Changing the Formula: Seeking Perfect Prices, CEO Tears Up the Rules; Parker's Washkewicz Weighs Market Power Of 800,000 Parts

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ABSTRACT (ABSTRACT)

Like many Parker executives, Mr. [Donald Washkewicz] is a lifer. He attended Cleveland State University before landing his first job as an engineer at Parker, where his first task was to manually replace faulty Parker hoses that had been installed in about 300 trucks. That involved spending six months in a grimy truck terminal, climbing under the hoods of still-hot engines. "I kept thinking to myself, 'I didn't go to college to do this crap,'" he says. He stuck with it and was soon promoted to management ranks.

Although he decided to adopt strategic pricing on his own, Mr. Washkewicz hired consultants to help each of Parker's businesses painstakingly study its full gamut of products and divide them into categories. "A" items were the high-volume commodities where there was at least one big competitor helping to shape prices. Other products were divided into "B," "C," and "D" items, which fell into increasingly narrow or specialized niches. The final and most narrow groups were "specials" and "classics" that only Parker produced.

Last year, Parker says one customer -- a maker of parts for car engines -- balked at price increases of 10% to 20% on the roughly 50 different items. The buyer's response was typical: It launched "line review," a process in which a customer puts products up for bid to see if some other supplier can provide them for less. "They said: 'Look, we're not happy with this -- we think the market is different than you do,'" says Mr. [Richard Braun], the Parker pricing boss.

FULL TEXT

CLEVELAND -- In early 2001, shortly after Donald Washkewicz took over as chief executive of Parker Hannifin Corp., he came to an unnerving conclusion. The big industrial-parts maker's pricing scheme was crazy.

For as long as anyone at the 89-year-old company could recall, Parker used the same simple formula to determine prices of its 800,000 parts -- from heat-resistant seals for jet engines to steel valves that hoist buckets on cherry pickers. Company managers would calculate how much it cost to make and deliver each product and add a flat percentage on top, usually aiming for about 35%. Many managers liked the method because it was straightforward and gave them broad authority to negotiate deals.

But Mr. Washkewicz thought that Parker, which had revenues of $9.4 billion last year, had stuck itself in a profit-margin rut. No matter how much a product improved, the company often ended up charging the same premium it would for a more standard item. And if the company found a way to make a product less expensively, it ultimately cut the product's price as well.

"I was actually losing sleep," recalls Mr. Washkewicz, a 56-year-old Cleveland native who started with the company when he was 22 and rose through its ranks as an engineer.

While touring the company's 225 facilities in 2001, Mr. Washkewicz had an epiphany: Parker had to stop thinking like a widget maker and start thinking like a retailer, determining prices by what a customer is willing to pay rather than what a product costs to make. Such "strategic" pricing schemes are used by many different industries. Airlines know they can get away charging more for a seat to Florida in January than in August. Sports teams raise ticket prices if they're playing a well-known opponent. Why shouldn't Parker do the same, Mr. Washkewicz reasoned.

Today, the company says its new pricing approach boosted operating income by $200 million since 2002. That helped Parker's net income soar to $673 million last year from $130 million in 2002. Now, the company's return on invested capital has risen from 7% in 2002 to 21% in 2006, putting it on the verge of moving into the top 25% of Mr. Washkewicz's list comparing Parker with "peer" industrial companies.

From the end of 2001 to present, Parker's shares have risen nearly 88% to about $86, compared to a 25% gain in the S&P 500.

For the past several years, many U.S. manufacturers have struggled to raise prices amid the growth of global competition and cost-cutting drives among customers. While this erosion of pricing power is often cited as a factor that has helped tame inflation, it put a strain on U.S. manufacturing, which contributes 12% to the nation's gross domestic product.

Now, a growing number of manufacturers are trying to fight back by scrutinizing every assumption underlying their pricing strategies. Some companies like Intel Corp. have used strategic pricing schemes for well over a decade. But much of industrial America -- 60% of U.S. manufacturers, according to Thomas Nagle, a pricing consultant at the Monitor Group -- still relies on oldfangled, "cost-plus" types of pricing methods such as the one Parker used.

Changing Parker's pricing was a complex undertaking. The company has tens of thousands of different types of products, often custom- engineered. The company estimates half of its offerings are specifically made for a single customer. And unlike retailers or airlines, a manufacturer generally can't see its rivals' prices. Discussing pricing with competitors is illegal, while published list prices from other manufacturers mean little in industrial markets, where most deals are negotiated. And pricing changes were certain to alienate some customers.

In October 2001, Mr. Washkewicz unveiled his big plan, which involved creating a new senior position for pricing and bringing in a host of outside consultants. Many managers throughout the company's 115 divisions immediately balked. There was so much pushback the CEO eventually assembled a list of the 50 most commonly given reasons why the new pricing scheme would fail. If a manager came up with an argument not already on the list, then Mr. Washkewicz agreed to hear it out. Otherwise, he told them, get on board.

"You're messing with a company's DNA when you change how you do prices," says Richard Braun, Parker's vice president of corporate strategic pricing, the position created that October.

It didn't help that Parker, like many manufacturers, has a conservative culture that treasures continuity. Founded in 1918 as a maker of hydraulic brakes for trucks, the company had a descendant of the founder as its chairman as recently as 1999. Today, Parker is a leading producer of industrial parts used in aerospace, transportation and manufacturing. It makes components used in everything from the space shuttle to a mechanism that helped tilt a faux steamship for the movie "Titanic."

Like many Parker executives, Mr. Washkewicz is a lifer. He attended Cleveland State University before landing his first job as an engineer at Parker, where his first task was to manually replace faulty Parker hoses that had been installed in about 300 trucks. That involved spending six months in a grimy truck terminal, climbing under the hoods of still-hot engines. "I kept thinking to myself, 'I didn't go to college to do this crap,'" he says. He stuck with it and was soon promoted to management ranks.

Mr. Washkewicz had just been made president and chief operating officer in early 2000 when he set out to visit all of Parker's facilities around the globe. He saw people boosting productivity, landing new accounts, and making shrewd acquisitions, even in the face of a deepening manufacturing recession. Yet the company never seemed to improve one key measure -- the return on invested capital. On his list comparing Parker with "peer" industrial companies, the company failed to make the top 25% by that measure.

Mr. Washkewicz decided the company needed to revamp its whole approach. He mandated that every business adopt "lean" manufacturing to streamline production and overhauled the way Parker purchased materials from its suppliers. The last -- and most crucial element -- he targeted was pricing.

To his surprise, Mr. Washkewicz discovered that computer programs for calculating prices, adopted in the 1990s, were part of the problem. "It became a cookbook approach," he says. Managers typed in myriad costs, and the computer spit out a recommended base price which was used as the starting point in negotiations.

The cookbook approach might make sense for basic commodity products, where there is enough competition and little wiggle room. But what about the unique products that only Parker or a handful of others can offer?

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What Mr. Washkewicz discovered was that about a third of Parker's products -- a huge number -- fell into niches where there was limited or no competition or where Parker offered some other unique value. Sometimes Parker could deliver the product faster. Sometimes Parker's product was just better.

By 2003, the business that makes industrial fittings, for example, had spent six months reviewing some 2,000 different items and gathered some 20,000 data points in total. The upshot: 28% of the parts, mostly metal fittings used in places like oil rigs and power plants, were priced too low. Overnight, Parker raised their prices anywhere from 3% to 60%, with the average increase about 5%. The fittings cost anywhere from $5 to $500 each.

Occasionally, the process led to price cuts. One type of hydraulic replacement filter, for instance, used on a wide range of industrial machines, saw a 15% price decrease when Parker realized that owners of the machines usually preferred to buy new filters from the makers of the machines, rather than an outside supplier like Parker.

The price increases were met with immediate protest. Many distributors complained, fearing they would be stuck footing the higher bill. Parker began running classes in 2005 to point out the unique attributes of various products to distributors, which in turn helps them justify passing on the higher prices to customers.

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In the end, Parker says the customer only switched to alternative suppliers for three of those 50 parts.

Parker says most customers accepted the price increases, either because they had to or because they accepted the company's rationale. One of those customers is Richard Pedtke, president of the compact- vehicle division at Ingersoll-Rand Co., which uses a wide array of Parker hydraulic fittings and other components in its Bobcat miniature loaders and excavators.

Mr. Pedtke says he first objected when one of Parker's new hydraulic fan motors cost much more than he expected. But when Bobcat's purchasing people sat down with Parker's sales team, Bobcat learned that the new motor replaced 11 separate parts in the company's existing machines. Moreover, the new design reduced leakage by eliminating hydraulic connections, was easier to install at Bobcat's factories, and opened up space inside the machines -- all of which saves Bobcat money.

Each of Parker's 115 divisions now has at least one of its own pricing gurus -- specialists who act as gatekeepers, and enforcers, of strategic pricing.

Sheila Konopka is the guru at the hydraulic valve division in Elyria, Ohio, which has four factories and sells $1.5 billion worth of valves in North America. "Before, everyone around here thought they were a pricing manager," she says. "If we could make 35% margin for a big order -- that was great. Nobody asked: 'Why not 45%?'"

When it came to one line of Parker's high-pressure valves, the question was particularly appropriate. These valves handle extremely high pressure -- up to 10,000 pounds of pressure per square inch -- with almost no leakage. Most industrial valves operate at half or less that PSI and are prone to varying amounts of leaks. The high-pressure models are used for things like airplane doors and the mechanisms used to raise and lower the flaps on the decks of aircraft carriers.

The company found it was able to increase prices for these items about 5% across the board because of their special attributes.

Parker's new approach has also helped it charge more for attributes that are difficult to quantify. It sometimes costs more, for instance, to produce a product in the U.S., which allows the supplier to deliver it more quickly and be more responsive. But how do you attach a price to that?

"The most common mistake manufacturers made in recent years was listening to experts who told them that they had to differentiate themselves by offering all sorts of service with their products -- but then didn't charge more," says Mr. Nagle, the partner in charge of strategic pricing at the Monitor Group, a consulting firm based in Cambridge, Mass. Parker's pricing teams now examine these sort of extra services and attempt to attach values to them.

Parker continues finding ways to apply the new approach. The company, for instance, has integrated pricing into its innovation process -- aiming to pinpoint and develop products that offer the most potential for price premiums.

"Once you start doing this, you never stop," says Mr. Washkewicz. "It's a different way of thinking that filters into everything."

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