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MDM Special Report:

Grainger's Web Pricing Initiative

By Lee Nyari

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About this Report

W.W. Grainger Inc.'s new web pricing strategy was launched to reverse unfavorable market share trends Grainger experienced in certain market segments in recent years, but it also had the side effect of driving down the company's margins for the short term. This series analyzes the results of the strategy so far and the challenges Grainger faces in implementing its pricing approach. It also offers tips for how other distributors can improve their pricing strategies in the internet age.

Note: The views expressed in this article are based solely on limited, publicly available information, which are by nature inadequate for a complete analysis and do not constitute advice.

About the Author

Lee Nyari is managing partner of The Innovative Pricing Group, a consultancy offering strategic price management solutions for distributors. Lee is a seasoned distribution pricing executive with almost 20 years of experience leading strategic pricing projects. His deep distribution industry pricing background is coupled with engagement leadership roles at top-tier strategy consulting firms. Lee is a certified pricing professional, a certified public accountant, and he holds a full-time MBA in marketing strategy from Kellogg School of Management.

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Pt. 1: A 'Suboptimal' Solution?

Lessons for midsize distributors from Grainger's pricing strategy

As of Aug. 1, W.W. Grainger Inc.'s new web pricing strategy was to be effective for all 1.5 million SKUs on its website. The pricing strategy was launched to reverse unfavorable market share trends Grainger experienced in certain market segments in recent years. Part 1 of this two-part series looks at how the pricing initiative has played out to this point, along with lessons other distributors can learn from Grainger's experience.

As the largest B2B MRO distributor in the industry, Grainger occupies a unique market position. However, its basic pricing challenges are typical for any distributor. As sales shift to e-commerce channels, customers are taking advantage of easier ways to compare prices, and this growing industrywide price transparency trend makes it more likely that weaknesses in price structures and pricing strategies will be exposed in the marketplace. This includes such certain aspects of how Grainger has operated its list-price structure.

Historically, Grainger's non-contracted list prices were the default prices (absent overrides) for many sales situations where contracted discounts did not apply, such as:

- spot buys for less frequent, non-contracted items by large contracted customers, and
- initial pricing inquiries on the web from non-contracted, often midsize, prospects or customers.

Grainger has successfully maintained its contracted (and typically discounted) prices at competitive levels, but management and others observed that it allowed its undiscounted list prices to creep out of the competitive market price range.

In 2015, in a blog entry on our website (http://www.pricinginnovation.com/Pricing-Practitioner-Blog.php), we warned distributors of the perils of pushing the envelope too far in charging higher prices in segments that seem noncritical to their business, such as smaller accounts. If distributors pursue repetitive price increases in these seemingly lower risk segments year after year, the cumulative effect of these efforts to chase margin percentage gains is that they will eventually backfire and cause more harm than good.

Here are three of the major risk areas:

1. The distributor may lose out on more otherwise attainable, higher-margin sales volume, driving down average margins in the business due to the shifting mix.

<u>Grainger's experience:</u> According to earnings calls and presentations to investors, Grainger is now reporting significant favorable mix-change effect on its margin rates, which it attributes to the pricing initiative, as higher-margin (non-contracted) sales volume returns to a higher percentage of its overall sales portfolio.

2. The small-account population may include customers with higher volume potentials, however this growth potential may not be realized if prices quoted are above the market range.

<u>Grainger's experience:</u> Grainger management has publicly recognized that overinflated list prices were prohibiting them from growing volume in the midsize customer segment of the U.S. market, where Grainger is underpenetrated with an estimated 2 percent share. (Grainger uses other brands, such as Zoro, to target truly small business customers – meaning midsize businesses are the smallest type of customers Grainger may actively be targeting with its flagship Grainger brand.) According to recent earnings calls, the unfavorable market share trend in the midsize customer segment is starting to reverse – a success management attributes, in part, to the pricing initiative. Earlier this year, the company reported a 14-percent jump in average weekly volume from U.S. midsize customers transitioned into the web-pricing program (the early adopters). Grainger projects that its newly competitive web prices will drive share gains in the U.S. midsize segment in 2019.

3. Although management and analysts may focus on other areas that seem more strategic, seasoned sales professionals will recognize pricing issues across all of the accounts they serve. They can respond to inflated, market-irrelevant system prices by discounting. If controls make discounting difficult, they may step back from actively pursuing business at smaller customers.

<u>Grainger's experience:</u> Grainger manage-

ment notes that a significant benefit of the ongoing pricing initiative has been to greatly reduce or eliminate the need to negotiate each individual price (presumably, this refers to a process of adjusting prices by way of overrides or exception records), particularly for spot buys. In addition to driving more spot-buy volume, management reports that the new pricing strategy increased customer satisfaction among contracted accounts, which now feel it is easier to do business with Grainger without feeling the need to hassle over "less than competitive" prices on non-contracted items.

Grainger recognized the need to change the operation of their historical list-discount price structure, so they can manage their pricing challenges. Their new pricing strategy discontinues the use of list prices in many selling situations. Instead, Grainger will use newly developed, more competitive web prices. They are not so low, however, that they would undercut prevailing industry-level prices (doing so is not a goal, according to CEO DG Macpherson). Rather, the web prices are set just low enough to get into the competitive market range while still allowing Grainger to capture a price premium for the value it delivers in terms of selection, availability, ease of doing business and other services.

Initial industry reaction seems to confirm what Macpherson has said: Grainger's move is unlikely to cause a large-scale industrywide price war, which would create a downward spiral of prices in the market. Although some competitors may adjust a few prices here and there in response to Grainger's move, a large-scale competitive price response does not appear likely. By telling Grainger's story and publicly discussing the rationale, Macpherson is helping make sure that competitors do not misread the motivations behind Grainger's pricing actions, so that a "race to the bottom" doomsday scenario is avoided.

Is Grainger's new strategy "suboptimal"?

In many ways, Grainger is doing the right thing. However, the particular solution Grainger chose to deal with its pricing challenges may be suboptimal. It has been destructive to short-term performance (measured in absolute margin dollars), and it may cause the distributor to miss out on significant long-term opportunities that could make a material difference in its performance.

To see why this solution is suboptimal, let's briefly revisit a basic principle in pricing science. The optimal price point for a given transaction is the price that maximizes expected margin dollars for that transaction, given prevailing price-volume elasticities. Adopting this textbook definition of optimal price always leads to more margin dollars because:

- If the old price was too low and a higher, more optimal price is implemented, the higher, more optimal price will drive enough per-unit dollar-margin gains to outweigh the negative impact of any volume drop from the price hike.
- If the old price was too high and a lower, more optimal price is implemented (as should apply in Grainger's situation), the lower, more optimal price will drive enough incremental volume to outweigh the negative impact of the per-unit dollar-margin losses from the price drop.

Grainger projects that the lower prices will drive absolute margin dollars downward in the short term (something that is already occurring, as margin rates continue to drop sequentially quarter-by-quarter). Management's guidance is that it will likely take several years before the pricing actions generate sufficient volume gains to drive an increase of absolute margin dollars. In other words, Grainger is moving to prices that may sacrifice short-term profitability, but will give a fighting chance to a more long-term focused share gain strategy. Grainger may feel that the new lower prices are optimal because they will drive incremental volume – just not in the short run.

Some observers (including other pricing experts) have noted that Grainger's projected long-term volume gains are not so certain – and that they may turn out to be wishful thinking. Grainger is targeting 6 percent to 8 percent U.S. volume growth in 2017 – aggressive targets by any measure. While we may have to wait a few years before learning the final verdict on this aspect of Grainger's initiative, there are some uneasy feelings that the share-gain plan won't pan out in the long run. Grainger's stock price has fallen significantly in 2017.

But why aren't Grainger's "better" prices expected to improve short-term financial performance, as the textbook definition of an optimal price should? Can we, from an analytical review of publicly available information, make an educated judgment on the effectiveness of Grainger's web prices on supporting its growth objectives in the midmarket?

Pt. 2: The Quest for Optimization

Next steps for Grainger to overcome its web pricing challenges

Since the January launch of its pricing initiative, Grainger has seen significant declines in profitability. While this margin trend is expected to reverse in 2019, its existence may signal that the pricing process Grainger is pursuing is less than optimal. This article, part 2 in a series, analyzes the challenges Grainger faces in implementing its pricing approach and provides additional lessons for other distributors looking to improve their pricing strategies.

The phased implementation of Grainger's web pricing strategy initially focused on price cuts on about 400,000, mostly slower-moving, SKUs where list prices seemed most misaligned. For many of these products, the demand curve in the non-contracted segment is likely made up by a wide variety of customers across different markets. These customers may vary a great deal in how they use the product, what services they value, what competitive options they have and so forth. This means wide variety in the underlying demand dynamics.

We know at least two things to be true:

1. In many cases, demand prior to the pricing initiative was high enough for customers to justify paying high list prices. If Grainger had not seen significant sales at or around list price, dropping these list prices would have been largely a non-event and doing so would not materially impact their margin rate. Their margin rate has been taking a hit, however. According to analyst conference presentations in June, Grainger projects a 210-basis point gross profit decline in the overall U.S. segment in 2017, mostly from overall (and mainly self-driven) price deflation of 4 percent to 5 percent. This gross profit decline guidance is at an aggregated level that rolls up both midsized and large accounts. Some would call this a massive financial hit.
2. In other cases, Grainger's value proposition was not strong enough to justify the high list price. Management admitted that inflated prices posed a barrier to volume growth in the non-contracted segment of their business, and that large contracted customers also tried to avoid paying these often inflated prices.

Even with limited understanding of the relevant markets that Grainger's strategies impact, there is very good reason to suspect that demand in the non-contracted business segment may, in many cases, be all over the place, particularly when it comes to the most impacted subset of slower-moving SKUs. These willingness-to-pay distributions have very high standard deviations and have shapes that bear very little resemblance to typical bell curves.

Grainger's strategy fails to adequately address this variation in demand patterns. The segmentation in the non-contracted part of the business remains somewhat myopic in that it seems to focus almost entirely on product attributes. Although we have not analyzed in detail or reverse-engineered Grainger's web-price structure, based on publicly available information, the web pricing strategy seems to largely perpetuate the practice of using a single price per SKU across most non-contracted customers/selling situations (similar to the previous practice of having a single list price per SKU).

Important customer dimensions and attributes may not get sufficient consideration in Grainger's segmentation/price management practices when it comes to managing non-contracted web prices. When this happens, willingness to pay will vary widely within most price segments.

In practice, this will likely continue to be a major problem. Such suboptimal, overly simplistic price structures make it impossible to set truly optimal price points in the context of specific transactions in specific markets. The problem (as is frequently the case in pricing) comes down to the ability of the business to effectively manage volume versus margin.

On the one hand, Grainger is unnecessarily missing out on margin-rate opportunities in many selling situations, where customers were historically willing to pay higher (i.e., closer to list) prices and would presumably be willing to pay higher price premiums going forward. These unnecessary drops may be widespread, as evidenced by the dropping margin rates Grainger has reported. With a more sophisticated, less product-myopic segmentation scheme to manage non-contracted prices, the distributor could hold onto much of this price premium/margin – both in the short and in the long runs.

On the other hand, lowering prices puts Grainger in a better position to pick up more share and volume in the non-contracted segment of their business. However, this volume pickup has limited potential in the short run, and therefore, it is not enough to pay for the margin-basis-point drops in the short run. Given the myriad selling situations and customer types involved, quite frequently even the new lower web prices will prove to be too high.

In the product-myopic web price structure, it remains impossible for Grainger to come anywhere close to realizing its full volume potential from non-contracted business. With a more sophisticated, less product-myopic segmentation scheme, Grainger could be more targeted in varying the magnitude of the price drops (including even more aggressive discounting in some situations) in ways that could help capture more of the profitably attainable volume in the non-contracted business segment in both in the short and long run.

Are Grainger's web prices more optimal?

Grainger's new web prices may be optimal in more situations than its old list prices were in the non-contracted business segment. We are not quite convinced, given the degree of short term margin degradation, the inherent bias of hearing only about prices being too high (customers and salespeople never complain about them being too low or just right) and the fact that a variety of non-price factors likely also contributed to Grainger's share/volume growth challenges with midsize customers (some of these are being addressed concurrently by Grainger's management).

Even if we assume that Grainger's new web prices for non-contracted business are more frequently optimal, this change does not necessarily drive great improvement. Just like Grainger's old list prices, the new web prices are still also likely to be suboptimal in most situations where they apply, because Grainger's web-pricing scheme seems overly simplistic to effectively deal with the high variability of prevailing demand patterns in the non-contracted business segment. Price optimality in the non-contracted business segment may still well be a rarity – just a shade less rare, perhaps. Because of this, much of the benefit typically associated with price optimization projects may not be realized.

Grainger's new web pricing strategy also may not do an adequate job of mitigating price transparency issues. Competition is likely to find ways to monitor Grainger's web prices, despite recently added controls to reduce how widely available pricing information is on Grainger's website. The continued high price transparency will still allow competitors to undercut Grainger on an account-by-account basis in specific selling situations. Although large-scale price wars may not erupt, these competitive dynamics will persist and further limit the potential for volume pickups to pay for reduced margin rates.

Did Grainger miss the boat?

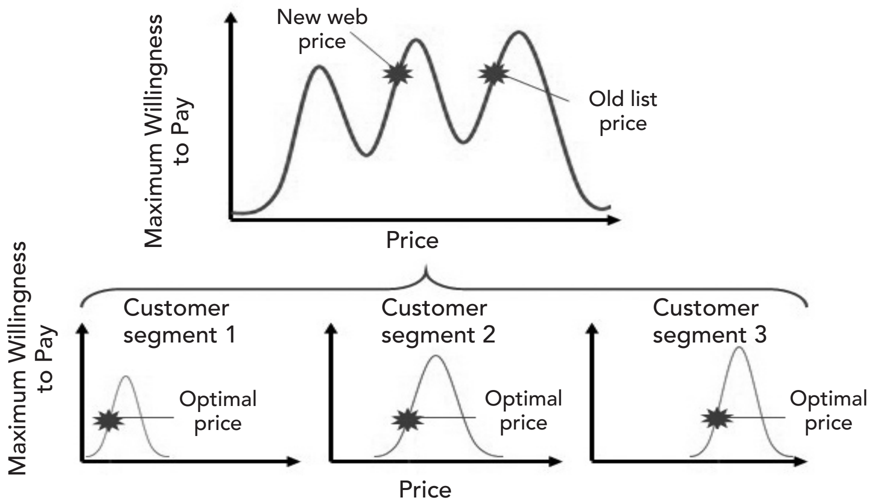
It's quite possible that Grainger considered several alternatives before settling on the fix that appeared most feasible in the short run. So why did it choose a solution with such an overly simplistic price structure?

It is common practice to operate list prices that are disconnected from the market range; many businesses do this, some quite successfully. It is also possible for prices shown on websites to reflect some type of a discount off list, even if existing customer contracts do not require those discounts. Surely, Grainger realizes that the demand patterns in the non-contracted segment of their business have a lot of variability. And surely, they understand that segmentation is a critical step in any price optimization project. This step cannot be skipped or cut short to the point of ignoring important factors driving demand patterns.

We suspect, however, that deciphering these demand patterns to develop an appropriate segmentation scheme (one that creates segments with more meaningful bell curves) may pose a formidable challenge, especially for a business of Grainger's size and complexity. It would require relevant datasets, particularly on customer profiles, attributes and purchasing situations. It may also require updates to execution tools (e.g., reporting systems, data structures, ERPs, etc.).

In the absence of such a more refined segmentation scheme to guide discounting for the non-contracted part of their business, Grainger opted for simplification. Relative to a true price optimization strategy, Grainger's current web pricing scheme may still leave a lot of money on the table – both in terms of volume/share and margin potential in the non-contracted segment of their business. In fact, the rationale behind Grainger's current web pricing strategy may not be one of price optimization, but rather to make pricing a less frequent barrier to growth in the midsize segment, allowing non-price marketing

Figure 1: Invalid Segment Produced by Overly Simplistic Segmentation



efforts a chance to get traction.

Grainger's web price structure may start to evolve over time, reflecting increasingly sophisticated segmentation. The company has a solid backbone when it comes to pricing analytics and technologies. It also has strong tools to perform the types of segmentation analyses needed to take its web prices to the next level. Even with just 2 percent of the highly fragmented U.S. midsize market, Grainger can likely generate more robust datasets on this segment of its business than most other players who actively serve this space.

As Grainger continues to focus on driving profitable growth in the midsize segment, the logical next step may be to take on these more in-depth pricing challenges. Until then, we are inclined to agree with the crowd's wisdom: We remain skeptical that Grainger's efforts to fix prices in the non-contracted segment of its business will yield benefits great enough to be in line with the aggressive targets management hopes to achieve.

Note: The views expressed in this article are based solely on limited, publicly available information, which are by nature inadequate and incomplete for a complete analysis, and they do not constitute advice.

6 Lessons for Other Distributors

What can other B2B distributors learn from watching Grainger's pricing story unfold?

Lesson 1: Review your price structure and segmentation schemes (not just price points) periodically.

As business models/sales channels in your markets shift and evolve, your price structures and segmentation schemes should, as well. Efforts to set optimal price points are unlikely to succeed when rigid and outdated price structures/segmentation schemes are impossible to align with changed, substantially more complex marketplace realities. Although you may be limited in what your systems and capabilities can support without significant investment, moves toward even slightly more sophisticated price structures/segmentation schemes can yield significantly stronger returns.

Lesson 2: Strategically align your pricing strategy with your business strategies.

New business strategies may also call for new pricing approaches. Price structures and segmentation schemes that may work well for your established book of business may be less than ideal, if they are applied to support growth efforts in other markets that represent new territory for your business. The deeper your understanding of these markets, the better prepared you will be to develop pricing approaches and segmentation strategies that can effectively support profitable growth in your target areas.

Lesson 3: Target price hikes and price drops, and manage them effectively.

Avoid blanket price changes, up or down. Grainger's price drops across its non-contracted business may seem targeted at first glance: the drops affect a defined subset of its product portfolio, they only affect selling situations where contracted discounts do not apply, and the drops are being implemented in a controlled, seemingly managed fashion. However, the drops seem to reflect an implementation methodology that does not adequately vary the magnitude by different types of customers and selling situations. Targeted price drops should involve proper segmentation that considers all relevant attributes (not just product attributes) to best identify the customer/item combinations with the most potential for volume pickup in response to lower prices. Like Grainger, look for (legally viable) ways to communicate the rationale to stakeholders to avoid igniting/escalating price wars. If possible, consider implementing price drops gradually, and carefully monitor the results so you can adjust course based on observed levels of volume response.

Lesson 4: Avoid charging grossly inflated prices, even in seemingly less "critical" segments.

Resist the temptation to endlessly chase excessive margin rate expansion in areas where risk-taking may seem reasonable (and profitable) at first. These strategies may work at the outset, but eventually they run out of steam and backfire. Next to share and volume trends, a good place to check for signs of pushing the envelope too far is stick rates: If past price hikes on small accounts, low-frequency items, etc., did not stick, then subsequent price hikes may backfire and add more problems, rather than provide targeted benefits.

The more widespread you allow pricing problems to become, the smaller the range of corrective options you may have and the harder/more painful these corrective actions may be to execute.

Lesson 5: Recognize and address areas of your business where pricing strategies are failing.

Pricing may be prohibiting profitable growth in some areas. Frequent overrides and/or extensive use of exception price records in certain segments should cause concern. It may be virtually impossible to materially improve performance in these segments if these pricing issues are not adequately addressed.

Lesson 6: Price transparency is here to stay, so ensure that your pricing practices address it.

The genie is out of the bottle. Customers increasingly expect web-based tools to be available in the normal course of conducting business with distributors. In this context, they are unlikely to reduce their appetite for electronic ways of comparing prices. Distributors need to develop new strategies so they can strike a healthy balance between catering to customer demands for easier, electronic ways of conducting business while safeguarding price lists that have been rightfully viewed as sensitive organizational assets.