COLLABORATIVE FOR
CUBES™
Customer-Based Execution & Strategy

POWER-UP PPI

COLLABORATIVE FOR CUBES™ BREAKS DOWN PRICE ELASTICITY

STRATEGY OUTCOMES
CUBES 100,000

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To remain profitable, companies must have pricing power. They must have the ability to raise prices while maintaining relatively stable unit sales. And at the 100,000-foot level, where CEOs are looking to examine the financial outcomes of their actions, B2B companies struggle to increase pricing power.

The concept of pricing power is associated with price elasticity, or price sensitivity. The more price-sensitive a customer, the more negatively the customer will react to an increase. Companies with higher relative pricing power find customers react less negatively to a price increase. Thus, they are able to maintain stable unit sales when they enact an increase.

Many business-to-business (B2B) companies use one of two pricing strategies. One, they price products and services based on what value customers think they receive. Two, they use cost-plus pricing, asking clients to cover the cost of materials, labor and overhead and pay an additional markup percentage.

Both value and cost-plus pricing lead B2B companies into a downward spiral in the long run. Because the prospect of raising prices is a stressful, contentious, and unpleasant experience, companies often find they must increase quality while holding the line on prices. Some companies even resort to harming themselves by reducing head count, lowering product quality, and reducing service just to stay price competitive.

The Customer Satisfaction Effect

Satisfied customers benefit firms in a variety of ways. Customers who are more satisfied are more likely to:

- Recommend and refer a company to their peers.
- Repurchase a company's product or service.
- Increase quantities purchased.
- Engage in positive word of mouth activity.
- Be committed to a brand.

Customers who are more satisfied are less likely to:

- Complain to outside entities, such as regulators.
- Switch to lower-priced competitors.

Pricing Power

How can B2B companies overcome their customers' price sensitivity? The classic solution to this problem looks to the Five Forces Model, which examines the conditions that affect a business' profitability: Competitive rivalry, suppliers' bargaining power, customers' bargaining power, the threat of new market entrants, and the threat of substitute products or services.

Using the Five Forces Model as their basis, B2B firms first look to reduce customers' bargaining power through structural means. These may include eliminating competitor through mergers and acquisitions, as fewer competitors presumably increase pricing power. However, research shows the majority of mergers and acquisitions fail to create value.

B2B companies may also consider increasing switching costs by implementing loyalty or rewards programs. The intention is to ensure customers stay with their existing supplier because they are afraid to give up benefits. But in examining business-to-customer interactions, airline loyalty programs have been shown to create substantial liabilities and induce end-customers and channel partners to engage in behaviors harmful to the supplier.

A simpler and more effective way to increase pricing power is to cultivate a base of satisfied customers. How can a B2B company gain pricing power by cultivating satisfied customers? The Collaborative for Customer-Based Execution & Strategy (Collaborative for CUBES™) has measured the relationship between overall customer satisfaction and price elasticity.

Specifically, the collaborative has developed the Collaborative for CUBES™ Pricing Power Index (CUBES-PPI) to quantify a company's ability to control elasticity.

Collaborative for CUBES™: Collaborative for Customer-Based Execution & Strategy

The Collaborative for CUBES™ is intended to develop a B2B customer-based perspective that enables executives to design and execute strategy. The goals of the project are to:

- Understand the extent to which overall customer-satisfaction — a key customer metric — is associated with executive-relevant outcomes like pricing-power, customer loyalty, willingness to recommend, and financial performance.
- Identify key strategic areas (e.g., bidding, safety, pricing) that can be leveraged to improve overall satisfaction.
- Determine specific execution levers to improve performance in key strategic areas.
- Provide a framework for executives to use a customer-based approach to crafting and executing strategy.

Collaborative for CUBES™ uses a multi-step approach to answer the key question: How, if at all, is overall customer satisfaction associated with non-financial and financial outcomes in a B2B context?

Step 1: Literature Review

A rich body of academic papers shows customer satisfaction can affect many company outcomes. However, the vast majority of papers address only B2C interactions. When academics have examined B2B interactions, they have examined single companies. And while it is easier to work with such case studies, it does not provide the level of descriptive confidence needed to understand the dynamics of the larger B2B marketplace.

Existing studies are also narrow in scope. Most examine a limited set of outcomes, focusing only on customer loyalty metrics and not aligning them with financial results.

The Collaborative for CUBES project examines a broad set of outcomes, including:

- **Customer loyalty metrics:** Whether a company will use a supplier for the next job, invite a bid, recommend the supplier, and pass along positive or negative word-of-mouth.
- **Top-line financial performance:** Sales and revenue.
- **Bottom-line financial performance:** Gross margins and earnings before interest, taxes, depreciation, and amortization (EBITDA).
- **Stock-market metrics:** Return on assets and Tobin's Q (*q* ratio, asset market value divided by asset replacement cost).

Step 2: Data Collection

In November 2016, a national panel of more than 4,900 B2B managers participated in the baseline Collaborative for CUBES™ survey. The researchers measured overall customer satisfaction using a seven-point Likert scale. The scale is balanced with three categories indicating dissatisfaction, one showing indifference between satisfaction and dissatisfaction, and three categories indicating satisfaction. Each category has a numeric value and verbal descriptor.

If the supplier rated by the respondent represented a publicly traded company, researchers matched the supplier name to financial information. This is the source of all sales, revenue, and margin data used in the study.

Step 3: Econometric Estimation

The Collaborative for CUBES™ team merged the overall customer satisfaction survey with the financial data. The results are based on an econometric model that statistically isolates the unique association of overall customer satisfaction with each metric. The econometric model controls for the confounding effect of non-focal factors associated with the B2B firm (e.g., liquidity), industry (e.g., industry concentration), and respondent. This procedure provides a representative picture of the association of overall customer satisfaction with the different outcomes.

How Overall Customer Satisfaction Improves CUBES-PPI

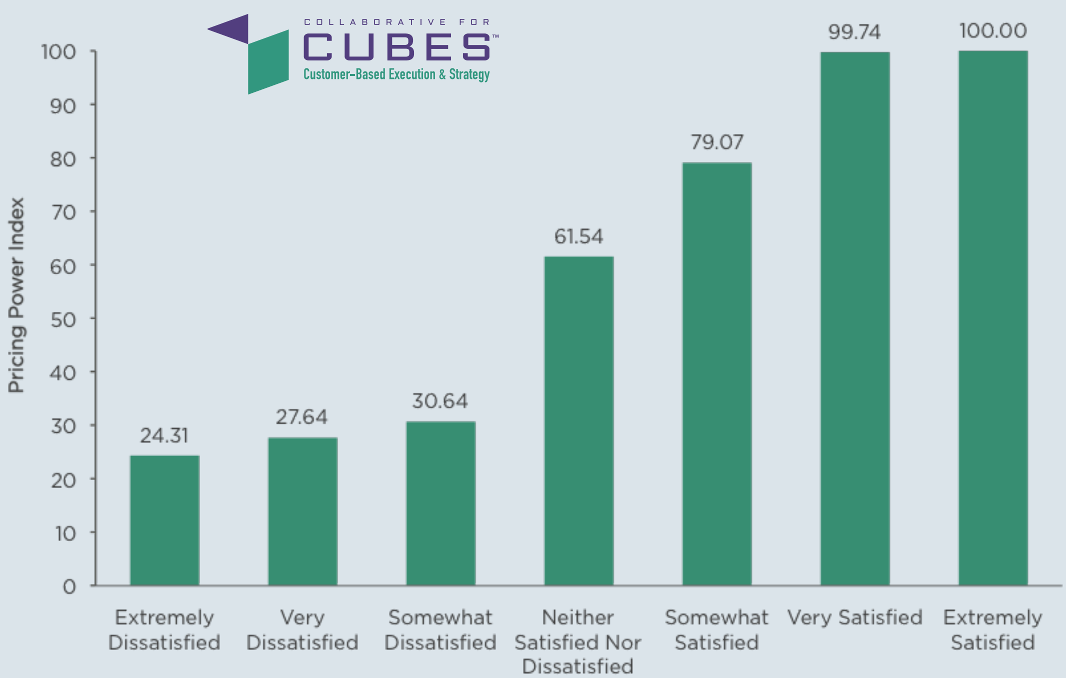
CUBES-PPI is rooted in the notion of price elasticity, a cornerstone of economic theory.

Economists define price elasticity as the change in quantity demanded by a buyer for a 1% price increase. Managers participating in the baseline Collaborative for CUBES™ survey were asked to report how much they would alter their purchase amounts if the price of a given good or service was raised from the current price of $100 to $110. The resulting change in quantity demanded was used to calculate CUBES-PPI, a unit-independent metric that measures decrease in demand for a 1% price increase.

Using the established Collaborative for CUBES™ econometric model to control for a variety of extraneous factors, the research team statistically isolated the association between CUBES-PPI and overall customer satisfaction. For ease of interpretation, CUBES-PPI was indexed at 100 for "extremely satisfied" customers. The metric for all other levels of overall customer satisfaction is shown in Figure 1.

Figure 1. CUBES-PPI and Overall Customer Satisfaction

A higher CUBES-PPI implies higher pricing power, as buyers indicated they would not decrease purchasing amounts as severely with a 1% price increase. CUBES-PPI for the average firm in the sample is virtually identical for "extremely satisfied" (100) and "very satisfied" (99.7) customers. However, the metric decreases to 79.07 for "somewhat satisfied" customers. The average firm has a CUBES-PPI of 24.31 for "extremely dissatisfied" customers.



Overall Customer Satisfaction and Quantity Demanded

Statistically, CUBES-PPI for extremely satisfied customers corresponds to the price elasticity of the customer segment. As shown in Figure 2, the calculated price elasticity for such customers is 3.89. So, among extremely satisfied customers, a 1% price increase will lead to a 3.89% decrease in quantity demanded.

Figure 2. Change in Quantity Demanded for a 1% Price Increase

A higher CUBES-PPI implies the price increase is less deleterious in terms of quantity demanded than when the metric is lower. Thus, where CUBES-PPI for extremely satisfied customers is 100, the quantity demanded decreases by only 3.89%. For customers who are ambivalent — "neither satisfied nor dissatisfied" — CUBES-PPI is 61.51, indicating each 1% price increase is associated with a 6.32% decline in quantity demanded.

By calculating and comparing its PPI to the Collaborative for CUBES™ benchmark a B2B firm can understand its ability to raise prices among clients in its existing customer base.

What's Next?

At the 100,000-foot level, B2B CEOs must help their companies maintain pricing power. A simple and sure way to increase pricing power is to cultivate a base of extremely satisfied customers. Extremely satisfied clients are less likely to curtail purchasing quantities in response to price increases. Customer satisfaction, therefore, can become a barometer for measuring the economic health of a firm's customer base, specifically their price tolerance and the company's ability to manage prices.

Companies should not have to resort to a spiraling strategy of cost-cutting, and pricing power should not be left to increasing monopolies through mergers and acquisitions or implementing costly loyalty/rewards programs. At the 100,000-foot level, maintaining pricing power starts by measuring, monitoring, and optimizing the customer base using overall customer satisfaction.

The Collaborative for CUBES™ has shown how overall customer satisfaction is associated with increased sales, margins, customer quality, and pricing power. So, what effect might satisfaction have on earnings before interest, taxes, depreciation, and amortization (EBITDA)?

FURTHER READING

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