The Pricing Evolution:
The Perfect Storm Compelling Retailers to Shift from Rules-Based to Optimized Pricing

Table of Contents

Abstract ................................................................. 1
The Perfect Storm .................................................... 1
The Pricing Evolution ................................................ 1
The Impetus to Progress along the Pricing Maturity Curve .......... 2
Evolutionary, not Revolutionary, Transformation .................... 4
Optimization becomes Table-Stakes ............................... 5
Abstract

The siren’s song of rules-based pricing solutions is tempting, however business rules are only one, albeit one very important, component of a comprehensive optimized pricing strategy that enables retailers to compete in today’s complex retail environment. This paper explores the evolution of pricing that has made optimization table-stakes and has required retailers to supplement business rules with data, science, analytics and strategy in order to survive and thrive.

The Perfect Storm

Historically, technology, data and analytical limitations forced retailers to use gut-feel, spreadsheets and rules to make pricing decisions. However, a trio of conditions has created a perfect storm that has compelled retailers to evolve and mature in pricing sophistication:

- Competitive Environment: Fierce & continuously shifting
- Data Deluge: New sources, increased frequency & granularity, lacking cohesion
- Empowered Shopper: Savvy, digital, social & price sensitive

The speed, the cost and the integration of the complex componentry required to process the enormous volumes of data and rapidly adapt to this constantly shifting landscape were beyond the budgets and bandwidth of most retailers for many years. However, the recent convergence of infrastructure technology (server, storage), optimization and Software-as-a-Service (SaaS) now enables retailers to achieve intelligent, strategic, granular shopper-centricity at speed and scale without requiring extensive consulting, teams of scientists, armies of people or breaking the bank.

The Pricing Evolution

The evolution of pricing has taken place over a number of years as this perfect storm has developed. In concert with this, optimization has also evolved by embracing each of the evolutionary stages and incorporating them into a pricing process that enables retailers to transform as the landscape continues to morph.

![Pricing Evolution Diagram](image-url)
The Impetus to Progress Along the Pricing Maturity Curve

It all began with cost-plus pricing because retailers recognized that they needed to not only generate traffic, revenue and growth but they also needed to sustain profitability to remain a going concern. This concept worked for many years, particularly when competitors were not on their doorstep (physically or virtually) and the cost/volume advantages of the retail giants were not yet unsurmountable. **Tacking on a minimum margin requirement was a quick and easy way to automatically determine the price of a product when pencil and paper were the typical tools used for calculating prices.**

As the competitive landscape began to shift and category killers and big box stores began capturing significant market share, the need for price matching and other forms of competitive indexing became apparent – because shoppers were less loyal, more price sensitive and prone to deal seek.

Many retailers made the mistake of price matching on too many products and were unable to profitably compete – so key value item pricing (used to maintain consumer price perception) became popular because it enabled retailers to remain competitive on the products that were critical to their price image while still maintaining their minimum margin on the rest of the assortment.

**Again, indexing was an easy way to apply a pricing rule to automatically determine the price of a product.** However it still left the decision on which items drove price image, what competitor to target, and how much to index, to gut feel. It also made retailers highly dependent on data collection processes that were inaccurate and error prone and on pricing strategies that followed others rather than led through deep understanding of the drivers of their own shoppers' loyalty.

Dangers associated with this type of pricing philosophy include the intrinsic assumption that another retailer has a better pricing strategy as well as the potential for excessive price image execution gaps when a retailer follows a follower. For example, if Retailer C collects competitive pricing data on Retailer B who in turn follows Retailer A. Retailer C can be weeks, or even months, behind the price image being projected by the price leader by the time each of the retailers in the chain has collected, processed and executed their price changes.

But price indexing rules targeting specific competitors did work for many years, until format encroachment blurred the lines between competitors and geographic growth created environments where different competitors for different products were competing in different channels and markets.

So retailers entered the third phase of the evolution which enabled them to differentiate their pricing for groups of stores in different environments. Initially, zones were based on proximity to a DC and/or some form of regionalization. This first generation of zoning drove up the number of zones actually required to differentiate pricing and **neither pencils nor spreadsheets could keep up with the data volumes at speed and scale.**
Price zones continue to evolve and now tap into both shopper demand and competitive data in order to enable differential pricing that is shopper-centric and cognizant of competitive positioning goals. **Science enables the derivation of store clusters that are appropriate for differential pricing and determines the optimal number of groupings** – ensuring that the benefit achieved with adding another price zone more than offsets the operational costs associated with adding another store cluster.

Using optimization solutions, retailers are able to bring in all forms of competitive data including shopped data, online data scrapes and market data to achieve targeted competitive positioning that recognizes and responds to very different competitive environments and shopper behavior patterns for different products in different markets and channels.

In conjunction with this movement from pencils to spreadsheets to software solutions was the introduction and evolution of the discipline of category management.

This again changed the game for retailers as growth forced them to segment their businesses – it enabled them to put a structure around the explosion of growth in the number of products they were carrying and created a system for classifying products into distinct groups. It also introduced the concept of category roles and, for the first time, **retailers recognized the fact that products could be used to shape the way shoppers perceived their brand and shopped their stores.** This resulted in the creation of category strategies designed to support these roles.

The real challenge came when category managers were unable to translate the high level strategies developed in the executive suite into action at the store level. **Pricing became more complicated as specific tactics associated with the different category roles and strategies came into pricing decisions** – they could no longer simply apply rules for margin and indexing, they needed tools to help them drive to specific strategic objectives.

Although computing power at the desktop had increased dramatically over this period, the amount of data to be analyzed was increasing even faster and spreadsheet capacities were exceeded. At the same time, shopper price sensitivity hit an all-time high, costs were increasing and margins were squeezed to the breaking point. Retailers went on a massive cost cutting spree – to the point where no more costs could be cut operationally but they still needed to find additional margin.

**They turned to demand-based science to analyze and predict shopper behavior at the store/item level.** These forecasts create the backbone of a process-driven, fact-based approach to pricing that systematically operationalizes internal and external data, enforces business rules and competitive indices, prioritizes decisions within operational constraints and enables retailers to take strategic, targeted action at speed and scale.

Optimization’s science and analytics permits retailers to:

- Simulate the impact that alternative strategies, rules and constraints have on sales, units and margin to ensure that optimal strategies that maximize their return on the entire category portfolio are selected
- Unemotionally select and limit KVI’s to the ones that truly drive price image
• Ensure investments made in price image are more than offset by margin gains on less price sensitive items

This shopper-centric approach to pricing incorporates all the components of the evolutionary timeline because retailers recognize that what used to work is no longer working and the only way to grow market share in a zero sum game is to drive loyalty through precise execution of targeted strategies.

And the future will continue to require more granular, adaptive and predictive capabilities as retailers move to segmented and personalized pricing to meet the demands and gain the loyalty of the empowered consumer. Changing the focus of everything they do from product-centricity to shopper-centricity, and doing it profitably, depends on understanding and exploiting variation in shopper and competitor behavior in different channels, markets and stores for different categories, sub-categories, item groups and products for different seasons, holidays and events.

Evolutionary, not Revolutionary, Transformation

Transforming a business from gut-feel, spreadsheets and rules to shopper-centric, strategic pricing is an evolutionary process that needs to be paced to the sophistication level, resources and bandwidth of each retailer. Many retailers take a ‘crawl, walk, run’ methodology when implementing an optimization solution.

• The crawl stage systematically operationalizes data inputs and puts a process-driven structure around pricing by automating the enforcement of business strategies, rules and operational constraints.

• During the walk stage, retailers become more strategic and granular in their pricing decisions. Then, as confidence in the recommendations build, they start to dial up the use of price elasticity as a component in their strategic decisions.
The run stage is an iterative process that enables retailers to become increasingly sophisticated in their decision making processes, ensuring that pricing strategies and tactics are tuned and aligned with shopper and competitor behavior.

Depending on the appetite for change and level of pricing sophistication, retailers can go from crawl to run in months or years. But one thing has become apparent, retailers must embark down the path to pricing sophistication in order to profitably drive loyalty.

In a recent whitepaper, Using Big Data to Make Better Pricing Decisions, McKinsey & Company states:

“It's hard to overstate the importance of getting pricing right. On average, a 1 percent price increase translates into an 8.7 percent increase in operating profits (assuming no loss of volume, of course). Yet we estimate that up to 30 percent of the thousands of pricing decisions companies make every year fail to deliver the best price. That's a lot of lost revenue. And it's particularly troubling considering that the flood of data now available provides companies with an opportunity to make significantly better pricing decisions. For those able to bring order to big data's complexity, the value is substantial.”

Optimization Becomes Table-Stakes

Gartner goes even further in their endorsement of the power of optimization:

“A successful price optimization and management (PO&M) implementation can increase margins by 50 basis points or more, and increase revenue by 2 percent to 4 percent. Based on this success, price optimization has shown steady growth during the past two to three years and has found its way onto the CxO’s agenda, aligning closely with executive priorities of revenue generation, customer acquisition and profit/margin improvement.”

The Gartner analyst also notes that:

“Managing price optimization through internally developed spreadsheets and data base tools is no longer viable. The increasing sophistication and capacity of the analytic, data, and application tools used for PO&M are increasing the granularity of pricing, while the growing volumes of data, the ability to use advanced analytic and visualization tools to enable the parallel analysis of product and price data, market segment insight, sales and customer data, inventory and competitive data, and the integration of both internal and external data sources are enabling the ability to create and manage microsegments.”
Optimization meets all of the evolutionary requirements, permitting retailers to propel themselves along the pricing maturity curve at their own pace and within their bandwidth by:

- Tapping into vast amounts of internal & external data
- Enforcing business rules & operational constraints
- Enabling competitive positioning at the most appropriate levels
- Analyzing shopper behavior & price sensitivity at the most granular levels
- Ensuring that strategies are translated into precisely executed pricing tactics
- Simulating alternatives & prioritizing decisions
- Measuring effectiveness & adapting on-the-fly

Although rules-based pricing is tempting in its simplicity, it is unable to recognize and adapt to rapidly changing shopper and competitor behavior or strategically maximize profitability at the speed and scale required to survive and thrive during this perfect storm.
About Revionics, Inc.

Revionics delivers the industry’s most powerful *End-to-End Merchandise Optimization* solutions, enabling retailers of all sizes to execute a fact-based Omni-channel merchandising strategy utilizing the most comprehensive set of shopper demand signals to enhance financial performance with improved customer satisfaction. Revionics’ solutions leverage advanced predictive analytics and demand-based science to ensure retailers have the right product, price, promotion, placement and space allocation for optimal results across all touch points in the Omni-channel shopping episode – online, in-store, social and mobile. Offered on a scalable, high performance Cloud-based SaaS platform, these solutions future-proof retailers from Big Data/Fast Data challenges, while providing speed-to-ROI. Over 37,000 retail locations globally and $150+B in annual revenue across grocery, drug, building materials, convenience, general merchandise, discount, sporting goods stores and eCommerce sites optimize with Revionics’ solutions. Revionics has been recognized as a *2012 Deloitte Technology Fast 500™, Red Herring Top 100 Global, Red Herring Top 100 Americas* and *JMP Securities’ Hot 100 Software Company*. For more information, please visit www.revionics.com.