

Operations Practice

Negotiating supplier price increases in an inflationary market

The return of inflation makes price negotiation a more demanding—and strategically critical—capability.

by Patricio Ibanez, Ricardo Gonzalez Rugamas, Sajal Kohli, and Eric Kuehl



For many years, inflation rates in much of the world remained low, a relic of the 1970s that little concerned most procurement, supply-chain, and operations leaders. Specific commodities would experience sharp price increases, but those forces typically eased before they could trigger broad-based price pressures across swaths of the economy.

However, that's changed, and merchants today are planning and buying for their categories amid one of the hardest inflationary environments industry has seen in decades. When a supplier brings a price increase to a merchant, especially in this economic environment, the buyer may not have the right tools, capacity, or time to determine whether a price increase is warranted.

How can an organization know that short-term price increases are fair and in line with expectations? How can companies prepare to deal with the long-term consequences of inflationary markets?

Which price increases are fair today?

To understand the process of determining which price increases are fair and which are not, consider an example. A leading apparel retailer recently received price increases from suppliers for many of its primary brands, each citing the inflationary environment as the reason for the increase. The company wasn't sure how it should respond.

This retailer needs to determine whether suppliers are passing along an increase that's in line with inflation's effect on the supplier's costs. Although it's not possible to answer this question exactly, the retailer can at least pressure test the increase by determining if it falls within a fair range.

To do this, it began by identifying the main cost inputs that have the highest level of change, especially in an inflationary environment. In this example, these cost inputs were commodities (such as cotton, polyester, spandex), as well as labor and transportation (such as import costs, shipping, and freight).

Second, it estimated the percentage of the total cost these inputs make up. We would expect that fabric makes up about 50 percent of the total cost of a men's cotton T-shirt. It's safe to assume that cotton fiber (which has a commodity index, making its cost relatively easy to research) makes up roughly one-third of the fabric's cost.

Third, the company chose an appropriate starting point from which to calculate the change in cost inputs. This is an important decision that sometimes requires alignment with the supplier to find a point at which the agreed price properly incorporates the supplier's materials, labor, and freight costs. The two sides can then review the past three to five years of economic data to see how prices fluctuated for commodities and other inputs and how equitably the resulting benefits and costs were allocated between the buyer and the supplier. Of course, the supplier would repeat this process with its own suppliers, down through each tier of the supply chain.

In the fourth and final step, the company calculated an acceptable price-increase range. A plausible estimate would be for a 6 percent increase in cotton prices to translate to a 1 percent increase in total costs: $6 \text{ percent} \times 50 \text{ percent} \times 33 \text{ percent} = 1 \text{ percent}$. In this case, cotton prices rose by 12 percent, resulting in a 2 percent cost increase (Exhibit 1).

Responding to the supplier

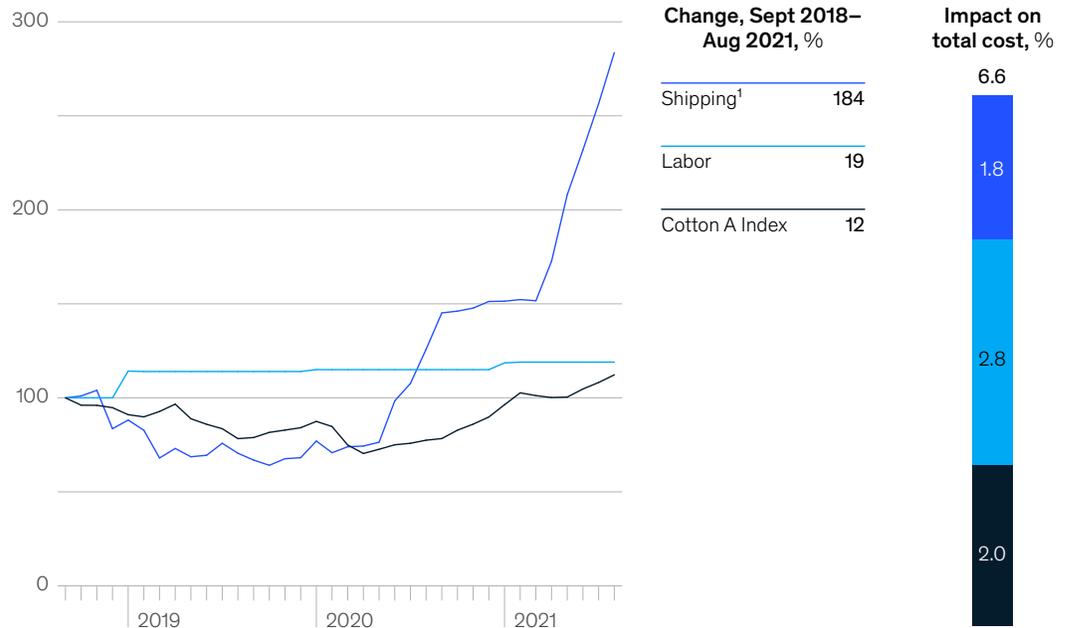
After analyzing a proposed price increase, the next focus is on prioritizing categories based on the company's exposure. Understanding which categories face inflation, together with the current terms of the contracts that involve these categories, helps in crafting a response to suppliers.

Exhibit 2 shows how an exposure matrix considering inflation (or deflation) and the degree of exposure to market forces can help identify an expansive set of commercial and technical levers that support a defensive position against inflation. Some levers can immediately mitigate cost increases; others boost future resilience.

Exhibit 1

Whether an input-cost increase is reasonable depends on a detailed review of its price history.

Commodity, labor, and shipping-lane pricing for a 100% cotton T-shirt, index (Sept 2018 = 100)



¹Average of ocean container costs, Shanghai to US West Coast and East Coast. Source: Emerging Textiles; Xeneta; McKinsey analysis

Immediate *commercial opportunities to mitigate volatility* typically include maximizing spend on existing contracts whose prices aren't indexed for inflation and requesting clawbacks on unindexed contracts that covered periods when commodity prices fell. Digital and analytics solutions can enhance cleansheet analysis to uncover how much purchases should cost for large parts of company spending, which lets managers quantify the extent to which inflationary pressure should affect supplier prices. To improve future resilience, supplier collaboration can drive joint efficiencies and potentially help the organization look beyond price and at changes to quality or specifications or at finding ways to use less. Finally, companies can consider ramping up collaboration between pricing and procurement teams to weigh inflation's

possible effects on the prices the company charges its own customers.

The *defensive, technical levers to respond to inflation* include accelerating value engineering and adjusting batch sizes or order frequency. Reducing SKUs or high-cost features and attributes by modifying specifications is a potential medium-term technical lever that can help improve resilience. Depending on the sector, options to address volatility in the short-to-medium term include optimizing supplier footprints for better control over logistics, cost, tariffs, and inventory. Longer-term volatility challengers could include strategic inventory stockpiling, relying more on vendor-managed inventory, expanding cross-industry collaboration to share commodity exposures, and

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long-term commercial and technical levers. If a price increase appears unavoidable in the prevailing market, and is backed up by reasonable, supplier-provided facts, alternatives may nevertheless be available to minimize the cost increase's effect on the category. For example, a vendor might be asked to help fund promotions to partly offset price increases for customers—an immediate action that can also help build a strategic-supplier relationship.

Explore new suppliers. If all else fails, reassessing a vendor matrix and exploring opportunities to engage other suppliers can be highly effective. While this process will not be as immediate, a strategic review can help identify nonincumbent suppliers or suppliers for other areas who might be able to provide better costing or service.

Preparing for future inflationary markets

No one can perfectly predict the next set of inflationary pressures, but it's reasonable to assume that they'll return eventually. Leaders can prepare now to minimize the impact when that day arrives.

Transfer risk upstream. Companies can employ a range of sourcing and contracting techniques to reduce exposure to additional costs. For example, diversifying the supplier base for priority raw materials gives companies greater ability to

substitute other sources should prices spike. In some circumstances, it is possible to partner with suppliers to share supply-chain risk by using fixed, long-term contracts.

Transfer risk downstream. Companies can include terms and conditions in contracts to adjust the timing of contract expiration and risk exposure. For example, volumes might be agreed on for the long term, with pricing updated frequently as the market changes. Other approaches include using public indexes or developing synthetic price indexes—that is, tying contract prices to a market price for a particular class of commodities or underlying cost drivers. Using collars to restrict price changes to a specified range and matching contract terms with those of supplier contracts can also help in structuring risk and allocating it fairly. Customers may also be willing and able to absorb some degree of risk, perhaps in exchange for reduced prices or other concessions.

Transfer risk to outside entities. Although companies should not rely on them exclusively, hedging strategies that transfer risk to counterparties in the financial markets can be of critical importance. A prerequisite, however, is an in-house finance team that understands the sophisticated positions that may be involved. Otherwise, a company may end up creating more risk than it mitigates.

Companies can also transfer risk externally by collaborating with other companies in pursuit of shared goals. Such cooperation can create a win-win situation that reduces both cost and risk. For instance, a manufacturer can gain access to raw materials outside its home market by contracting to swap or share raw materials with another manufacturer, allowing both companies to reduce costs and giving them the flexibility they need to minimize supply-chain risk.

Internal risk mitigation. The key to internal mitigation is developing flexibility in product development and manufacturing. Flexibility lets companies switch to cheaper raw materials when prices rise or shift production to different geographic locations that have cost or strategic advantages. Companies can also stockpile raw materials when prices are low and draw on these when prices spike. Although there are costs associated with maintaining high inventory volumes, these costs may be justified by the benefits when raw-material prices are highly volatile.

To mitigate risk through flexibility, one company developed an analysis tool to identify where it

should buy a particular raw material and whether it should change the specifications (such as the quality or grade). Balancing input costs, demand requirements, and market prices let the company approve multiple catalysts for its production process and choose which to use based on its product's regional prices, thereby reducing cost and risk. When its supply costs rose, the company bought a higher-performing catalyst that created a higher yield. Although the company was paying more for its raw materials, the higher yield was large enough that overall profits actually rose. When prices declined, it shifted back to a material that produced slightly lower yields but at a significantly lower cost.

Finding creative ways to mitigate supply inflation is a skill that lies dormant in many organizations. But with the right approach, companies can rebuild their price-negotiation capabilities—and their long-term resilience.

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