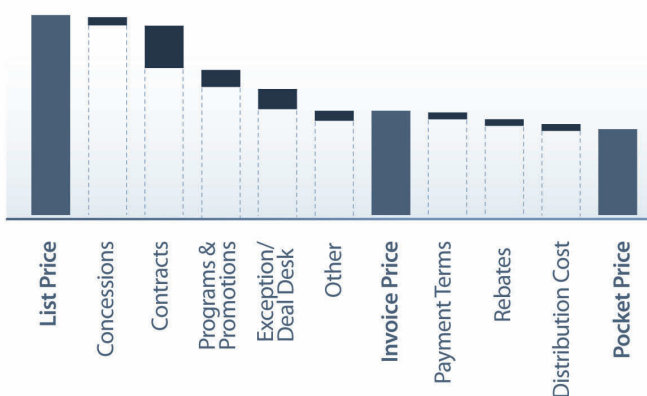
Beyond the Price Waterfall

The Price Waterfall is a great tool for understanding the effect of pricing and discounting – but it's only a starting point. It is of limited value if it is not preceded and accompanied by efforts directed at the other influences on the pricing operation. Properly linking the Price Waterfall to them is indispensable to gain control over how much actually ends up in the company's pocket.

Managers in pricing, sales operations, and finance often try to employ the Price Waterfall (PW) as a tool to control and manage pricing and discounting. The PW – a chart showing revenues cascading down the multiple steps from list price to invoice to pocket price – can indeed be a powerful way to visualize the chain of transactions leading to money in the company's pocket.

However, this paper will show that the PW by itself doesn't lead to effective pricing execution. In fact, the PW can wind up as just another financial tool that disappoints. It can even be misleading, if it is undertaken without a correct understanding of the levers involved in the organization's pricing processes, without sustained maintenance of the information systems that support it, and without trained practitioners in charge of making pricing decisions.

Fig. 1 - A typical price waterfall



To make the PW chart a real management tool, a sales organization has to build its PW as part of a larger process of assembling a coherent pricing ecosystem. Management has to be able to map the elements in the chart to actual activities and process steps in sales operations. The Increasing



Complexity of Pricing Execution

As a company grows, the complexity of its pricing structure and processes can grow exponentially. The organization introduces new products and services. A “solutions” approach to sales and customer relationships multiplies the permutations, so that nearly every customer has its own pricing structure. The sales organization faces a pricing nightmare as it attempts to cope with a huge volume of quotes and proposals.

The organization must address these kinds of challenges with an increasing level of sophistication in the systems it uses to organize, collect, distribute, and consume relevant pricing and discounting information, and in the way it organizes itself with internal and external stakeholders.

A waterfall in an actionable discount-management process is built on operational elements

The PW, introduced during the early 1990s, has enabled companies to implement effective discountmanagement practices and diagnose revenue leaks.

However, designing and identifying the components of the PW requires more than just calculating the economic profitability of transactions as defined by pocket price or margin.

The Price Waterfall Must Map to Real-World Operations

To employ the PW in an actionable discount-management process, managers must build a strong foundation on operational elements found across the complete pricing cycle. Building this foundation means mapping the components of the PW directly to two types of activity:

1. The activities or process steps that lead to the actual preparation of a quote or proposal, and
2. The activities or steps that happen once an order is booked.

So, for example, if the company routinely includes contractual discounts in its commercial offers, the PW must be designed with those discounts as elements. If the company grants additional credits as back-end rebates conditional on some event after invoicing, those rebates have to be built into the PW as well.

A PW can help practitioners detect pricing leaks, that is, undesired or unplanned price concessions. But this works only if the components of the chart are mapped adequately to the causes. If they are not, the PW fails as a control tool, since the information from the chart can’t lead to any practical or actionable conclusion.



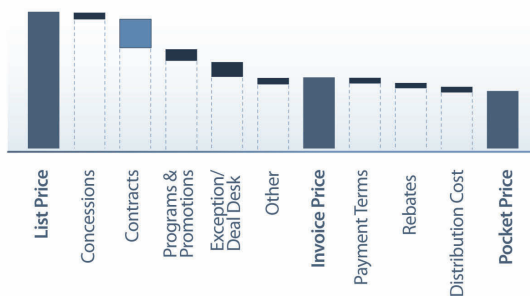
Thus, one of the key first steps in building a PW is thinking about how it is to be used in a practical sense and what are the necessary operational areas that map to its components.

If it is not possible to create that mapping, or if there is not enough detail, the designer of the PW must make operational changes to generate the data needed; this will include both the type of data to be generated and the granularity of it. The various elements must be designed to provide a viable level of detail needed to accurately reflect the underlying economics of the chart, perhaps exploding a given type of pricing concession into its constituents. (See “Example: Defining the Elements of a Price Waterfall Chart.”)

Another PW consideration is its relation to overall pricing execution. Pricing execution builds on each transaction, which in turn is possible because process, people, systems, and policies are in place. An incorrect understanding of the pricing levers when designing the PW, short-lived maintenance of the information systems that support it or a poorly trained audience in charge of making pricing decisions with it can make the PW less effective or even misleading. Building a

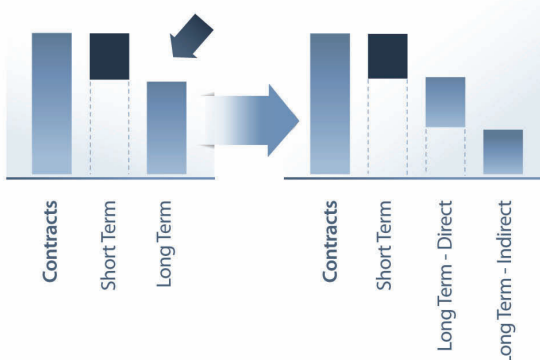
Example: Defining the elements of a Price Waterfall Chart

Fig. 2 - A price waterfall with contractual discounts



In a typical chart such as this one, components are presented in an oversimplified fashion. For example, contractual discounts (“Contracts”) are lumped together in one bar, as if they were a uni-

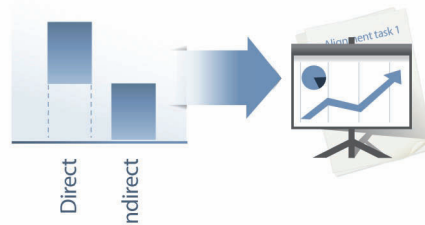
Fig. 3 - Delving into higher levels of detail



In reality, though, the company in this example carries contracts with different characteristics and economics (e.g., “Short Term” and “Long Term.”) Presenting them in such a high-level fashion is insufficient, as the chart cannot track significant differences across contract types.

As things stand, the company cannot express the natural split of contracts – which can create problems if the company is having trouble managing details in one particular type of contract (for example in “Long Term Indirect” contracts). Problems will be multiplied if the company lacks a clear policy for sorting out contracts and the process to enable that policy.

Fig. 4 - Shifting to an actionable waterfall



Correcting such a situation and getting to an actionable PW requires a series of adjustments to the sales and pricing operation over time; so the PW has to be designed for today’s conditions (even if they are insufficient right now for full pricing execution) and then transitioned to achieve the desired future state.



Coherent Pricing System: How to Get Started

As mentioned above, building an effective PW as a tool for pricing execution must be viewed in the context of a coherent pricing ecosystem. Such an ecosystem includes such elements as:

- Strategy
- Processes
- Policies
- Information systems
- Decision making
- People

How does a company start building a coherent pricing system, and, thus, effective pricing execution? Following are the steps we recommend in our client engagements.

Step 1: Visualize the pricing cycle

Start by visualizing the specific steps that make up the pricing process and the pricing architecture.

The pricing cycle is a structured repetitive routine, performed by decision makers, comprising all the process stages necessary to produce final and definitive prices to be communicated to the next party, whether a direct customer or a channel or distribution partner.

The cycle typically starts with pricing strategy and planning, often merges with product and service configuration, and continues with price setting and publication – e.g., list, dealer, partner, market, or retail prices. Next, embedded in the sales cycle, comes pricing execution, during which prices are negotiated with or redefined to the next party. Finally, after a period of time (and some orders, one hopes), comes a review and adjustment of the prices. The pricing architecture is reflected in the components of the PW, which is structured to communicate value and manage transactions.

Step 2: Evaluate pricing execution as it exists today

Identify how activities are executed today in each of the stages of the pricing process, and identify gaps or areas where performance falls short.

Once the company has listed the specific pricing steps, it should break them down to a level of detail that allows clear definition of inputs, outputs, and metrics that indicate whether the process is performing adequately. For example, for the phases of design, implementation, and tracking of promotions, management should identify the participants in each of those phases and their corresponding goals and evaluation criteria. Performance metrics must be defined according to the perspectives of those stakeholders. The design team must ask, how will managers and supervisors judge that the job is well done? Going through this evaluation process will identify issues that must be addressed.



This activity is essential to building a PW that is an effective tool for management to monitor the financial progress of pricing execution and its operational underpinnings.

Step 3: Detail the issues to be addressed and their priority and sequence

This step requires project leaders to gain the perspectives of all stakeholders and enumerate priorities in the optimal fashion. Obviously, there will be tradeoffs all around. Priorities are a function of many factors – strategic, operational, economic, and human – and their definition needs to take into account the expectations of all stakeholders and balance them out.

Building an effective and coherent pricing process requires an integrated view of the operation and involves optimizing the whole, not just the parts. It could be that various activities will end up operating at suboptimal levels to ensure that the company as a whole reaches the highest level of performance at the end.

This stresses the importance of executive level support for construction of the pricing framework and resulting PW. To decide what trade-offs will be made requires the perspective and authority to set priorities and to make sure that operational performance is tied to financial and customer-related metrics. Otherwise, the organization is at risk of undertaking a costly and time-consuming operational project with unclear outcomes.

Step 4: Execute

The rest of this paper will be devoted to issues of execution. The reader will no doubt find abundant literature about pricing strategy and some of the possible tactical actions. We find, though, that practical and operational ways of execution are seldom addressed.

A PW without complementary analytical and monitoring tools and the proper environment will perform much lower than expected in helping an organization deal with price monitoring, alignment, and revenue leaks.

In our experience, this discussion of PW and pricing execution warrants a warning about the purchase and adoption of IT systems: Don't make decisions around technologies too early in the process of building the pricing system.

The performance of waterfall is dependent on complementary tools and a proper operational environment.

Hold off on selecting a software solution until you have acquired enough operational depth and you understand what the overall process is supposed to achieve. Technology tools and processes must be designed and specified to balance and support each other. If the IT system is chosen too early in the analysis, processes will end up getting defined to conform to the technology.

Most companies understand that capital expenditures by themselves are not a panacea. However, the temptation can be great to embark on a capital project in response to vendors' marketing of "solutions," especially if the word "solution" is nothing but a euphemism for the vendor's software product. The timing of adoption should be just right, so that "white elephants" don't proliferate.



What Are the Alternatives for Action?

To undertake pricing execution leading to an effective PW tool calls for a scarce but essential asset: expertise. So the execution phase should begin with a search for expert assistance. Experience in just one stage of the pricing cycle is not enough. Following are the principal alternatives for bringing expertise to the project.

Pricing execution efforts require expertise and experience in multiple stages of the pricing cycle

1. Search for internal expertise

Think creatively. Pricing expertise doesn't necessarily reside only in the pricing strategy function. Pricing is a multidisciplinary process that relies on inputs and decisions from many corners of the organization.

For example, the approval of discounts and the negotiation and management of contracts involve people in customer support, legal, and channel operations, as well as other areas not usually thought of as hosting pricing strategy.

If internal expertise is not available or feasible, try the next approach.

2. Complement internal expertise with external support

Bring in external expertise to complement your team. Look for a provider, not just with the ability to formulate recommendations, but with a proven track record at solving cross-functional problems, from strategy to operational improvements and analysis.

Likely you can find highly-specialized individuals and assemble a team of experts from different areas (e.g., one strategist, one operations person, one accounting expert, etc.) Nevertheless, it is indispensable that the team leader and most of its participants have dual skills in "thinking" and "doing" across disciplines. Use this criterion to select specific external talent.

3. Get external and unbiased assessment

If the internal sourcing and hybrid approaches discussed above seem insufficient, bring in an outside firm offering expertise and extensive experience in end-to-end project design and implementation.

You need someone with experience from assessment all the way through to implementation, even if you don't anticipate needing implementation support. This makes a big difference, since experience with real-life projects gives decision makers a more down-to-earth, practical perspective, and allows them to make the critical calls around priorities in terms of urgency and importance.

4. Develop a change management plan

As any implementation practitioner knows, change management (CM) requires executive support and cover for change agents if they are to act effectively. Building a coherent pricing process is no



exception, given the crucial steps of assessing the existing pricing process and setting priorities and making adjustments. The principles and practices of CM apply in PW projects as in other organizational efforts. But two additional points should be made:

1. The person in charge of coordinating the overall effort must have enough crossfunctional, cross-domain expertise to adequately assess all options and provide a balanced view of the pricing-cycle situation within the company. An individual with a single-functional track, without exposure to other disciplines and roles, naturally forces a bias toward one-dimensional assessments and decisions. This is not a disqualification but a warning flag.
2. A basic caveat: A project like this can run up against the same obstacle as any other change or innovation effort, namely, resistance to change or to acknowledging deficiencies in one's own operation or domain. As a consequence, the diagnostic can suffer from lack of balance and transparency. Internal measurements or benchmarks tend to promote the status quo, and external benchmarks or experience get dismissed. Thus, critical pain points get ignored, even if the overall effort to assess the pricing process is undertaken.

Look Beyond the Price Waterfall

The PW is a valuable tool for analyzing the company's pricing process and its effect on revenues. But don't fool yourself into thinking that building a PW is enough to execute pricing. It is of limited value if it is not preceded and accompanied by efforts directed at the other influences on the pricing operation. Overlooking these other elements reduces the company's chances of completing an actionable PW, and it prevents the organization from truly monitoring financial performance and addressing the root causes of business and operational inefficiencies. The more complex your business becomes, the easier it is to miss the opportunity to execute your strategy through pricing.



About the Authors

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About Sales Economics

Sales Economics provides innovative business solutions to increase the profit contribution of any sales organization. SE helps clients win more and better business, increase their bidding efficiency, and lower the cost of selling and supporting activities.

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