BUSS 671 Global Marketing Management

Interactive Computer Systems Corp.

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1.0 EXECUTIVE SUMMARY

Interactive Computer Systems Corp. ("ICS") is facing a pricing dilemma between its subsidiaries for its model 2000 multiplex communications interface ("M2000"). We recommend ICS to (a) adopt a localized pricing strategy for M2000, (b) use product differentiation to supplement and support this pricing strategy, and (c) modify its performance evaluation criteria for the subsidiaries and specialists.

2.0 BACKGROUND

ICS's M2000 was designed and produced in Frankfurt as a specialized item. First launched in Germany and sold in Europe at US$3,900, the product is gaining market acceptance in the US. To cope with the competitive local market while complying with the 15% profit before tax ("PBT") target, the US headquarter reduced the price of M2000 from US$3,900 to US$3,000, resulting in a 150% increase in sales in 1990. Conflicts arose when the German subsidiary faced a 10% decrease in sales while having to bear the cost of after-sales services to local customers who bought their M2000 from the US offices. Peter Mark, the marketing manager of ICS, is faced with the task of resolving this issue.

3.0 THE OBJECTIVE

Our objective is to look for a feasible alternative for the pricing of M2000 to maximize the total current and future profits of ICS, taking into account non-financial factors like customer goodwill and internal coordination.

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4.0 PERTINENT ISSUES

The following are the pertinent issues involved in the pricing dilemma of M2000:

4.1 ***Cost allocation.*** Prices of specialist products are marked up at 15% on the selling price. The US treated the transportation cost (US$200) and import duties of 5.1% (about US$75) of the M2000 as general overheads to be allocated over all other products. When they are properly included as part of direct costs (to be deducted from the contribution margin), M2000 should be priced at US$3,550 to meet the 15% PBT requirement (see **Appendix I**). The current selling price of US$3,000 actually produces a per unit loss of US$19, and this probably explains the high growth rate in the US from 1988 to 1990.

4.2 ***Different market condition.*** The communications interface market in the US is more competitive and the customers there expect better price performance than the European customers. Other ICS products sold under the Master Price List ("MPL") are generally more expensive in Europe through a higher uplift factor that takes into account the higher cost of doing business. Generally speaking, customers in Europe are willing to pay a slightly higher price in Europe.

4.3 ***Parallel imports.*** Parallel import occurs when the price difference is big enough to cover transportation and other costs to be incurred when buying the product from another location. The low selling price of M2000 in the US encourages parallel imports by European customers. ICS should narrow the price differential or introduce sufficient product differentiation to justify the price difference.

4.4 ***Performance evaluation criteria that reduce conflicts.*** Conflict arises when the US arrives at a different (lower) price following the same target PBT. Yet the German subsidiary will not be able to meet the 15% PBT target if the M2000 is priced below US$3,900. The internal conflicts intensified as the European subsidiaries lost sales to its US counterpart while shouldering the cost of their after-sales services. Assessing the profitability of specialist products with the target 15% PBT further complicates the situation if the products are allowed to be sold at different prices in different countries.

4.5 Capacity of existing facility and expansion possibility. The US group plans to add M2000 to their official US price list to further increase its sales. However, M2000 is designed and produced in a low-volume production line in Frankfurt, which may not be able to cope with any rapid increase in demand. Although a higher production volume will lower fixed cost per unit, the production capacity of this production line may pose as a limiting factor to sales growth. An alternative is to produce the M2000 at a high-volume line or set up a second production line if the demand justifies one.

5.0 PRICING STRATEGY FOR M2000

In formulating its pricing strategy, ICS has to consider the following:

5.1 Global vs localized pricing. ICS can adopt global pricing and sell its products at the same price around the world. ICS's MPL is based on global pricing. It provides customers with a consistent price and discourages parallel imports. However, each location's cost base is different and the evaluation of its profitability will become difficult. Alternatively, ICS can adopt localized pricing and set prices to maximize profits. The price should take into account the local supply and demand conditions, price and demand elasticity, competitive environment, internal cost, and other relevant factors. Generally, localized pricing increases overall profits and makes performance evaluation more equitable. However, parallel imports will occur if large price differential exists.

5.2 ***Product homogeneity vs differentiation.*** M2000 is a homogenous product and its specifications are the same regardless of purchase location. ICS can justify a reasonable amount of price differences between locations using other forms of differentiation. Differentiation strategy may involve changes to product features, warranty duration and terms, distinct levels of after-sales service packages, and other inherent feature or service factors of M2000. A properly developed product differentiation strategy can justify price differentials between locations and deter parallel imports.

5.3 ***Performance evaluation criteria.*** Performance evaluation criteria at the subsidiary and specialist level can be changed to reduce internal conflicts. ICS can add coordinating and facilitating activities to its evaluation criteria. Coordinating activities include inter-subsidiary coordination like joint client calls, client introduction and sales leads across locations. Facilitating activities include non-sales contribution to client services like warranty and after-sales service for non-locally sold products. By championing these coordinating and facilitating activities, ICS encourages its subsidiaries and specialists to focus on improving its overall profitability and customer service level.

6.0 PRICING ALTERNATIVES

Based on the three considerations stated above, we come up with the following six pricing alternatives, two under global pricing and four under localized pricing:

Global Pricing Strategy

Alternative 1 Increase the US price to US$3,900 to match its price in Europe. No other action.

Alternative 2 Price M2000 between US$3,550 and US$3,900 globally. No other action.

Localized Pricing Strategy

Alternative 3 Keep the status quo, that is, selling at US$3,900 in Europe and US$3,000 in US. No other action.

Alternative 4 Set local prices at 15% target PBT: Europe at US$3,900 and US at US$3,600. Use product differentiation to support the price difference.

Alternative 5 Allow subsidiaries to independently and optimally price M2000 based on local conditions with varied markup. No production differentiation. Performance measure based on PBT plus coordination and facilitation efforts.

Alternative 6 Allow its subsidiaries to independently and optimally price M2000 based on local conditions with varied markup. Use product differentiation to support any price difference. Performance measure based on PBT plus coordination and facilitation efforts.

The details of the alternatives and their respective advantages and disadvantages are tabulated in **Appendix II**.

7.0 EVALUATING THE ALTERNATIVES

In an attempt to conducting a systematic analysis, a scoring system is devised whereby the results could be conveniently modified upon necessary adjustments to the scoring or weighting. The scoring factors are:

- US sales and customer goodwill
- European sales and customer goodwill
- Parallel imports
- Overall profitability
- Internal conflict
- Utilization of production capacity (assuming the existing production facilities can accommodate any sales growth)

Against each of the factors, a score of -5 to -1 may be awarded when an alternative is considered to bring about very unfavourable to unfavourable impact on the factor, or a score of 1 to 5 for favourable to very favourable impact. For example, pricing M2000 at $3,900 for both US and Europe will help to eliminate parallel imports (5 points) but will severely hamper US sales (-5 points). A zero score is awarded the effect is considered to be nil or neutral. **Appendix III** outlines the relationships between the three variations in the pricing strategy and the scoring factors.

Appendix IV lists the scoring of the six pricing alternatives. Based on the results, we recommend ICS to implement **alternative 6** as it receives the highest scores.

8.0 LONG-TERM STRATEGIES

The foregoing are meant to be short-term measures to tackle the M2000 pricing dilemma. ICS should, however, perform a fundamental review of the following issues for its long-term planning:

8.1 Market approach to pricing. ICS set prices worldwide with prices in each country being set at MPL plus a pre-determined uplift factor to take into account the cost of doing business in different countries. The pricing of specialized products similarly adopts a cost-driven approach whereby a PBT percentage is added to the total unit cost to determine the product price. As discussed previously, this approach has a number of internal and external problems. ICS should consider the adoption of a market approach that encompasses marketplace variables such as political factors, social and cultural environment, individual perceptions, competition and timing. Depending on the pricing objectives, marketing positioning and segmentation, and the competitive structure of the market, the pricing strategies available are: skimming pricing, penetration pricing, prestige pricing, follow-the-leader pricing, leader pricing, relative pricing, etc.

8.2 Global supply chain management. Currently ICS products are mainly produced in eastern US with some low-volume production lines in Singapore, Germany, Brazil, and Taiwan. Each location specializes in the supply of certain products for the sales all over the world. The subsidiaries essentially function as sales offices processing orders. ICS can review its global supply chain with a view to minimizing production and distribution costs and maximizing the group's profit.

8.3 Transfer pricing. Where products are manufactured and sold in a number of countries, the issue of transfer pricing comes into play. In view of the varying cost of doing business, import duties and local taxes incurred, the transfer pricing policy will have a significant impact on the overall profitability of the group. In addition, the policy must also take into account the related requisition (internal and external) policy and the resultant motivational impact on individual subsidiaries.

8.4 Performance evaluation. A different pricing strategy may warrant corresponding changes to performance evaluation as it directly affects profitability. If performance is remain to be assessed at the level of a product line, the specialists may require a greater say on the transfer price to award them with near-market profitability.

9.0 CONCLUSION AND RECOMMENDATION

Pricing globally sold products is a daunting task involving a wider range of 'internal' as well as 'external' environments than that of products sold in the domestic market only. The level of difficulty is elevated when a relatively homogeneous product is sold in countries where the level of competition differs among them but the communication and transportation between them are advanced (facilitating parallel imports).

Based on our qualitative analysis and a systematic scoring system to rank the alternatives, we recommend ICS (a) to adopt a localized pricing strategy for M2000, (b) to use product differentiation to supplement and support this pricing strategy, and (c) to modify the performance evaluation criteria for its subsidiaries and specialists. For a longer term solution, we recommend ICS to consider (a) a market approach to pricing, (b) an evaluation of its global supply chain management strategies, (c) changing its transfer pricing policy, (d) and applying the modified performance evaluation criteria across other products.

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Appendix I Profit Analysis For M2000 In The US

	Profit Analysis At Existing Price	Profit Analysis At Revised Price	Profit Analysis At Existing Price but Revised Cost [2]
US List Price	$ 3,000	$ 3,550	$ 3,000
Direct cost(s)	1,500	1,775 [1]	1,775 [1]
Contribution margin	1,500	1,775	1,225
Contribution margin %	50%	50%	41%
Allocated fixed costs (35%)	1,050	1,243	1,243
PBT	$ 450	$ 532	($ 19)
PBT %	15%	15%	(1%)

1 The transportation cost of US$200 and import duties of US$75 are added to the manufacturing cost of US$1,500. They are included as part of the direct costs (rather than as part of the allocated fixed costs).

2 This profit analysis compares the current actual selling price of M2000 to the re-calculated cost base.

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Appendix II Pricing Alternatives and Evaluation

	GLOBAL PRICING		LOCALIZED PRICING			
	Alternative 1	**Alternative 2**	**Alternative 3**	**Alternative 4**	**Alternative 5**	**Alternative 6**
Price: US (US$) Germany (US$)	 3,900 3,900	 3,600 [1] 3,600 [1]	 3,000 3,900	 3,600 3,900	 3,300 [2] 3,800 [2]	 3,300 [2] 3,800 [2]
Performance Evaluation	15% PBT	15% PBT	15% PBT	15% PBT	PBT +coordination & facilitation efforts [3]	PBT +coordination & facilitation efforts [3]
Product Differentiation [4]	None	None	None	Yes	None	Yes
Advantages	• Higher profit per unit in the US • No parallel import	• Higher profit per unit in the US • Higher European demand • No parallel import • Direct costs of US taken into account • Performance evaluation that can motivate specialist	• Increased US sales • Subsidiaries' own preferred pricing	• US price taking into account direct costs • Both US and European subsidiaries meet target PBT • Parallel imports unlikely	• Optimal pricing based on local demand condition • Increased European sales • Lower profit per unit will not affect performance evaluation	• Optimal pricing based on local demand condition • Increased European sales • Lower profit per unit will not affect performance evaluation • Differentiation helps to reduce parallel imports
Disadvantages	• Lost competitiveness in US • Lost US sales with no compensation in European sales • Profitability biased against US • Not optimal pricing based on local demand	• Lost sales in the US • Not optimal pricing based on local demand • European subsidiaries unable to meet target PBT • Profitability biased against European subsidiaries	• US unable to meet target PBT • Severe parallel import problem • European subsidiaries lost sales to US • US selling at a loss	• Increased cost on product differentiation • Lower US competitiveness and sales	• Accuracy of local price calculation • Lost US sales as price increased • Parallel imports more likely	• Accuracy of local price calculation • Lost US sales as price increased • Increased cost on product differentiation

1. Assumed. ICS can price M2000 between US$3,550 and US$3,900. The final global price should maximize the overall profitability of ICS.
2. Assumed. In view of the more competitive market, a price $3,300 is set for the U.S. The price of $3,800 is set for European subsidiaries assuming that it has been set higher because of the required 15% PBT.
3. Include coordinating and facilitating activities in performance evaluation to reduce internal conflicts and redirect focus to overall corporate financial and service performance.
4. Differentiation strategy refers to making changes to product features, different warranty duration and terms, distinct levels of after-sales service packages and other inherent feature or service factor to differentiate M2000 sold in different geographical locations.

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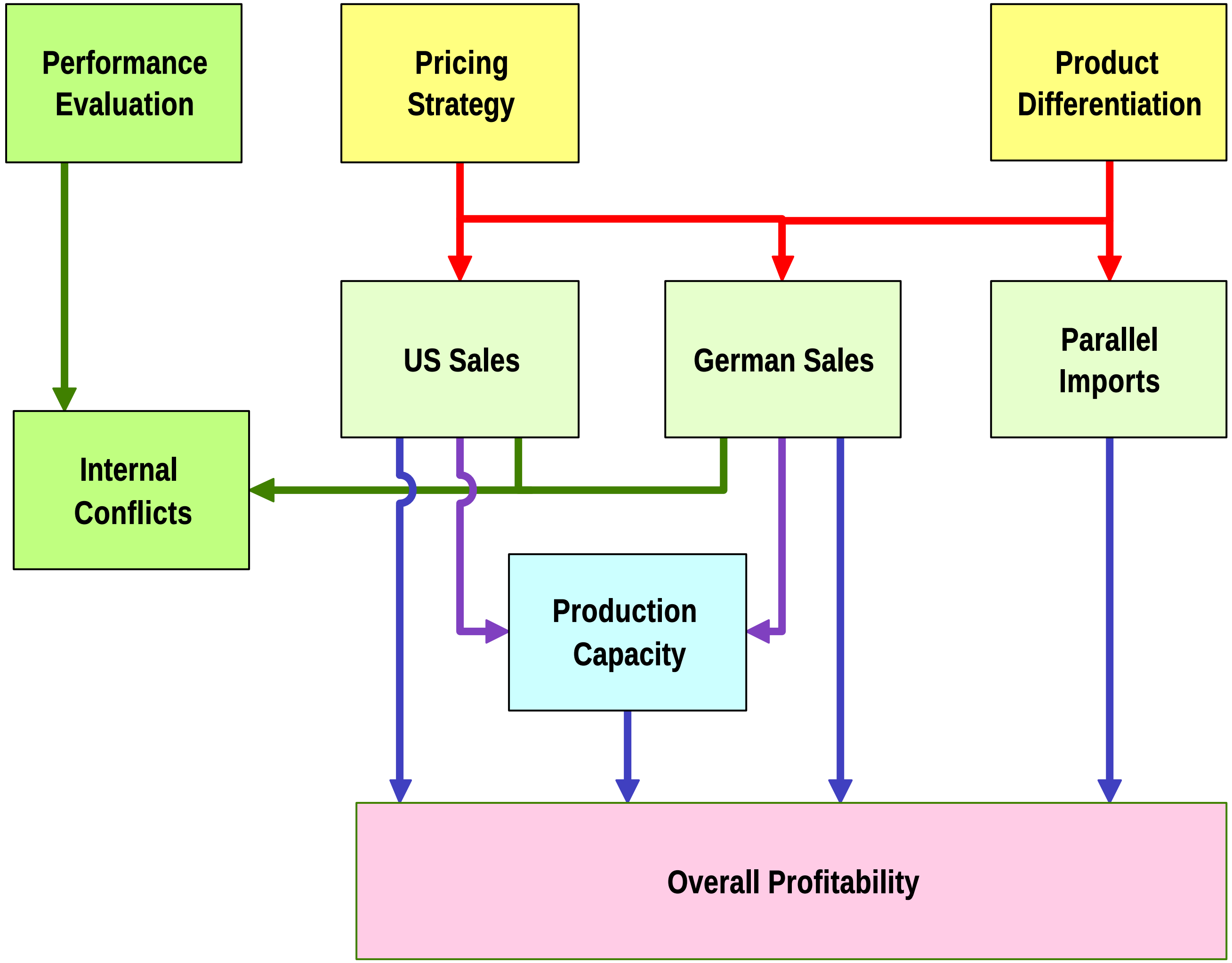
Appendix III Relationship Between Variations in Pricing Strategy and the Scoring Factors



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Appendix IV Scoring of the Pricing Alternatives

	GLOBAL PRICING		**LOCALIZED PRICING**			
	Alternative 1	**Alternative 2**	**Alternative 3**	**Alternative 4**	**Alternative 5**	**Alternative 6**
Price: US (US$) Germany (US$)	 3,900 3,900	 3,600 [1] 3,600 [1]	 3,000 3,900	 3,600 3,900	 3,300 3,800	 3,300 3,800
Performance Evaluation	15% PBT	15% PBT	15% PBT	15% PBT	PBT +coordination & facilitation efforts	PBT +coordination & facilitation efforts
Product Differentiation	None	None	None	Yes	None	Yes
Scoring Factor	**Point**	**Point**	**Point**	**Point**	**Point**	**Point**
• US sales and customer goodwill	-5	1	5	1	4	4
• European sales and customer goodwill	1	5	-5	3	2	4
• Parallel imports	5	5	-5	-1	-4	-2
• Internal conflict	-3	-2	-4	1	3	5
• Utilization of production capacity	-3	1	3	-1	4	4
• Overall profitability	-3	1	-1	2	4	3
Total Points	**-8**	**11**	**-7**	**5**	**13**	**18**