PRICING ACROSS BORDERS

HOW SMART MANUFACTURERS MAXIMIZE VALUE

By Just Schürmann, Amadeus Petzke, Frederik Böttcher, and David Langkamp

It's a fundamental axiom that prices vary. The differences reflect the economics of the manufacturer and the customer, the value of the product to different buyers—including their willingness to pay—and market-specific competitive circumstances. In B2B and B2B2C markets, where quantities and contracts can be large, competition fierce, and value chains complex, there's typically plenty of room for negotiation.

It ought to be an axiom that prices do not recognize borders, especially in free-trade zones such as the EU (where geographic distances are short), ASEAN (the Association of Southeast Asian Nations), and Mercosur in South America. Buyers in large national markets, such as the U.S., can also shop across neighboring regions, where prices are often different.

Almost anywhere these days, when prices get out of line in one place, manufacturers can quickly find themselves being undercut nearby—by sophisticated buyers, by their own sales teams, or by a third-party player pursuing an arbitrage strategy. On the other hand, if the manufacturer doesn't price aggressively enough, it can leave revenue and profit on the table.

Cross-border pricing has become a high-stakes game. Sophisticated manufacturers invest substantial time, money, and resources in building the knowledge, data, policies, and systems that enable them to set prices at the point where they maximize revenues and margins across their entire product and market portfolio, just as they would if they were pricing for a single customer in a single market. This article explains how all companies should approach cross-border pricing.

Predators from Without—and Within

Companies that don't tackle pricing in a strategic and concerted manner, and especially those that allow too much flexibility at the local level, are likely to face a number of cross-border predators—not all of them external. Price discrepancies across

markets open the door for so-called gray imports—products destined for one market that end up being sold in another. Professional purchasing departments of large customers, whose primary raison d'être is to get their company the best price on the best terms, are highly effective at taking advantage of these opportunities, often playing sales teams off against each other—including sales teams from the same company with different geographic territories. These buyers have sophisticated systems that track marketplace developments on a regional and global basis, helping them decide what to buy where and at what price. They are often much better informed than the manufacturer or the manufacturer's sales teams.

Large grocery retailers are especially effective at spotting price differences among markets and using those differences to their benefit in negotiations. One leading grocery retailer imported through gray channels half of all the cases it purchased of a particular product and bottle size, with the dual goal of reducing the average purchase price for that SKU and increasing the pressure on the spirits manufacturer to reduce prices on its other products.

For a manufacturer, the aggregate impact of the purchasing decisions made by such buyers, which we call Value@Risk, can be enormous. Manufacturers don't lose out by selling less; they forgo revenue by selling the same amount at lower prices—and the bottom-line impact can be even more pronounced. (See Exhibit 1.) A Value@Risk analysis for one global consumer-products category leader revealed that 4 to 5 percent of its total revenue was in jeopardy because of cross-border pricing—which translated to more than 10 percent of its EBIT. We have seen other cases where the profit at risk is up to one-third of the company's total.

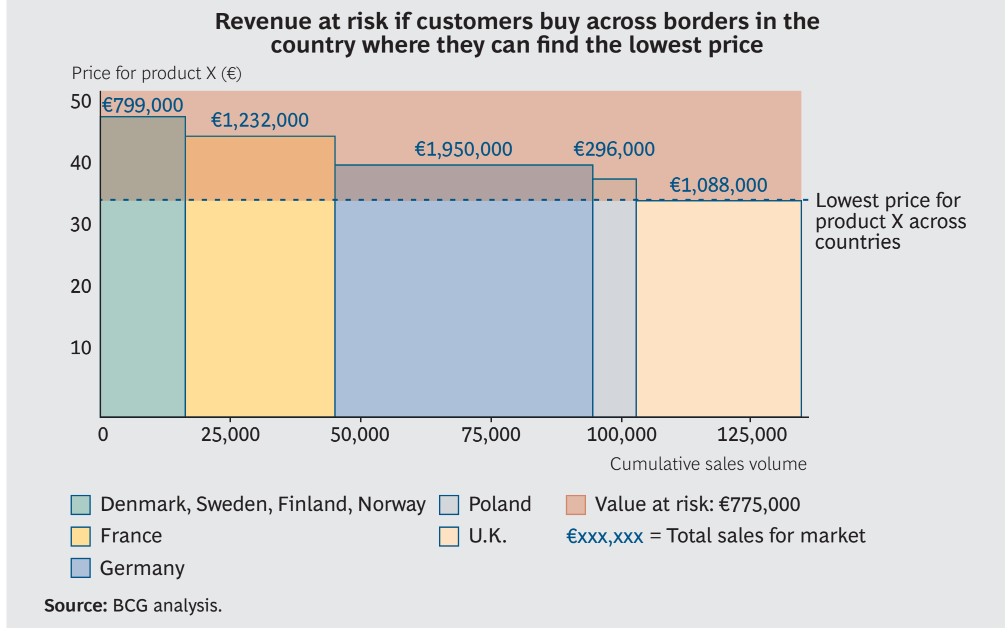
Trade buyers are not the only pricing predators. In some industries, professional arbitrageurs make a handsome living by buying low in one market and selling high in another. It's not uncommon for manufacturers to have wide enough pricing spreads for such players to realize their own margins of up to 10 percent. These pricing professionals have invested heavily in their trading capabilities, and the Internet has given them the additional ability to spot and exploit product-by-product opportunities. They too are experienced at negotiating with country-by-country sales teams.

Again, the quantities can be large and the values substantial. More than 10 percent of all tires sold in Europe, for example, end up mounted on a car in a different country than the one in which the tires were originally sold by the manufacturer. Low-weight, high-margin items are particularly susceptible to cross-border arbitrage because transportation is cheap. Manufacturers must resist the temptation to create "island solutions"—situations in which they price too aggressively either when they see an individual market opportunity or when they are overly eager to meet margin expectations of local distributors. In both of these scenarios, manufacturers put substantial value at risk.

Consumers play at arbitrage as well. Large price differences from the manufacturer to the retailer often translate into wide price spreads at the store. The Internet—and increasingly the smartphone—have leveled the price playing field: consumers have near-total transparency at their fingertips, and they can access any store, anywhere, anytime. More and more consumers are willing to cross borders in search of the best deal, particularly in branded segments in which emotion plays a big role in the purchasing process. Fashion is one such example. The risk to companies in this instance goes beyond lost revenue; it can undermine brand strategy. If a company is seen to price its products inconsistently over time, this calls into question the products' value—for consumers and retailers alike.

Other factors, such as currency fluctuations and shifting fuel and raw-material costs, also affect cross-border pricing decisions. They are mostly outside any company's control; nonetheless, they need to be factored in as manufacturers determine how to set prices.

Exhibit 1 | Value at Risk of a Sample Branded Consumer Product



Source: BCG analysis.

Five Imperatives for Cross-Border Pricing

Manufacturers can do five things to minimize the loss of pricing-related revenue and maintain (or regain) an advantage in dealing with their customers and distributors.

Regain the information advantage. The first is to regain the information advantage over customers—or at least establish information parity. The objective is not to give all buyers the same price but rather to balance the risk of charging more in one market with generating maximum profits overall. A good Value@Risk analysis should answer the following questions:

- Which customers are likely to take action when prices vary across markets?
- At what price differentials does the manufacturer create an incentive for buyers to shop across borders or an opportunity for arbitrageurs to step in?
- How big are the current revenue, volume, and profit exposures by market, brand, and product?

To fully appreciate how much value is at risk (and the potential knock-on effects of different pricing scenarios on consumer prices), manufacturers need to understand the economics of the entire value chain, including gaining insight into their customers' business models. For example, how many intermediaries (distributors, wholesalers, retailers) does the product pass through before it reaches the end user? How profitable are these players? In which sales channels do they earn money and where are they more likely to feel squeezed?

To gain this kind of understanding, most companies need to systematically improve their market intelligence, especially when it comes to monitoring prices further down the value chain, by either tapping into available sources of information or creating new ones. Manufacturers can access some of the same resources as their customers, such as consumer data vendors and B2B platforms conducting commerce between intermediaries and buyers.

This is not a complicated undertaking. Companies should start by looking at the products and distribution channels most at risk with the resources available now. The foundation of a solid Value@Risk analysis can be laid in a few weeks. One senior manufacturing executive put it this way: "We'd known for quite a while that our pricing architecture created arbitrage op-

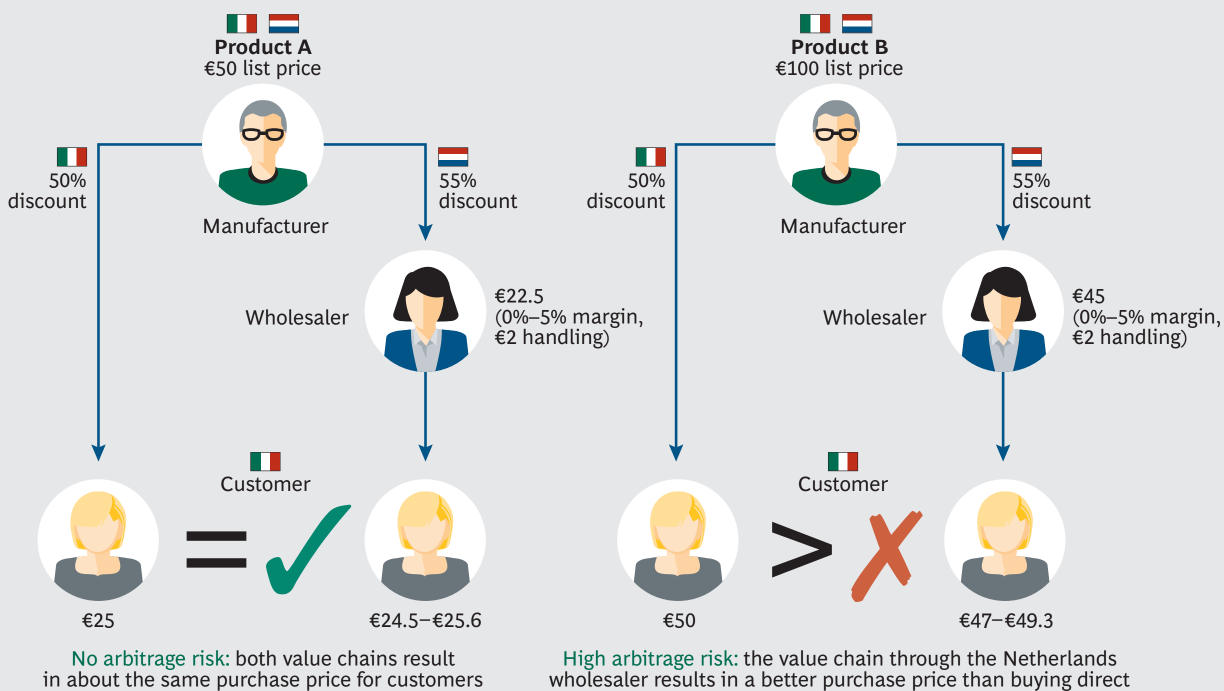
portunities, but we were blind in terms of the actual business opportunities. Conducting a systematic analysis of the economics along the value chain was eye opening." (See Exhibit 2.)

Apply a rigorous pricing policy. Once they have developed a robust risk assessment, manufacturers should apply a rigorous pricing policy. The key is to set clear cross-country pricing guardrails by product, which on the one hand mitigate arbitrage risk and on the other hand give sufficient flexibility to each market to set its own prices according to local demand. Achieving the right balance of local flexibility and central control can be difficult and may require experimentation and adjustment over time. The policy also needs to provide for clear escalation mechanisms, under which well-grounded exceptions can be granted to satisfy local business requirements.

Enforce effective governance. Policy in place, the third imperative is to establish an effective mechanism for pricing governance. The primary objective is to dismantle the country-specific organizational "silos" and prevent sales teams from optimizing their results (from their point of view) by pushing volume locally instead of balancing shipments with company-wide profitability. In our experience, most companies have an organizational bias toward volume. No sales rep ever got fired for exceeding plan, while plenty have been sacked for underperforming—even if the plans were known to be overly ambitious. The pressure to get the deal done typically does not take into account margin impact. This dynamic can be a big cultural hurdle to overcome.

Manufacturers can foster consensus decision-making through a centralized pricing entity or a coordination mechanism that encompasses relevant markets, such as a pricing center, or "war room." The latter can be particularly effective when a high degree of attention is needed over a short period of time—something most organizations and processes are not set up to facilitate. A number of industries have active "negotiation seasons," in which two-thirds or more of an entire year's business is agreed upon in a period of weeks or months.

Exhibit 2 | Value Chain Analysis Reveals Cross-Border Arbitrage Risk



Source: BCG analysis.

The war room of one automotive-parts manufacturer handles most of the company's annual orders in a negotiation season of two months. A centralized team uses its own data and market intelligence to set a baseline of target price ranges by product, customer type, and country. Within these guardrails, local sales teams negotiate deals. Weekly meetings with the sales directors of each country are used to assess actual pricing for each deal, as well as progress with customers still in negotiations. Participants share the latest market insights and help build an information advantage for negotiations elsewhere. They can also discuss whether exceptions from the guardrails may be necessary to come to an agreement with particular customers. Following a clear decision-making hierarchy, the group determines whether to allow an exception or seek more senior-level involvement in the decision.

The move from silos to more consensus-based decision making is a big change for many companies. The effort can play out over several pricing periods (often meaning years) and require training and other initiatives to foster shifts in approach and mindset and to develop a mature and well-oiled pricing operation.

Reset discounts and rebates. Most companies approach discounts and rebates from a historical perspective—"this is the way we've always done it"—rather than as an investment on which they can realize a return. Optimizing pricing execution requires the right discount and rebate systems, based on strong pay-for-performance incentives. The objective should be not only facilitating immediate sales but also rewarding joint business development over time.

The advantage of using rebates and other incentives rather than invoice discounts is that the incentives can be tailored to local circumstances. They make prices less comparable, moving from apples-to-apples to apples-to-peaches, thereby reducing the risk of cross-border trade. One example of such a performance-based approach is rewarding retailers (especially those that don't import gray-market merchandise) with manufacturer-funded point-of-sale support. Another could be working in partnership with a leading retailer on an omnichannel strategy by which a particular product, or a dedicated size or configuration of a given product, is sold only through that retailer's e-commerce capability at an attractive price point for consumers.

Enable the organization. Manufacturers that want to succeed at cross-border pricing will undertake a comprehensive enablement program. They will tackle all the aspects of pricing, from aligning pricing strategy with the overall business strategy to reworking how a company charges for its products to making sure all the pricing enablers are in place—the organization, tools and systems, and people. Getting all these elements to function properly and play in sync is a journey of at least one to two years, in our experience. If a major reset of price levels is needed, the process could take considerably longer, since it will likely require negotiation with customers.

Manufacturers need a clear vision of where they want to go and a game plan that can be realized step by step through each pricing round. Careful planning and execution are required in order to mitigate risk and develop alternatives on how to absorb potential volume losses. Some companies need relatively few fixes, but by quantitatively assessing the downside risk, they will be able to better manage the trade-off between putting margin at risk and realizing the potential upside of more differentiated pricing.

BUYERS WILL ALWAYS seek a better price. The long-term trend in global trade is toward more open markets and fewer barriers to cross-border commerce. Digital technologies open up whole new avenues for buyers and sellers to connect, wherever the companies are located. Manufacturers that invest now in the capabilities—human, technological, and informational—that allow them to price for overall revenue and margin maximization will find themselves rewarded many times over in the increasingly global economy.

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