Case

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The case summarizes field research and interviews with Mark Jefferies. The company, data, and events

are real, but names were disguised to protect privacy and confidential information.

firms ignored. Unlike the CRM systems from Oracle or SAP, Clearwater customized the

QTX for companies with sales forces of 10 to 30 people. Clearwater had been first to

market in this particular segment, and QTX sales represented $45 million of its $80 million

sales in 2004.

The QTX product line represented Clearwater’s core franchise. Clearwater’s premiumpriced

products were renowned for high reliability in performance supported by free lifetime

technical support. The QTX line held 70 percent of its mature market. To date,

competition in this market had been minimal, because no competitor had been able to

match Clearwater’s general functionality, and Clearwater held a U.S. patent on a popular

feature that directed faxed documents to a specific salesperson’s e-mail rather than a central

fax machine.

Since 1999, Clearwater had used the cash generated by the QTX line to support

engineering-intensive internal product development and to buy four other companies. None

of these other businesses had achieved a dominant market position or profitability, so maximizing

the QTX cash flow remained a priority.

The QTX Product

QTX was a sales support server that allowed multiple users to simultaneously maintain

their sales account databases. These databases covered contact information, quote histories,

copies of all communications, and links to the customer’s corporate database for

shipping records. The basic QTX package consisted of a processor, chassis, hard drive,

and network interface, with a manufacturing cost of $500. The package provided simultaneous

access for 10 users to the system, referred to as 10 “seats.” Each seat represented

one accessing employee. The product line consisted of 10-, 20-, and 30-seat

capacity QTX servers. Each incremental 10 seats required $200 of additional manufacturing

cost. Yearly sales were at the rate of 4,000 units across all sizes. In initial sales,

approximately 30 percent of customers bought the 30-seat unit, 40 percent bought the

20-seat unit, and 30 percent bought the 10-seat unit. Customers who needed more than

30 seats typically went to competitors servicing the medium-to-large company market

segment.

Clearwater set a per-seat manufacturer’s suggested retail price (MSRP) that decreased

with higher quantity seat purchases, reflecting the customer perception of declining manufacturing

cost per seat. Clearwater also saw this as advantageous because it encouraged

customers to maximize their initial seat purchase.

Clearwater typically sold its products through value-added resellers (VARs). A VAR was

typically a small local firm that provided sales and support to end users. The value added

by these resellers was that they provided a complete solution to the end user/customer from

a single point of purchase and had multiple information technology products available from

various vendors. Using VARs reduced Clearwater’s sales and service expense significantly

and increased its market coverage.

These intermediaries operated in several steps. First, the VAR combined the QTX from

Clearwater with database software from other suppliers to form a turnkey customer solution.

Second, the VAR loaded the software with customer-specific information and linked

it to the customer’s existing sales history databases. Finally, the VAR installed the product

at the customer’s site and trained the customer on its use. Clearwater sold the QTX to resellers

at a 50 percent discount from the MSRP, allowing the VARs to sell to the end user at

or below the MSRP. The discount allowed the VARs room to negotiate with the customer

and still achieve a profit (Table 1).

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The Upgrade

Initially, the expectation had been that the 30-seat unit would be the largest volume seller.

In order to gain economies of scale in manufacturing, reduce inventory configurations, and

reduce engineering design and testing expense to a single assembly, Clearwater decided to

manufacture only the 30-seat server with the appropriate number of seats “enabled” for the

buyer. Clearwater was effectively “giving away” extra memory and absorbing the higher

cost rather than manufacturing the various sizes. If a customer wanted a 10-seat server, the

company shipped a 30-seat capable unit, with only the requested 10 seats enabled through

software configuration. The proposed upgrade was, in reality, allowing customers to access

capability already built into the product (Table 2).

Clearwater knew that many original customers were ready to use the additional

capacity in the QTX. Some customers had added seats by buying a second box, but because

the original product contained the capability to expand by accessing the disabled

seats, Clearwater saw an opportunity to expand the product line and increase sales to a

captive customer base. Customers could double or triple their seat capacity by purchasing

either a 10- or a 20-seat upgrade and getting an access code to enable the additional

number of seats. No other competitor offered the possibility of an upgrade. To gain additional

seats from the competitor, the customer purchased and installed an additional

box. Because customers performed a significant amount of acceptance testing, which

they would have to repeat before switching brands, the likelihood of changing brands to

add capacity was low.

The objective of this morning’s meeting was to set the price for the two upgrades.

As QTX product manager Rob Erickson stopped to collect his most recent notes from

his desk, he reflected:

What a way to start the week. Every time we have one of these meetings, senior management

only looks at margins. I spent the whole weekend cranking numbers and I’m going in there

using the highest margin we’ve got today. How can anybody say that’s too low?

He grabbed his notes, calculator, and coffee and headed down the hall.

From the other wing of the building, financial analyst Hillary Hanson was crossing the

lobby towards the conference room. She was thinking about the conversation she had late

Number MSRP to VAR Unit Unit

of Seats End User Price Cost\* Margin\*\*

10 $8,000 $4,000 $500 87.5%

20 $14,000 $7,000 $700 90.0%

30 $17,250 $8,625 $900 89.6%

TABLE 1

\*Unit cost reflects additional $200 for memory capability for each additional 10 seats.

\*\*Margin \_ VAR Price \_ Unit Cost

VAR Price

Number Original Original Actual Actual

of Seats Unit Cost Unit Margin Unit Cost Unit Margin

10 $500 87.5% $900 77.5%

20 $700 90.0% $900 87.1%

30 $900 89.6% $900 89.6%

TABLE 2

Friday afternoon with her boss, Alicia Fisher, Clearwater’s CFO. They had been discussing

this upcoming meeting and Alicia had given Hillary very clear instructions.

I want you to go in and argue for the highest price possible. We should absolutely maximize

the profitability on the upgrade. The customers are already committed to us and they

have no alternative for an upgrade but with us. The switching costs to change at this point

are too high since they’ve already been trained in our system and software. Let’s go for it.

Besides, we really need to show some serious revenue generation for the year-end report to

the stockholders.

Hillary had not actually finalized a number. She figured she could see what the others

proposed and then argue for a significant premium over that. She had the CFO’s backing so

she could keep pushing for more.

From the parking lot, Brian James, the district sales manager, headed for the rear entrance.

He, too, was thinking about the upcoming meeting and anticipating a long morning.

I wish marketing would realize that when they come up with some grandiose number for a

new product, sales takes the hit in the field. It’s a killer to have to explain to customers that

they have to pay big bucks for something that’s essentially built in. It’s gonna be even tougher

to justify on this upgrade. At least with the QTX, we have something the buyer can see. It’s

hardware. With the upgrade, there isn’t even a physical product. We’re just giving customers

a code to access the capability that’s already built into the machine. Telling customers that

they have to pay several thousand dollars never makes you popular. If you think about it,

that’s a lot of money for an access code, but you won’t hear me say that out loud. Maybe I

can get them to agree to something reasonable this time. I spent the weekend working this

one out, and I think my logic is pretty solid.

Price Proposals

Once everyone was settled in the conference room, Rob spoke first:

I know we have to come up with prices for both the 10-seat and 20-seat upgrades, but to keep

things manageable, let’s discuss the 20-seat price first. Once that number is set, the 10-seat

price should be simple. Because the margin on the 30-seat unit is the highest in the line, I

think we should use that as the basis to the price for the upgrade.

He went to a whiteboard to show an example:

If a customer is upgrading from a 10-seat unit to a 30-seat unit, they are adding two steps of

capacity costing $200 each to us, or $400. $400 /1-0.90 \_ $4,000 to the reseller, and $8,000

to the end user. We keep the margin structure in place at the highest point in the line. The

customer gets additional capacity, and we keep our margins consistent.

He sat down feeling pleased. He had fired the first shot, had been consistent with the existing

margin structure, and had rounded up the highest margin point in the line.

Brian looked at Rob’s calculations and commented:

I think that’s going to be hard for the customer to see without us giving away information

about our margins, and we don’t want to do that, since they are pretty aggressive to begin

with. However, I think I have solved this one for us. I’ve finally come up with a simple, fair

solution to pricing the upgrade that works for us and the customers.

He walked over to a whiteboard and grabbed a marker:

If we assume an existing 10-seat customer has decided to upgrade to 30-seat capability, we

should charge that customer the difference between what the buyer has already paid and the

price of the new capacity. So . . .

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New 30-seat unit $17,250

Original 10-seat unit $8,000

Price for 20-seat upgrade $9,250

It’s consistent with our current pricing for the QTX. It’s fair to the customer. It’s easy for the

customer to understand and it still makes wads of money for us. It also is easy for the customer

to see that we’re being good to them. If they bought a 20-seat box in addition to the

10-seat box they already have, it would be costing them more.

He wrote:

New 20-seat unit $14,000

A new unit provides customers with redundancy by having two boxes, which they might want

in the event of product failure, but the cost is pretty stiff. Upgrading becomes the logical and

affordable option.

Hillary looked at the numbers and knew just what she was going to do.

That all looks very logical, but I don’t see that either of you has the company’s best interests

at heart. Brian, you just want a simple sale that your sales people and the customers will buy

into, and Rob, you are charging even less than Brian. We need to consider the revenue issue

as well. These people have already bought from us; are trained on our hardware and software

and don’t want to have to repeat the process with someone else. It would take too long.

They’ve got no desire to make a change and that means we’ve got them. The sky is really the

limit on how much we can charge them because they have no real alternative. We should take

this opportunity to really go for the gold, say $15,000 or even $20,000. We can and should be

as aggressive as possible.

All three continued to argue the relative merits of their pricing positions, without notable

success. Jefferies listened to each of them and after they finished, he turned to a clean

whiteboard and took the marker.

I’ve done some more thinking on this. In order to meet the needs of all three departments, there

are three very important points that the price structure for these upgrades must accomplish:

1. The pricing for the upgrades shouldn’t undercut the existing pricing for the 30-seat QTX.

2. We want to motivate our buyers to purchase the maximum number of seats at the initial

purchase. A dollar now is better than a potential dollar later. We never know for sure that

they will make that second purchase. If we don’t do this right, we’re going to encourage

customers to reduce their initial purchase. They’ll figure they can add capacity whenever,

so why buy it if they don’t need it. That would kill upfront sales of the QTX.

3. We don’t want to leave any revenue on the table when buyers decide to buy more capacity.

They are already committed to us and our technology and we should capitalize on that,

without totally ripping them off. Therefore, while Hillary says “the sky’s the limit,” I think

there is a limit and we need to determine what it is and how close we can come to it.

If we assume that those are the objectives, none of the prices you’ve put together thus far answers

all three of those criteria. Some come close, but each one fails. See if you can put your

heads together and come to a consensus price that satisfies all three objectives. OK?

Heads nodded and with that, Jefferies left the conference room. The three remaining occupants

looked at one another. Brian got up to wipe the previous numbers off the whiteboards

and said:

OK, one more time. If our numbers don’t work, why not and what is the right price for the

20-seat upgrade?