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Defying cost volatility: A strategic pricing response

While input cost increases and volatility are challenging, they present an opportunity to improve pricing and institutionalize best practices—but margins will likely suffer if these are not executed in a strategic way.

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Key takeaways

— The ongoing input cost increases and volatility, while representing a difficult challenge, provide an opportunity to improve pricing through adoption of best practices.

— Organizations that adopt a strategic approach to pricing actions can significantly minimize margin leakage during a pricing action.

— Our four-step approach can put your organization on a path to pricing excellence, allowing you to recover cost increases and minimize negative impacts to financial performance in a responsible, transparent, and customer-centric manner.

The impact of the global pandemic on demand and pricing varied across industries. While demand initially fell significantly for segments such as luxury retail and food service, others such as consumer building products saw demand spike as people invested in their homes. The pandemic also disrupted supplier operations and supply chains, leading to significant availability issues across products and geographies.

Not surprisingly, most companies during the past 18 months focused on meeting customer demand and managing profitability through targeted cost savings. Pricing remained an afterthought. And while many upstream players have begun to increase prices in response to cost increases, downstream organizations have balked. Many have left prices largely unchanged or have implemented only minor increases, especially during mid- to late 2020, concerned about the impact on communities when lives and livelihoods are at risk.

Yet the business environment in recent months has been very different. In the United States, the consumer price index jumped 5.4 percent in June, its biggest monthly gain since August 2008.[1] Raw-material costs have also been increasing steadily since July 2020 (Exhibit 1). As a result, several manufacturers and distributors have implemented price increases to keep up with rising costs and minimize impact on financial performance.

The decision to implement price changes in an atmosphere still heavily impacted by a global pandemic is not easy. Pricing strategies grounded in advanced data analytics, informed by value created for customers, and supported by well-planned price execution can help put a check on the degradation of financial performance, potentially narrowing the gap between supply and demand. It may also position companies for improved financial performance when business returns to postpandemic normalcy. Yet price changes are not simple and can carry risks: our analysis shows poor management of pricing actions can wipe 66 cents off every dollar of potential price improvement (Exhibit 2).

As companies imagine the postpandemic economy, leaders ready to invest in pricing to counter inflation and to build strong foundations for growth may want to carefully consider four steps:

1. building an analytical fact base

2. setting a value-based dynamic pricing strategy

3. creating conviction among the sales force

4. governing and carefully tracking execution and results

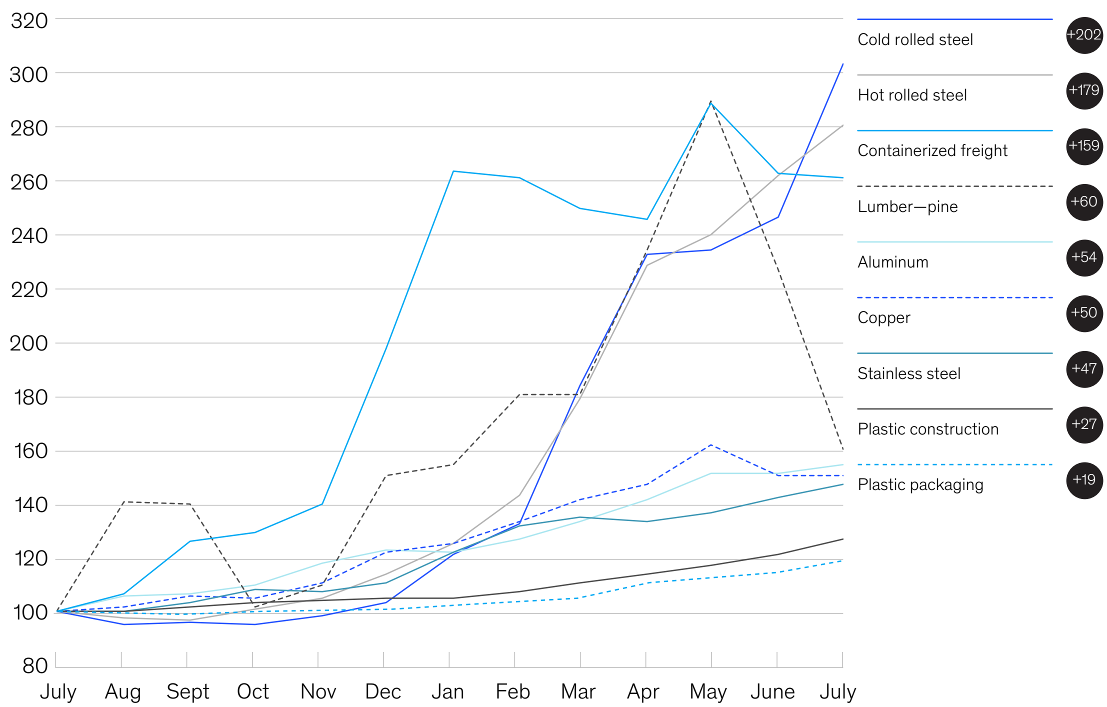
By strategically and systematically implementing price changes, companies could effectively pass on input-driven cost increases (or decreases) in a value-based way while potentially creating healthier pricing practices and stronger customer relationships that will endure.

[1] Agence France Presse, “US Annual CPI Jumps 5.4% In June, Biggest Since 2008: Govt,” Barron’s, July 13, 2021, barrons.com.

Exhibit 1

Manufacturers and distributors must adjust their pricing strategies to account for rising costs of raw materials.

Select raw-material costs indexed to July 2020, %



Source: Drewry; ITC; Metal Bulletin; Nasdaq; SBB; US Bureau of Labor Statistics

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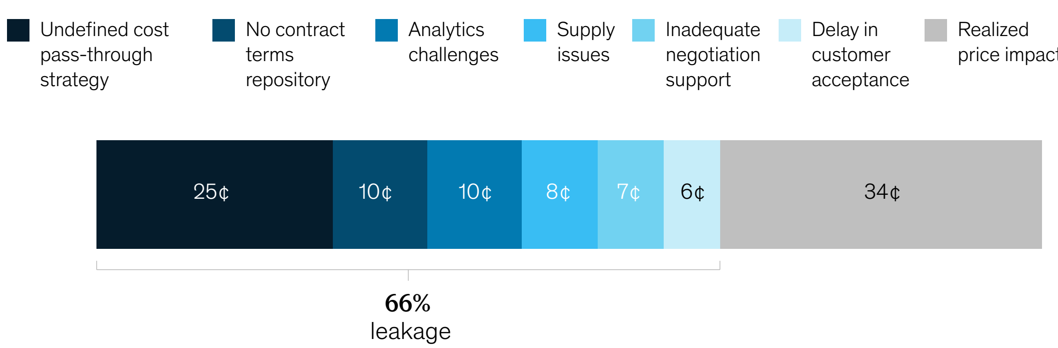
Exhibit 2

Two-thirds of potential price improvements tend to leak out because of inadequate strategy, policy, and process support.

Distribution of one dollar in price improvement, cents



Source: McKinsey analysis

Many commercial leaders have hesitated, reluctant to reflect the impact of input cost increases in their product prices.

A (new) world of cost volatility

After the upheaval of the past year, demand has begun to stabilize at a new level—often very different than before the COVID-19 pandemic. Supply chains are adjusting to the next normal, and prices of raw materials are increasing rapidly, primarily trending upward across categories. To accommodate this shift in input costs, manufacturers and distributors may have to adjust their pricing strategies. Yet many commercial leaders have hesitated, reluctant to reflect the impact of input cost increases in their product prices. This hesitation may be driven primarily by the fear that being the "first mover" in their segment could potentially hurt customer relationships in a way that is only worsened by the pandemic (for example, significant volume loss). Yet we believe there are few alternatives to passing on (at least partially) input cost increases.

In our experience, being reactive about a price increase often leads to last-minute, generic, broad-brush price hikes that lower customer satisfaction and worsen any systematic pricing or margin strategies companies may have in place. For example, in a previous article we shared the story of a packaging company that delayed changing its prices for a few quarters before being compelled to pass through a sweeping price increase to mitigate the impact of a 20 percent yearly rise in raw-material costs.[2] The move wasn't aligned with its overall pricing strategy, and the organization hadn't prepared its sales force to respond to customers' concerns and questions. Within three months, it lost double-digit market share and had to roll back a portion of the price changes.

A four-step approach to pricing success

Companies should consider investing in a careful and strongly executed plan both to maintain margins and to create stronger customer relationships and healthier pricing practices. To carry this out, most decision makers can adopt a four-step approach to pricing discipline:

1. *Build the analytical fact base.* Compile transactional data down to contribution margin for the past two to three years and create transparency on all key contracts. Assess historic cost pass-through performance and current cost pass-through policies (if there are any in place). Evaluate contractual obligations and opportunities for renegotiation in a systematic way. In parallel, revamp standard, actual, and forecast costing processes to ensure the true impact of input cost changes is reflected in the cost of goods sold. Assess forecasting accuracy of cost, and supply and demand. Building the analytical fact base that shows the impact of expected cost increase, as well as planned and potential pricing actions on future profitability, allows for the development of a future pricing strategy based on insights rather than gut feel. This helps remove abstraction—especially when input costs haven't been tracked historically—and provides the logic and language business leaders and sales teams need to credibly and transparently communicate with customers. In addition to a more long-term pricing strategy, the transactional and contractual transparency allows for the rapid identification of quick wins, such as outdated,

[2] Alex Abdelnour, Christopher Angevine, and Jeremy Seeley, "The commercial response to cost volatility: How to protect margins against inflation and tariffs," June 2019, McKinsey.com.

margin-bleeding contracts that should be renegotiated right away.

2. *Set your dynamic pricing strategy.* A key objective of any good pricing strategy needs to be the protection of margins. But the approach to achieving that needs to be tailored to the business and economic situation. For a price-sensitive commodity business that is highly affected by select raw materials, the focus needs to be on rapid and full cost pass-through. This is often achieved by linking prices to commodity indexes. This approach is reactive, and often leads to delayed cost pass-through and consequently margin loss. While effective for a commodity business, the same approach could be damaging for a business selling specialized, differentiated products and services. Leading organizations have used advanced analytics to forecast changes in raw-material costs and imbalances between supply and demand, as well as prices in their end markets, and built capabilities to proactively change their pricing and contracting approaches. Depending on the situation, a value-based treatment of price changes (where the value is quantified and priced in relation to competitive products) or a more steady, measured price increase—to ensure margins are protected when raw-material cost increases pass through production, inventory, and finally to goods sold—could be the right approach. In addition, organizations can look for remediations that are related to the purchasing or manufacturing of the products, such as switching contracts to alternative suppliers, changing product content to lower the impact of raw-material cost without compromising product quality, updating standard cost processes to build in latency and accuracy, and matching customer contract duration to supplier contract duration.

3. *Create conviction in the sales force.* Provide appropriate training so sales teams can gain confidence in holding effective price-change conversations with customers, manufacturers, and distributors. Commercial leaders need to anticipate buyers' questions so that sales representatives and managers are comfortable discussing price with procurement organizations—we find that an effective preparation is for sales teams to role-play customer conversations in a variety of scenarios. Many organizations institute a comprehensive performance-management system, including training, value-selling, updated incentives, and key performance indicators, along with rollout of cutting-edge analytical pricing tools. All of these are in service of building sales confidence and conviction. In fact, many leading sales organizations find that the price-change conversation is an opportunity to discuss other ways the supplier can create value with the customer. If the supplier is viewed more as a partner and less as a vendor, the price-increase conversation could be seen as a win–win for both sides.

4. *Implement governance and impact tracking.* Establish clear escalation processes for pricing approvals, and delineate performance-management processes specifying how customer concerns are handled, what information and approvals are required to make exceptions to a planned increase, and how quickly information and answers will be provided to the decision maker on the account team. Standard pricing processes and performance reviews are often too slow to manage rapid change in a magnitude that has not been seen in a long time. Management must be able to quickly and easily monitor which customers have been contacted, which are at risk, what price levels have been approved, and whether the business is on track to achieve its target. This can mean tracking results at a customer-item level on a weekly or even daily basis to gain an understanding of where to increase focus. Depending on the nature of the change (temporary versus sustained), this could require a temporary short-circuiting of standard processes or long-term, structural change of key processes.

While these four steps feel intuitively accurate and simple, the real challenge organizations face is their ability to execute them with enough granularity, accuracy, and speed to make them effective and actionable. In our experience, organizations may avoid taking action because of a perception that they lack sufficient data and analytic talent to make progress. The reality is that most organizations have adequate data within existing systems to undertake basic analyses and straightforward actions.

Those realizing value with this approach can then begin to invest further in their systems, especially dynamic pricing systems, as well as in acquiring analytic talent to uncover future pricing opportunities. Coupled with a focused change-management effort across the organization, these organizations put themselves on a road to achieving the cross-functional collaboration necessary to deal with cost increases, price volatility, and any other challenge that might arise. It's a path to pricing excellence: organizations can potentially recover cost increases and minimize negative impacts to financial performance in a responsible, transparent, and customer-centric manner.

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