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From free fall to gliding

The agile cost management challenges in an "after corona" world

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Didn't the first two months of the coronavirus lockdown feel like being pushed out of a plane in the middle of the night? It was a free fall into uncertainty: revenue collapse, liquidity crunch, desperate cries for help.

In recent weeks, though, you found the ripcord, the handgrips – by miracle, some would say. The parachute opened. You were still falling, but slower, more gently, and with greater control over the descent. You understood that you had a very good chance to survive, even though the impact might leave you with serious injuries.

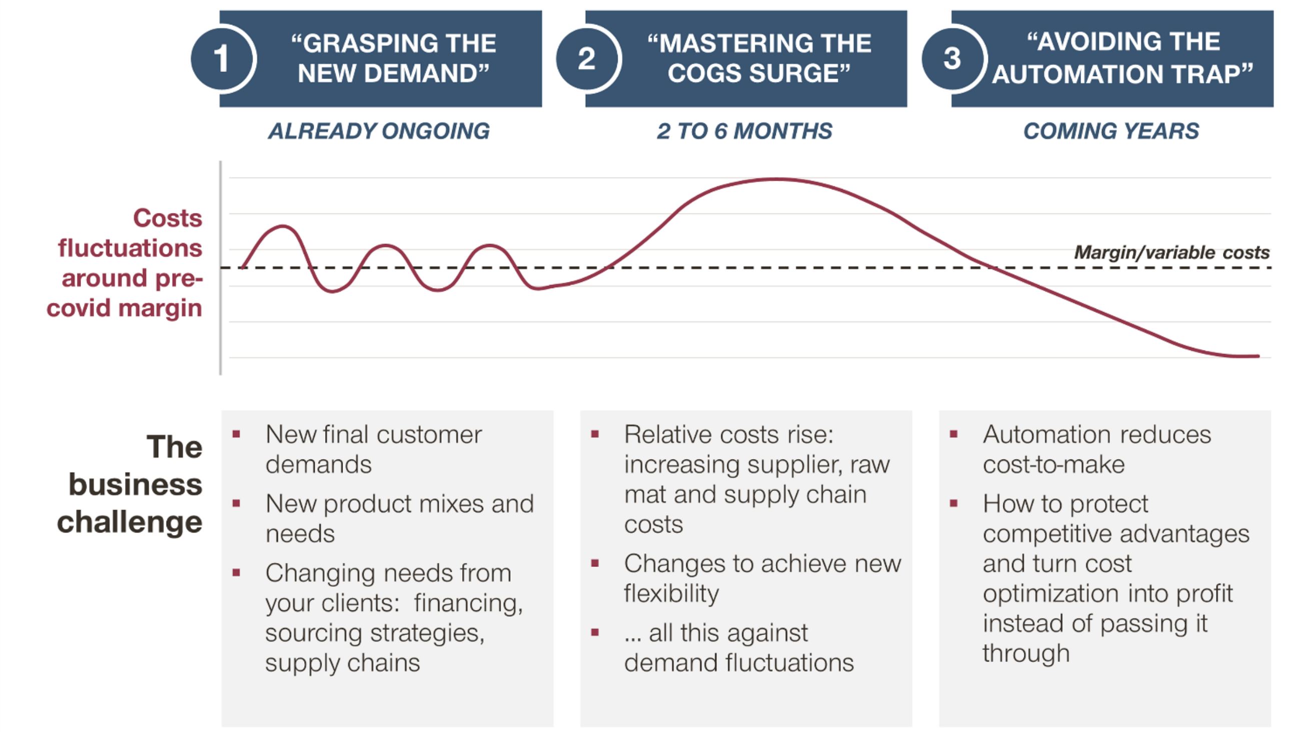
And now? Some favorable winds are lifting you up again. Old customers are calling you again but with different needs. The moment of truth is here. Where you eventually land may look nothing like the place where you started, but now the challenge is to ride the resurgent winds and find the best landing place you can. You could land in a place that leaves you overwhelmed due to demand you can't meet, or overweight because of excess capacity. You could land in a space that leaves you threatened, or ride the winds to a place where you end up thriving.

Are you up for the challenge?

The one trait that will separate the winners from the rest in this pandemic is a rare combination of capabilities that we call commercial agility: the ability to make resilient pricing, design, sales, and cost management decisions with unprecedented speed and flexibility – over and over again – until some form of equilibrium returns to your market.

Peter Drucker, the great apostle of modern management, wrote in 1969 that, "Profit is the cost of survival." As the crisis disrupts value chains, the companies that win will need the economic resilience to focus on profitability, and not just on volume. Any gains in market share should not come at the cost of profitability.

Companies will face three cost management challenges that will test their agility through this resurgent crisis. While these challenges are universal, we will use B2B examples to illustrate the key points.



Challenge # 1 - "Grasping the new demand"

Demand is fundamentally shape-changing before our eyes in the "with corona" period. These changes are completely altering sourcing strategies and reconfiguring supply chains, but companies are also seeing new customer needs emerge. Before they can develop their commercial responses, companies need to understand how these changes will put their go-to-market models under stress. In other words, they need to see what their current landing space looks like and see if they can ride the winds to a better space.

In particular, the volatility of demand will put pressure on your cost base. This confronts companies with a dilemma in the short term: pass on those costs to customers, or absorb them. Neither is an easy attractive option at a time when customer price sensitivity may be heightened and a company's own ability to absorb a margin hit is very slim.

Let's look at one example:

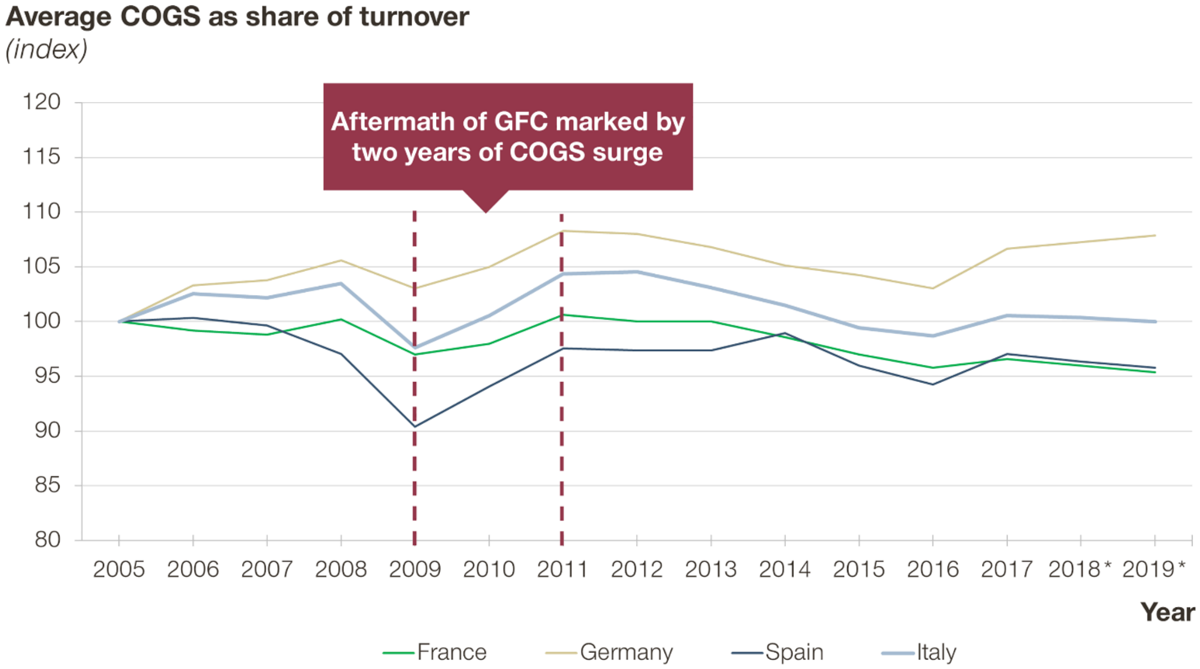
Leading European specialty chemicals manufacturer (Overwhelmed). The company had adopted a model of close proximity between its teams and customers, not only in terms of sales, but also through laboratory services at the customer's premises and through work on the customer's production lines to manage waste. How does this model survive in the face of increasing customer demand for greater safety?

Understanding this surge of interest, and translating it into new willingness-to-pay criteria, is critical to being able to size the commercial response. But it also comes at a greater cost in two forms. Preserving the existing service model in an era of social distancing will likely impose significant costs, and expanding it to serve additional customers may not have the economies of scale.

The extent to which the company can serve the surging demand and, at the same time, pass on some additional costs to protect its margins will be a make-or-break decision.

What is needed now is a thorough understanding of how new demand is redefining willingness to pay and the ability of companies to pass through cost increases. Use proven Simon-Kucher methods to understand what drives value creation from the customers' perspective. Develop a needs-based segmentation to scale up your capabilities.

We recommend several ways for companies to add agility to their pricing processes and price models. First, companies will need to move to differentiated pricing as quickly as possible, ideally at the micro-segment or even the individual level. Differentiated pricing is no longer a distant goal as you wait for technology and customers to catch up. This is right now.



Source: Statista, survey from 2005 to 2017 and forecast for 2018 and 2019

Challenge # 2 - "Mastering the COGS surge"

To get some insights into the current resurgent crisis, it is instructive to look at the period following the crisis of 2008-2009. We can see that cost of goods sold (COGS) actually rose for two years. This little-studied phenomenon has a straightforward explanation: Each adaptation of the factors of production generates immediate additional cost.

In theory, such cost increases would play into the hands of companies that claim to offer a low-cost solution. But there is an important twist on that theory during this resurgent crisis: the best supply chains will be the ones that are low-risk, not low-cost. Flexibility costs money, and buyers in a time of crisis may be willing to pay more for a lower-risk option.

This is the opportunity for companies to become masters at raising their prices. Understanding this cost surge in detail, and its impact to your business' operations and finances, quickly reveals the pricing pivots you will need to make. At some point, the companies making these investments will need to pass along at least some of those costs through the value chain. This is another point where agile pricing comes into play: how can a company increase its prices at a hypersensitive time when any such moves risk being viewed as profiteering or price gouging? The ability to pass on these cost increases to the customer is critical. Many sectors were already struggling to do this before Covid-19.

Another element to address via agile pricing is inflation. The billions or even trillions poured into our Western economies will eventually trigger bursts of inflation, just as similar actions did in 2008-2009. Understanding the real vs. nominal impact – the inflation-adjusted differential between cost and income – will influence one's own ability to operate more profitably.

Answering this question requires companies to find the right timing, the right levels, and the right level of differentiation, all backed by a communications plan that minimizes the risks of any misunderstandings. Companies can benefit from adopting concepts from revenue management, such as demand forecasting.

It is also critical to select and monitor the right pricing KPIs coupled with well-oiled price increase processes. Many companies have thick rulebooks around price reductions (i.e. how to increase demand by lowering prices) but little or no structured way to increase prices.

Greater automation's potential seems undisputed...

- International Federation of Robotics : "A 2019 report by Oxford Economics predicted 12.5 million manufacturing jobs will be automated in China by 2030. **In the aftermath of the pandemic, it could be many more**."
- SK calculations : this equates to 15-20% of Chinese manufacturing jobs
- In the US, 36 million jobs that have a "high" susceptibility to automation – with degrees of 70 % in production, food service and transportation. **Brookings foresees a "new bout of structural changes**"

Source: Brookings, IFR, Simon-Kucher calculations

Challenge # 3 - "Avoiding the automation dilemma"

The resurgent Covid-19 crisis is accelerating automation and digital trends. Automation will have significant impact on jobs and will enable several industries to reduce their operating costs. How will this translate into profitability? Companies can waste an opportunity if they do not adapt their pricing processes. As one French industrialist told us a few weeks ago, "We heated a house in the winter, while keeping the windows open. The heat evaporated."

In other words, they reduced their expenses, but because the company set prices using a markup over costs, they passed on a massive price cut that slashed their revenues. Winning the market through lower break-even points is only as sustainable as your ability to maintain your topline – and your pricing power – over time.

In other words: passing through price increases in some form is wise, but passing through cost savings can be deceptively dangerous. The agile companies know when to pull either lever, and also know how far they can go.

Let's look at an example of a company that resisted the temptation to cut prices on a high cost solution.

Leading heating system provider (Thriving): In early 2019, this company had developed a remote maintenance tool. But the solution was abandoned shortly after launch, because customers judged it to be too costly and internal maintenance staffs opposed it because it threatened their jobs. But eight months later, during the “with corona” period, guess what? Demand surged for remote maintenance! Fortunately, training had been completed and prices set. Within four weeks, the new offering had become cash flow positive, benefiting from a subscription model plus entry fee. The company caught a favorable wind and maintained its fee structure despite greater scale and reduced need for training.

The same risk applies to digital. Most industries are now embracing digital sales, thereby saving significant amounts of money. But they should not pass all these savings directly to customers.

In the last step, the key question is now on transforming your price and revenue model. We have a toolbox with some hundred different models available and ready to be tested for acceptance by customers, and combined with your ability to track and manage costs.

Closing thoughts:

For most companies, whether and when to reinvent their commercial models is no longer their decision. The answers are “yes” and “now.” The “with corona” period will last for so long that they will not see the “after corona” world unless they fundamentally change the way they do business.

As you ride the winds to a safe landing, where you land depends on how you answer these five questions:

- How prepared is our pricing model and decision framework to respond quickly enough to volatile demand?
- How do we need to redesign our offer to deliver an appropriate customer experience and still make money?
- What are our playbooks and processes to manage inevitable cost-base inflation in our pricing?
- How well can our sales model adapt to a remote world?
- How can we ensure that our revenue and profitability models can endure multiple episodes of the crisis?

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