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"The Pain of Discounting"

Discounting is as addictive as any drug. Witness two recent articles appearing in the same April 10 edition of *The Wall Street Journal*—the first about Ron Johnson, now ex-CEO of J. C. Penney, and a second about top tier law firms that discounted their fees following the financial crisis.

Both stories depict the pain and sorrow of this age-old vice. From these examples, however, we can begin to understand how businesses fall victim to this trap—instead of staying on the more powerful and profitable path of net pricing, companies believe that resorting to discounts is only a temporary measure to capture volume, something they can stop whenever they want. Spoken like a true addict.

As we will explain, the best way to avoid the addiction of discounting is to abstain from such behavior in the first place. If, unfortunately, your company has already given in to the rush of the short-term sales boosts that come from discounts, fear not, there is a way (albeit a tough way) to get back on the straight and narrow (and profitable!) path of net pricing.

Penney's Attempt to Break Free

Ron Johnson's first move when he took over J.C. Penney was an attempt to break the decades-old practice of attracting customers by discounting. Using a practice common in retailing, Penney historically offered a constant stream of sales and coupons to bring shoppers into its stores. When it hired Johnson, the company's largest shareholder, Bill Ackerman, said that the move to "low everyday pricing" would "be the most important day in retailing in 25 years." It turned out he was right, but for the wrong reason.

Johnson recognized one cold hard truth of discounting: Customers become hooked on "beating the retailer" by purchasing items only when they are discounted, thus making it difficult or impossible for the retailer to make a sale at a price that fairly represents the value of the item. By stopping discounts and coupons, he believed that consumers would shift their view of J.C. Penney from a place to buy items only when they are on sale, to be instead, the "go-to" retailer for all of their everyday department store purchases.

Unfortunately, he missed the other cold hard truth of discounting: Once started, it almost never ends. Customers quickly become convinced that if a discount is given once, the supplier can and will always sell the same or other items at an equal or greater discount. This, in turn, delivers to consumers the extra perceived benefit of "winning" the buying contest with the suppliers.

Prior to hiring Johnson, Penney, like most suppliers, tried to balance this perception by raising its list prices so it could offer equal or larger discounts over time. As a result, and as is the case in nearly all discounting environments, list prices at Penney lost all credibility.

Further compounding the problem, by lowering prices across the board, Penney took away its customer's ability to "beat the retailer." This led to a lower perceived value of its offering, and thus a major power shift from Penney to its customers. Volume shrank and profits fell; not only did the bottom line disappear, so did Ron Johnson.

Top Tier Law Firms Are Not Immune

This same sad story, for a completely different industry, was reported in the *WSJ* on the same day and page. "On Sale: the $1,150-per-hour Lawyer" tells the story of many large law firms that started discounting their fees, especially for their top attorneys, during the financial crisis and related economic downturn from 2008-11. The result was that many firms found their collections declined to only 85% of their stated fees.

Although the business of large law firms has picked up substantially in the past year, many have been unable to stop discounting their rates. Clients are pushing back on fees as never before and even the largest and most prestigious firms are now finding themselves forced to discount billing rates.

What happened to the law firms? The same thing that cost Ron Johnson his job: Once suppliers start using discounts, customers become suspicious of stated prices and push hard to get to the "right" discounted price. We have seen this same effect in scores of industries, and as this article demonstrates, even prestigious service providers at the top of their industry are not immune.

How the Addiction Begins

While all businesses are susceptible to succumbing to the addiction, businesses that sell through distributors are particularly vulnerable to the pain of discounting.

For example, manufacturers that sell through distributors typically have found the easiest way (administratively) to manage pricing is by publishing a list price sheet for all items and providing a distributor a single discount across all products. The discount is typically designed as the mechanism to provide distributors with an appropriate margin for their value added services, assuming they sell all the products at list price.

Unfortunately, it does not work this way in the real world—end customers typically buy from distributors at different prices based on the value they receive from the product, their volume, and their buying power. Distributors then push the supplier for higher discount levels, product-specific discounts, volume rebates, and other deals to maintain the margin they need in their business. Over time suppliers and distributors fight for volume and margins and two things usually happen as a result:

1. Suppliers increase list prices across the board on all products to try to maintain their margins. This looks like the easy answer, but different levels of actual cost increases/decreases and changes in product performance often create a complete loss of alignment of price and margin by product.

2. Distributors successfully counter portions of across-the-board price increases by demanding and receiving even greater discounts. As a result we have seen the single discount to distributors move from 25% to over 50% over a five to 10 year period.

The bottom line is that businesses with list prices and discounts—whether they are retailers, lawyers, or manufacturers selling through distribution—wind up leaving both money and volume on the table. Their list prices have been disconnected from their offering value, and they have effectively transferred power to their customers.

Antidote for the Addiction

What is the answer? Like breaking any addiction, it requires really hard work, and there is a significant risk of failure. The easy answer is to never start discounting in the first place (i.e., avoid the addiction). Set a net price and stick to it. If a customer needs a lower price, change the offering by reducing some aspect of the product or service along with the price—do not simply discount by cutting the price, because once you begin to do so, it is very hard to stop.

The hard answer is to find a way to shift from list/discount pricing to net pricing. This takes time, backbone, and, too often, a very strong balance sheet. We have seen, however, real success when businesses understand the value they deliver, develop and implement a solid and powerful internal and customer value communication plan, and ensure that the change from list to net pricing is viewed by customers and distributors as fair and equitable.

Ensuring that the internal team understands the value delivered to customers is the first, and often the hardest, step in the transition. Once the internal team understands and believes in the significant value that customers receive from the company's offering, a solid and effective customer value communication plan can be developed and implemented, resulting in customer perception of net price as fair and a good value. This change in internal and external mindset is usually the hardest and most important component of successfully shifting from a list/discount practice to successful net pricing.

Once accomplished, the move to net pricing will almost always yield a far stronger business, where prices reflect value and there is a proper balance of power between the seller and buyers. How big is the payoff? A courageous change to net pricing in a segment of the electrical equipment industry a few years ago led to the cessation of a price war and an increase in bottom line margins of over 10 points in only one year. The company's tough action to break the decades-old addiction in turn created a huge return for all suppliers.

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In the end, we have just one simple message for those suffering from discounting addiction: ***Show courage and resolve, administer the antidote, and watch your bottom line grow.***

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