The potential of pricing

An exploration of how Australian retailers will need to embrace new and more scientific pricing techniques to thrive in the increasingly high-pressure atmosphere of the retail marketplace.
Introduction

‘Price optimisation’ is an approach that can help Australian retailers overcome competitive challenges and tailor pricing to a customer’s need, place and time, in order to maximise profit and revenue in a market where discounting pressures are ubiquitous.

KPMG has teamed up with software firm Revionics to work with retailing clients to ensure they understand their customers’ response to pricing changes, and to implement the best pricing for their needs.

In this report, KPMG and Revionics experts discuss how retailers have responded to the pressures so far, the shortcomings of business-as-usual pricing approaches, and how retail price optimisation enables retailers to identify the right prices throughout their business.
Traditional Australian retailers have rarely been under more pressure from more sources. Years of slow income growth have made consumers price-conscious. There’s new competition from discount retailers, local online-only players and overseas brands selling direct to the public. In recent years customers have learned to explore their options online before entering a physical store.

The headlines tell the story of the challenges faced by Australian retailing in recent times. Electronics retailer Dick Smith entered liquidation in July 2016, heralding a cascade of retailers entering administration, such as Pumpkin Patch and Howard’s Storage World. Marc’s, David Lawrence, Topshop and SurfStitch have entered voluntary administration. Meanwhile, the media is foreshadowing the arrival of a new wave of international retailers operating a range of categories and formats, including Kaufland, Decathlon, and online giant Amazon.

Magnus Gittins, of KPMG’s Strategy Group, says: “The external factors – the global entrants coming in, the price transparency online – all of this is putting margin pressure on the retailers here.”

These pressures have been building. KPMG’s 2015 Pricing Study reported that 57 percent of Australian companies believed there was some form of ‘price war’ in their industry. A 2016 Reserve Bank report even cited retail competition as a key factor in keeping down Australia’s inflation rate. ¹

**Confront the retail squeeze**

Some retailers have reacted to this squeeze by focusing on reactive tactics such as price matching or promotional activity to stimulate customer engagement, explains Gilhawley. However, without an underpinning investment in technology to understand drivers of margin performance and to gain insight into which ‘levers’ in the business activate customers, these campaigns inevitably run out of steam leading to margin erosion.

## The challenge facing Australian retailers

Ronan Gilhawley, Head of Retail, KPMG, identifies two factors that make many Australian retailers particularly vulnerable to price pressure. The first – that they lack the economies of scale of the international entrants and the largest Australian players – is largely out of their control due to a general lack of international diversification.

The second is that many Australian retailers have failed to establish a differentiated positioning – whether in product or range innovation, store experience, service proposition, or customer insight – that would allow them to resist pricing pressures.

“They’re quite exposed to the double whammy of smaller scale but heavy discount pricing pressure. We’ve seen a number of exits, and suggest you’ll actually see continued exits in the market in the near-term due to these pressures,” Gilhawley says.

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The move to continuous promotion cycles has somewhat desensitised consumers to the effects of promotions.”

Jonathan Attia, Associate Director, Strategy Group, KPMG

Jonathan Attia, of KPMG’s Strategy Group, notes that continuous promotions will reduce customers’ propensity to pay when items are not discounted, as they wait for a promotion. Simply ‘investing’ in price discounts through frequent promotions across whole ranges is too unsophisticated in today’s environment, when competitors are using much more scientific means to drive specific results for specific items. Retailers need to use data insights to understand what type of promotions, for which products and over what timeframe, will optimise results.

Gilhawley, Gittins, Attia and other KPMG experts have a better solution to this retailer squeeze: smarter pricing, and particularly a process called ‘retail price optimisation’. To bring retail price optimisation techniques to the Australian market, KPMG is working with global price optimisation software firm Revionics.

Bring science to pricing
Retail price optimisation analyses how customers respond to different prices in retail channels, and then identifies the prices that will best meet a retailer’s aims — higher profit, for instance. It does this with a mathematical model that adds science to pricing — crunching data on prices, sales, inventories and other important factors.

“The science can enable fundamental decisions at the product level in terms of trading off between enhancing your revenue or enhancing your margin dollars,” Gittins says.

Revionics estimates that determining appropriate prices in this way can provide a business with gross margin improvements ranging from 2 percent to 20 percent (see page 3).

Retail price optimisation may sound daunting, but software has made it feasible to do the calculations and present the results in an actionable form. Attia uses Revionics’ as an example of the recent improvements in pricing tools. For example, the software can provide simple dashboards for various category managers.

“It makes recommendations and shows what the potential results are, and they can make decisions based on simple, clear insights and data,” he says.

Gilhawley says to date, take-up of these tools has been low, in part because of the relative scale of many Australian retailers, and also due to most retailers’ tendency to prioritise investment in ‘front of house’ over ‘back of house’. For many, retail is still an art, not a science, despite the increasing complexity of their environment due to the impact of technology such as social media, price comparison sites, omni-channel demand and fulfilment, and borderless competition.

“The traditional approach has been to focus on growth, getting the stores open, getting the processes right, getting the stock in store,” Attia says.

In such businesses, there’s been little time for refining pricing. The prevalence of the franchise model in Australia also stands in the way of better pricing, Gilhawley notes.

However, Gittins says the time is right to drive a new level of sophistication in Australian retail pricing.

“There’s a really interesting opportunity. The toolsets have reached the right maturity, the growth and the focus within the retail organisations has shifted, and they’re now trying to get these sorts of processes right.”

However, as Revionics Chief Operating Officer Steve Leven notes, software alone can’t make retailers change how they do their pricing. Pricing data and pricing analysis must be part of a retailer’s larger strategic plan.

“A lot of the conversations which have come to us are better suited to KPMG,” Leven says. “The most successful retailers have recognised this is more strategic, and to do it right, you align the tool to your strategy, backed by the right pricing organisation to execute.”
The potential of pricing

To survive in a world of multiplying challenges, retailers need powerful responses. By bringing retail pricing optimisation into their business, retailers can gain new control over their business and move towards the growth and margins they want. “People like to see successful Australian retailers. The margin pressure is getting so strong that if they don’t do something about it then these organisations won’t be sustainable going forward. By doing this you’re creating a more sustainable long-term marketplace,” Gittins says.

Revionics’ Chief Marketing and Strategy Officer Cheryl Sullivan estimates that more sophisticated pricing can bring:

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<th>On general sales:</th>
<th>On promotions:</th>
<th>On markdowns, particularly in fashion:</th>
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<tbody>
<tr>
<td>Gross margin improvement</td>
<td>2% – 6%</td>
<td>10% – 20%</td>
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<td>Sales revenue improvement</td>
<td>1% – 5%</td>
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How it works

Gilhawley explains that optimisation software calculates, among other things, how consumers’ demand for a product alters as its price changes – in other words how ‘elastic’ demand is. Based on this consumer sensitivity, simulations within the software will then reveal the likely sales volumes at different price points for a product. It can find the point where demand for further volume is saturated, meaning a retailer should concentrate on expanding margin rather than sales volume.

Cheryl Sullivan, Chief Marketing and Strategy Officer at Revionics, says the optimisation process can then provide recommendations on the optimal mix of prices to support different retail strategies — for instance, increasing traffic, growing basket size, or enhancing margins. It can be used to find specific tactics for promotions, such as whether an item should be on the front page of a catalogue. It can also tell you when you should shift from driving volume through lower prices to driving margin through higher prices. She says it can also tell you when a promotional offer “shouldn’t be a 25 percent off, it should be a 10 percent off”.

Attia says most Australian retailers are not finding these detailed trade-offs across their portfolio of offerings. Sullivan adds that too many are concentrating their data analytics effort on analysing large amounts of historical data to find out what did happen. Instead, she wants businesses to master ways of using complex and changing datasets to make recommendations on future actions.

“Typically the number one driver for a purchase decision is price.”

Cheryl Sullivan,
Chief Marketing & Strategy Officer,
Revionics

“Adopting a strategic approach to pricing can enable fundamental decisions … trading off between enhancing your revenue or enhancing your margin dollars.”

Magnus Gittins,
Director, Strategy Group,
KPMG
What not to do
For Australian retailers caught in the margin squeeze, one apparent solution is to focus on cutting the costs of doing business. KPMG’s Ronan Gilhawley warns that while unnecessary costs should always be trimmed, deeper cost-cutting risks mortgaging the business’s future, a problem KPMG has seen a number of times.

“You can drive short-term margin improvement through cost-cutting exercises inside the business, but the risk is that you’re actually taking out capability in the organisation.”

A further challenge is the issue of national pricing. Price comparison sites and an increasing consumer tendency to research for larger ticket buys has led to an increased awareness of the need to align online and store prices. Due to the sheer scale of Australia, national pricing also helps to address the issue of perceived imbalances in the way retailers serve rural and regional communities.

Gilhawley notes that while there can be benefits to national pricing, there can also be challenges.

“National pricing can be a blunt instrument, in that it fails to consider the retailer’s opportunity to tailor pricing structures to specific customer needs within a catchment, and fails to consider that different locations will have different costs to serve, whether it is leasehold cost, labour cost, or supply chain cost.”

Gain control
To survive in a world of multiplying challenges, retailers need powerful responses. By bringing retail pricing optimisation into their business, retailers can gain new control over their business and move towards the growth and margins they want.

The benefits of a change in approach are twofold. It results in a lower overall ‘investment’ in price reductions, helping avoid giving margin away unnecessarily. It also delivers to customers an improved value perception of what products are worth.

Making it happen
Many retailers are aware that their traditional promotions have problems. Vickesh Kambaran, Associate Director, Customer & Operations, KPMG, says: “They know what they’ve been doing; they know it’s not working; it’s driving a lot of complexity in their business.”

Reviions has encountered this issue repeatedly in its work with clients on promotions. Reviions’ Cheryl Sullivan sees many retailers continuing to perform only basic analysis of their promotions – “absolute sales, absolute margins” – without analysing the drivers of promotion results and the costs of delivering them.

“A lot of retailers are just reacting. They are promoting just to promote. They spend a lot of time on historical analysis of the promotions they’ve run, but they do not have the ability to predict what they should do,” she says.

Reviions’ Steve Leven notes that some promotions may be cannibalising sales of other products, leaving retailers ill-equipped to calculate their total profit impact or identify better patterns of promotions. He estimates that “a third of the promotions are driving all the value, a third are contributing nothing, and a third are eroding value.”

“A better alternative,” Scott Gillies, Regional Director APAC for Reviions says, “is to use the data on previous promotions as a tool to predict what will perform best in the future.”

Gittins adds that another opportunity to maximise returns on promotion investments is to look beyond their short-term effect. Retailers should aim not only to promote the product’s immediate sale, he says, but to promote longer-lasting changes in behaviour.

“By using more science and understanding the effectiveness of the promotion you can then track that through in the long term and see: Did I actually convert customers to a new flavour variant, to a new premium product rather than the base level product? Have I converted them from the brand name to my private label where I might be getting more margin?”
Case study: KPMG and Revionics deliver a pricing solution

KPMG and Revionics recently helped a client with both strategic insight and a scientific approach to the analysis of pricing data. KPMG and Revionics accessed multiple years of historic transaction data to build a baseline picture of the organisation's current pricing.

The team then used interviews with merchandisers, category managers and customers, as well as competitive analytics, to understand the difference between the reality of current pricing and customers’ perceptions.

That revealed a customer disconnect: the client’s pricing was perceived as being at least 10 percent higher than their competitors’, even though in most instances the client was pricing below the opposition.

KPMG and Revionics then identified key value items – items where the customer was aware of the pricing sensitivity to it. Instead of dropping prices 10 percent across the board to change perceptions, however, the team identified a small subset of products whose prices could be corrected.

“Given pricing is the biggest profit lever and a fundamental driver of purchasing decisions, there is tremendous opportunity for Australian retailers to unleash the potential of pricing.”

Ronan Gilhawley,
Head of Retail, KPMG
How to get started

The best way to start is to develop a price and promotions strategy that is based on the value created for customers, rather than cost-based pricing decisions, or a ‘one size fits all’ approach.

This entails engaging with your partners and customers, and analysing your customer and transaction data, to answer some fundamental questions:

– How do you create value for customers compared to competitors?
– Who are your customer segments and how does the value you create differ across segments?
– What is the right price and promotions structure that aligns with customer value created?
– How is the product and service portfolio managed?
– How are prices set?

Once these questions have been answered you’ll be well positioned to set policies that define price and discount schedules and controls that ensure consistent price management, and develop organisational and individual capabilities to ensure high-quality pricing decisions.

In support of a clear strategy, organisations should give thought to their capabilities and the way in which they manage pricing. Attia notes that “clear responsibility and accountability of pricing is hugely important to deliver on the pricing strategy and ensure pricing tactics are considered in line with, not independent of, the broader business strategy”.

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