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MARKET OUTLOOK PRICING STRATEGIES

Agile pricing counters volatility

In a volatile market, dynamic pricing capabilities and agile contracting practices are key factors to successfully protect – and even improve – margins

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The volatility of raw material costs, exchange rates and tariffs continues to create a dynamic and unpredictable market environment. Companies that are not sufficiently flexible in their contract practices, or too slow to adjust prices, will encounter unexpected margin pressure. So how can companies secure the "right" level of agility in pricing and contracting?

Commoditisation is continuously moving downstream. As "traditional" specialty chemicals like additives, pigments and resins are becoming increasingly commoditised, chemical companies face increased exposure to volatile input costs, demand and selling prices.

The natural reaction is to focus on cutting operational costs and adjusting business models to the new realities.

Under these circumstances, "filling the plant" then becomes the typical mantra for keeping the costs down.

One polyolefin producer summarised its priorities as "operations first, innovation second, sales and marketing third." However, placing marketing and sales (pricing) considerations so low on the list will be detrimental to margins, as the following hidden pricing traps demonstrate:

THE TIME LAG TRAP

Price formulas are considered a risk-free option for passing on raw material cost fluctuations. Product prices are linked to a published index to secure a stable unit margin. But due to index publication dates, there is at least a one-month lag between prices and actual cost development.

Formulas generate windfall profits as costs decrease, and windfall losses as costs increase. There is a widespread misbelief that these balance each other out in the long run. What is not considered is that increasing costs tend to coincide with an increased demand, while decreasing costs reflect softened demand.

Therefore, by design, windfall profits are insufficient to compensate for windfall losses. Actually, we calculated that up to 30% of annual profits remain unmanaged due to time differences.

> Quarterly or monthly pricing allows for flexible ongoing adjustments, and price changes might occasionally even be double digits. The key to success is having agile pricing processes and models in place to react instantly to changing conditions

THE CONTRACT TRAP

When costs increase, attempts to implement higher prices often lack traction due to long price validities. In the worst case, costs are on their way back down again before the cost recovery is completed.

As result, margins erode during both the cost decrease and increase phases.

THE TOOLING TRAP

In recent years, many companies invested heavily in software and systems to achieve control over pricing. The result is complex "killer tools" that slow processes down, are high maintenance and could paralyse a large part of the commercial organisation during the implementation of price increases.

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THE OWNERSHIP TRAP

As cost volatility increases, price adjustments are required more frequently. These decisions come with risk of either margin erosion or volume losses. Increase prices and you risk having customers switch suppliers. Do nothing in response to cost increases and you will lose margin.

Often organisations are not accustomed to making such decisions on a frequent basis. Thus they lack a sense of urgency, the required capabilities to execute price changes, clear ownership of decision making and the willingness to assume risks.

THE PRICE EFFECT TRAP

According to a recent Simon-Kucher Global Pricing Study, in 2017 the average implementation rate of planned price increases was 49% for specialty chemicals and only 32% for commodity chemicals.

For planned price increases above 5%, the implementation rate dramatically declines despite the need for action typically being higher in these situations. Typical reasons cited include existing contractual obligations, selective price decreases to secure volume at risk, or mix effects in the product and customer portfolio.

Often companies lack transparency on the true price effects of price increases, negatively impacting their ability to accurately track performance, plan more effectively and follow up on outcomes.

REQUIRED ACTIONS FOR AGILE PRICING

How can companies avoid hidden pricing traps? Companies with the "right" level of pricing and contracting agility can confidently navigate volatile conditions by observing these practices:

■ **Set the "right" pricing cycle:**

For a specialty product portfolio, prices are typically adjusted on an annual or semi-annual basis, with moderate price changes to reflect inflation. For commodity-type products, volatile markets and fluctuating cost require shorter pricing cycles.

Quarterly or monthly pricing allows for flexible ongoing adjustments, and price changes might occasionally even be double digits. The key to success is having agile pricing processes and models in place to react instantly to changing conditions.

■ **Choose the "right" price model:**

Establishing price formulas is a good option to manage prices if dependencies between supplier and customer are high. Pricing is "neutralised", and the customer relationship stabilised. Opening clauses in contracts accounting for exceptional cost hikes or unexpected market events helps to maintain a certain level of flexibility.

However, the more supply/demand-driven and fragmented a market is, the less suitable formula pricing becomes. Negotiated prices allow companies to capture market opportunities and apply a dynamic pricing strategy.

■ **Establish an internal pricing "drum beat":**

Successful price adjustments follow a coordinated and clear rhythm – preparation, execution and follow-up. Preparation involves a structured and documented review of pricing indicators such as supply, demand and costs. It requires clear price change targets supported by a valid rationale that is communicated clearly to the sales team.

Execution includes announcing the price change, conducting negotiations and updating prices in the systems. While follow-up often falls short, it is about tracking pricing and volume KPIs, gathering competitive intelligence and dynamically adjusting price increases if needed.

> Pricing is a leadership task... The responsibility cannot be delegated or left to collective decision making

"Best-in-class" price management means selling the product at the "best" price while achieving volume targets within one's market share bands. In case of deviations, dynamic adjustments are required.

■ **Provide actionable price guidance for negotiations:**

Every organisation has approval workflows to control pricing and reduce margin leakage. But installed systems are often too complex, too cost-driven and too internally focused.

In one example, a system used by a lubricants producer forced its sales management to approve 80% of pricing decisions. Such cumbersome tools and inflexible processes add no value and result in a frustrated and disincentivised sales team.

To empower and support your sales team without losing control requires simple and market-driven pricing guidance. Easy-to-use price lists help capture the value of variants, derivatives or by-products, and simple price-volume curves leave room to negotiate trade-offs. Solutions need to be scalable, easy to communicate and execution-oriented.

■ **Achieve transparency on the true price effects:**

Looking only at average prices, unit contribution margins or, even more difficult, absolute profit contribution, will not provide any insight into price performance and achievements. Measuring the true price effect, separating product and customer mix effects, is fundamental to any unambiguous pricing KPI.

For example, if the dependency on raw material costs is high, a "price over (market-based) raw material cost" helps to more effectively measure price performance.

■ **Secure execution with technology:**

While it is tempting to believe that pricing algorithms provided by large software vendors can help to automate and optimise pricing just like in production, the contrary is actually the case.

Technology and tools cannot replace solid skills and management engagement in making pricing decisions.

However, technology is an important enabler for good pricing. In the meantime, dashboards are easy to use and inexpensive to configure in stand-alone visualisation software, providing salespeople with overviews on customers, products, volume and price changes.

And early warning platforms can provide a common view on leading indicators such as raw material cost trends or demand/supply dynamics.

These platforms can be built in modular systems, without significant investment, all focused on turning data into information to enhance decision making.

■ **Clearly define responsibilities:**

Pricing is a leadership task. One person must make the call on price changes, assume the risk of margin or volume losses and accept the potential consequences. These responsibilities cannot be delegated nor left to collective decision making among Product Management, Marketing and Sales. It requires knowledge, insight, skills, appropriate tools, and perhaps most of all, courage.

In volatile environments, there is a lot of money at stake. Commoditisation, particularly in the specialty chemicals market, will continue to be an issue and lower margins can be expected.

While strict cost controls are a necessity, they are not sufficient to manage volatility.

Dynamic pricing capabilities and agile contracting practices are key factors to successfully protect, and even improve margins. ■

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