THREE STEPS TO CREATING VALUE FROM B2B DISCOUNTS

By Just Schürmann, Simon Völler, Amadeus Petzke, and David Langkamp

In most B2B industries, discounts represent a company’s largest marketing investment, often amounting to 30% or more of list-price sales. However, companies often neglect to make this important investment strategically. Without clear and effective guidelines in place, discounts do not create the value they could. Even worse, they often destroy value.

In our experience, 80% of B2B companies fall into one of two camps. Fixed discounters offer more or less the same discount to every customer—or they would offer the same discount if the customer asked. The resulting lack of price differentiation leaves lots of money on the table by not reflecting differences in customers’ willingness—and ability—to pay. On the other hand, flexible discounters vary discounts on the basis of common characteristics, such as sales or order volume, channel, or customer segment. While varying discounts in this way can sometimes make sense, flexible discounters often don’t consider whether they’re rewarding value-creating behavior. For example, high discounts may be common practice for large orders or certain channels, such as wholesalers, but do they really create value?

The smartest 20% of companies follow a different path—a strategy we call value-based discounting. First, they tie discounts to the value that a certain customer behavior offers them. This can include anything from placing a standing order, which provides the benefit of a smooth pattern of demand for optimal production, to giving the seller more time to fulfill the order, which eliminates the increased cost of rush jobs. In addition to offering incentives for value-creating behavior, companies that follow this strategy also consider expected and observed competitor dynamics. For example, in competitive markets it makes sense to give additional discounts to large customers that have significant power to negotiate, as measured by factors such as competitive positioning and level of product differentiation. Our research has shown that in these competitive markets, a customer’s negotiating power is directly proportional to its size.
In our experience, companies that apply value-based discounting can increase EBIT by between 1 and 4 percentage points within 18 months. When paired with other pricing improvements, these gains can be doubled.

**Ending Nonstrategic Discounting**

Nonstrategic discounting can come in several forms. Sales representatives may give discounts simply because their customers ask for them or on the basis of some “standard” customer and order criteria, most often the size of an order. If customers ask for bigger discounts, they tend to receive them. Since many sales incentives tend to focus on preserving volume, customers typically get the discount they ask for if they can ensure the same volume as in the previous year. As a result of actions such as these, companies forgo substantial value. (For a list of telltale signs that a company’s discounting is not strategic, see the sidebar, “How to Spot a Poorly Designed and Executed Discounting Policy.”)

Consider the case of a global medical-technology company that leads its market segment by selling highly customized products. In the past, it typically rewarded large orders with greater discounts. But the policy backfired: most customers pooled demand until they could place an order large enough to get the greatest discount. These infrequent but still highly customized orders created huge challenges in production. To cope with the substantial variability of demand, production was forced to install 25% more capacity than would have been needed if orders had come in more evenly. Even with this extra capacity, delivery times were long and unreliable.

The company discounted on the basis of large orders, but those orders had little value to the company. In fact, they destroyed value. Realizing this, the company decided to provide discounts for standing orders with delivery dates spread throughout the year. As a result of the new policy, customers received discounts only when they supplied the company with predictable demand.

**How to Make Discounts Work for You**

Many people believe that discounting is an immutable force. But we have found that with the right value-based-discounting strategy and effective execution of discounting policies, companies can indeed change the rules of the game. We recommend that executives take the following three steps to value-based discounting.

**Design a discounting strategy around the major sources of value.** Many companies follow common industry practice when deciding which customer behaviors (or channels) to reward with discounts. We recommend that companies think strategically about the value-creating behaviors they want to encourage, asking questions such as, Do we really want to reward this large onetime order? Does this channel really create adequate value for our company? How well do we understand what really drives negotiating power?

The following are typical examples of value-creating customer behavior:

- Switching to higher-margin products
- Using sales channels that are consistent with the seller’s growth strategy, such as online channels or channels with lower customer-service costs
- Committing to a standing order or purchasing equipment that guarantees future sales and predictable demand
- Establishing a preferred-supplier relationship that puts in place such practices as advance ordering, joint efforts to control costs, and harmonized processes
- Agreeing to serve as a reference to potential customers
- Providing data that helps to refine products and services
- Making logistical arrangements that reduce operational costs, such as delivery to a central warehouse
Three Steps to Creating Value from B2B Discounts

- Reducing the relative cost to serve—for example, by generating large sales volumes without requiring extensive selling resources.

Designing this kind of discounting strategy requires a shift in mind-set from treating discounts as a cost of doing business to seeing them as a strategic and deliberate investment. The decision about which customer behaviors and characteristics to reward should be made with the same rigor as the decision about whether to open a new plant or buy a competitor—and should also involve marketing, sales, operations, and finance. After all, the value at

**HOW TO SPOT A POORLY DESIGNED AND EXECUTED DISCOUNTING POLICY**

The following are some telltale signs of nonstrategic discounting:

- Your company lacks a clearly articulated discounting strategy—including views about which customer behaviors to reward and about the main drivers of negotiating power in the industry, such as customer size.

- The discounts you give don’t match your discounting guidelines.

- “Hidden” discounts (such as free shipping) come from multiple budgets, without a corresponding value delivered by the customer.

- A large share of orders feature “default” discounts—usually multiples of 5%. (See the exhibit below.)

- Huge variances in discounts exist across territories and field representatives.

- Sales managers don’t regularly discuss discounting with field representatives, and sales reps don’t receive regular training in pricing.

- You haven’t been able to raise prices over the last five years.

**An Analysis Pinpoints Poorly Executed Discounts**

**HORIZONTAL BANDS OF NET PRICES DISPERSED ACROSS A WIDE RANGE OF VOLUMES SUGGEST THAT A LARGE SHARE OF ORDERS RECEIVE A DEFAULT, RATHER THAN A VALUE-BASED, DISCOUNT**

Source: BCG analysis.
stake is probably similar. As a result of this effort, many companies find that their discounting policy is failing to reward value-creating behavior.

Establish guidelines for value-based discounting. Even the greatest discounting strategy can backfire if companies fail to translate it into consistent and easy-to-implement guidelines.

In this step, companies use the insights generated in the previous step to set the types of discounts they will offer and the behaviors linked to them, as well as the respective sizes of the discounts. They should include the following guidelines.

- Set only one type of discount for each source of value. For example, if your company wants to ensure a smooth pattern of orders, it should have exactly one discount type rewarding that behavior, such as a standing-order discount.

- Limit the number of discount types for each customer, in order to increase their impact.

- Ensure that the investment for each discount type is above a meaningful minimum threshold for the customer.

- Make sure that the investment for any discount type is commensurate with the benefit your company receives.

- Be consistent in the discount types you offer to customers within a given channel. Similar customers should be treated equally.

Ensure execution in the field. The best discounting policy is worth little without a well-managed plan to make it operational. All too often, however, we find poorly monitored execution of discounting in the field. At other times, we see companies offer financial incentives for sales reps and leave it at that.

In our experience, financial incentives should be only one step in a series of actions that ensure relentless execution of the discounting guidelines. First, companies should create clear customer-facing communications to convey the benefits of the value-based-discounting approach. Next, the sales team needs to receive regular training that focuses on the true value of discounting to customers and the company, including instructions on how to sell beyond price alone. Companies should also develop consistent messages about pricing that include all discounts and rebates. Communications should provide full transparency on all the sources of customer support or discounts, such as free shipping and extended warranties.

The most effective organizations ensure near-real-time monitoring of discounts. They also hold regular discussions about prices and discounts among sales reps and managers, as well as across functions. Pricing “war rooms” can help. These feature joint decision-making across regions and are chaired by a senior marketing-and-sales executive with final authority over decisions. War rooms typically track and update discounting policies for major accounts and make decisions about granting exceptions and changing the sequence of negotiations.

Leading companies stringently apply a clear escalation process when sales reps wish to offer greater discounts than they are allowed to give, such as requiring a manager’s approval. Effective escalation processes and required approvals are based on how far the requested discount is from those suggested in the guidelines, not on uniform and absolute discount thresholds, such as “each sales manager can approve a 25% discount.” Last but not least, a good escalation process should always include the potential of saying no.

Sales force support tools that assist with pricing deals are also necessary. The best tools clarify how deep a discount the sales rep can give, what discounts individual customers have received in the past, and so on. Only when the previous actions have been taken should companies establish sales force incentives, often in the form of...
a commission, focusing on the net price negotiated (including all discounts and giveaways).

Effective incentive systems consider revenue and volume as well as price realization (or revenue quality). In our experience, the most effective price-realization metrics are based on the distance of the discount from the guidelines. When effectively combining revenue, volume, and price realization metrics, companies can tie sales rep incentives to realized margins without disclosing detailed cost information to the sales force.

Consider the journey toward value-based discounting of a European manufacturer of renewable-energy equipment with $2 billion in revenues. Before its transformation began, the company, which operates globally, offered project-specific pricing that depended primarily on the “gut feel” of sales representatives about who else would be pitching for the project. The single point of reference was the company’s costs, rather than the significant value delivered in terms of higher power production for the customer.

The company ran into several problems because of its approach. Low initial price quotes made it difficult to increase prices over the multiyear selling process. The company also gave away much of the value its technology produced for customers in the form of efficiency gains. In addition, it had no systematic way to understand customers’ willingness to pay, which varied significantly depending on the degree to which investors wanted to receive steady cash flows and therefore lower risk.

To generate the maximum value from each deal, the company moved to a clear discounting guideline known as “list price minus,” with project-specific discounts given from the list price only if power production delivered to a customer at a site fell below the level provided by a competitor at the same location. The guideline was set to achieve the maximum price according to the value created for the customer on each project, not on the basis of production costs. Customers received discounts only when they were required in order to beat out a more competitive company.

The new approach helped the company achieve higher prices more consistently without negatively affecting volumes. The company also became better at communicating the value of its products: it now discusses with customers the value its products create and how they compare with alternatives from competitors. No longer does it base discounts on internal costs. In the end, by adopting value-based-discounting policies, the company more than doubled its EBIT margin.

Ultimately, discounts are an investment. Smart companies ask if they are getting enough in return for their investment in comparison with what they are giving away. That’s a question executives must answer from multiple angles: strategic, operational, financial, and organizational. When they do, the payoff can be substantial.

About the Authors

Just Schürmann is a senior partner and managing director in the Munich office of The Boston Consulting Group. He is also the leader of BCG’s Marketing, Sales & Pricing practice in Germany and Central Europe, the Middle East, and Africa, as well as a core member of the firm’s Consumer practice. He has more than 19 years’ experience in pricing across a wide range of industries. You may contact him by e-mail at schuermann.just@bcg.com.

Simon Völler is a principal in BCG’s Berlin office and the firm’s topic expert for pricing in medical technology. He has 9 years of experience in B2B pricing. You may contact him by e-mail at voeller.simon@bcg.com.
Amadeus Petzke is a principal in BCG’s Berlin office and a founding member and leader of the firm’s Pricing Enablement Center in Europe. He has more than 10 years’ experience in pricing across a wide range of industries. You may contact him by e-mail at petzke.amadeus@bcg.com.

David Langkamp is a project leader in BCG’s Hamburg office and a founding member of the firm’s Pricing Enablement Center in Europe. He has worked on pricing topics across industries, with a focus on B2B pricing. His areas of expertise include pricing strategy, analytics, and enablement. You may contact him by e-mail at langkamp.david@bcg.com.

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