

# Easy, But Not Simple

## Commodity Pricing: Flexible Prices for Mature Products

The times when prices were set by the market are over. Unfilled capacities, price-aggressive competitors and price-sensitive customers are putting more and more pressure on prices and price-makers. Managers are now confronted with the challenge of actively steering prices. Is it possible at all to proactively set and steer commodity prices, the products most strongly driven by market prices? CHManager Europe discussed this question with the pricing consultants Karl-Heinz Sebastian and Andrea Maessen from Simon-Kucher & Partners. Both are specialists in pricing in the chemical industry. The firm conducted more than 1,000 pricing projects worldwide in the last five years alone.

*CHManager Europe: Ms. Maessen, what is a commodity?*

**A. Maessen:** That's not a simple question, and the answer is usually given too quickly and mostly wrong. A commodity is a completely exchangeable, homogeneous and standardised mass product. Customers have direct, instantly usable alternatives and enjoy the high price transparency of commodities. Prices follow market cycles. The market drives prices into an upturn and downturn. They are only seldom balanced. Typical com-



**Dr. Karl-Heinz Sebastian,**  
Senior Partner, Simon-Kucher & Partners

modities are styrol, caprolactam or ethylene.

**K.-H. Sebastian:** When defining a commodity, it's equally important to find out what it's not. Products that are at the end of their life cycles and have been broadly imitated are also undifferentiated and exchangeable, but they aren't commodities according to our definition. They are referred to as commoditised products. Products like specific dyestuffs or coating resins belong to this category. They are offered in the same quality and specification by various suppliers. Knowing if you compete in a commodity environment and understanding how to react to price changes are the number one success factors for companies and even for the profitability of an industry as a whole.



**Dr. Andrea Maessen,**  
Partner, Simon-Kucher & Partners

*So what is the concrete difference between a commoditised product and a commodity?*

**K.-H. Sebastian:** In both cases the products are undifferentiated. Commoditised products have lost their competitive product differentiation value. As a result, the price and margin pressure increases. Service differentiation options are applied as a remedy. The customer relationship plays a key role in this situation. Commodities are completely different. Securing capacity utilisation in a cyclical market is essential. Success in commodity business is primarily based on utilisation rates and business processes. Processes have to be simple, flexible and quick to cope with the market's ups and downs. Investing in customer-oriented, value-added strategies is just the

wrong way to go with commodities.

*Many managers today are under price and margin pressure and complain about the increasing commoditisation of their products. Is it possible to stop or even reverse this trend?*

**A. Maessen:** You can put off commoditisation if you manage to switch from offering a product to offering a system or solution. The basic offer has to be enhanced by services or warranties like quality control guarantees, certifications or lab services. The success of these measures is determined by the value the customers place on these add-ons and their willingness to pay for them. But only true innovation can stop and reverse the trend of commoditisation.

*When does a product become a commodity?*

**K.-H. Sebastian:** At first glance, the shift to a commodity starts when all kinds of product and service differentiations lose their effect. If that is the case, it is already too late to stop or reverse the trend. A deeper look, however, reveals that there are three early warning signs: declining margins, decreasing customer loyalty and rising business volatility. Commoditisation is a sneaky process, but there is still time to prepare and react. A commoditised product only becomes a "true" commodity if the management consciously

decides to change the business model.

*What needs to be changed within the company for a product to become a commodity?*

**A. Maessen:** In extreme cases, the entire business model has to be overhauled. A different kind of employee is needed. Lean and cost-efficient processes need to be installed. For example: A major manufacturer of base chemicals reduced its product portfolio from 1,000 different products to less than 50. The production set-up was redefined. The marketing budget was cut, the sales force reduced and completely restructured. There was a complete organisational turn around. Obviously, it is very hard to make these decisions since there are no "ifs and buts," only a clear "either ... or."

*What is the key success factor in the commodity business?*

**K.-H. Sebastian:** The commodity business is a mass business with a high share of fixed costs. The business model focuses on volume and cost efficiency. Those who master the costs – including the transportation costs – and efficiently control the volume are well positioned. In the commodity business, profitability is a very good result, but it's not a good target.

*What does that mean for pricing? Always the lowest price?*

**A. Maessen:** No. Commodity pricing means aiming for the highest price for a defined volume. That requires high flexibility in pricing: prices often have to be adjusted on a daily basis. In principle, the price should follow the market cycles. To artificially delay the price downturn and anticipate a price upturn makes no sense. It regularly leads to overreactions. Prices always have to be competitive. Consequently, significant and permanent price differences do not exist between competitors.

*Does that mean there is only one uniform price for a commodity?*

**K.-H. Sebastian:** Absolutely not. Despite the high price transparency in commodity markets, prices are still differentiated between customers. Another driving factor for price differentiation is usually the volume: the total yearly volume of a customer, the product volume bought by the customer or the order size.

*How are prices for commodities set?*

**A. Maessen:** You have to track and be able to forecast the supply demand situation, to accurately observe competitors, their volume and price moves, and to closely watch your supply markets.

*Are companies able to gain a competitive advantage through pricing in the commodity business?*

**K.-H. Sebastian:** We've observed an increased use of pricing models for commodities. These models include price forecasts, which support the company in proactively setting the price and helping them to systematically differentiate prices. "Better" prices are the result, since hasty price moves and overreactions in pricing are minimised. Companies applying this type of a pricing model and professionalised pricing processes are able to increase their profitability by about two percentage points.

*How significant is the performance gap between companies in commodity pricing?*

**K.-H. Sebastian:** There are strong differences in the performance. We have distinguished three groups of companies: A small group of companies applies comprehensive pricing models and shows high professionalism in pricing. Many companies now actively try to close the gap between themselves and their best-performing peers. Today, the most successful players are able to manage and control their prices as well as their costs and cash-flow in real-time.

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