MFL
The Pricing Times
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Pricing in A Declining Raw Material Environment

Oil just fell below $40 (or whatever the number is today). What should you do given two or more years of blaming oil for the multiple price increases you have passed on to your customers? The answer is not easy, but you should not wait to decide what to do. Act now – waiting will most likely hurt, not help your business. We have identified 4 straightforward steps that can help you sort out what to do and when to act.

1. Get the hard facts about your situation **today.**
2. Decide and document your short-term pricing goals.
3. Develop detailed pricing tactics for every account
4. Carefully manage communications to all audiences that will become aware of your price actions.

1. Get the Facts

The facts you need are straightforward, but for too many businesses are more often guesses not hard facts. In addition, the facts are rarely fully documented and discussed by people across the organization so that they can be challenged, updated, and used on a real time basis.

The place to start is gathering facts about your customers, second about your competitors, third about your raw materials, and finally about your own business. Businesses usually prioritize and collect their information in the reverse of this order and run out of time and energy needed to gain a solid understanding of their customers. Although every business should have a different menu of facts, they should cover the same common sense topics.

Customer information

Understanding the impact that you have on your customers' businesses should be a first order issue. For example: What percent of your customer's cost do your products represent? How has that changed in the past 2 years? Are your customer's price moves to their customers ahead or behind relative to your prices moves to that customer? It is also important to understand where each customer stands relative to their profit, share, and growth goals. These data help sort out the pressures customers are facing to cut their prices. Where are those pressures coming from? How strong are they? How do your customers stack up relative to their customers and to their competitors? In addition, it is also important to understand what information your customers know about your raw materials and what is happening to their other raw materials. Most importantly, developing a factual understanding of your customers' switching costs, (the expense, time, capital, and risk involved in changing to one of your competitors, or to an alternative material). Finally, try to gain an understanding of how your customers may have changed their buying process or even their internal metrics in response to their current uncertain and unstable environment.

Competitor Information

Finding and documenting information about your competitors is a sound business practice at any time. In the current environment, however, it is even more important to track your competitors to understand their costs, their goals, and their strategies so that you can anticipate their moves. For example, are your competitors' raw material costs changing in the same way and at the same time that your raw material costs are changing? Do you or they have a cost advantage in procuring raw material? It is critically important to understand in detail when and how your competitors have changed their prices over the past two years and specifically what they have said - not only broadly to the market, but also to each one of your accounts. Understanding their price communication strategy should yield insight into whether or not they are now going to use price reductions to try to gain share. And, of course, it is important to understand how their sweet spots line up with your sweet spots. Competitors will be defending theirs more aggressively than they will be attacking yours. Finally, understanding a competitor's ownership, financial structure, and incentive plans can provide unique insight as to when and how they may be changing their prices.

Material cost information

There is no question that every business closely tracks its own raw material costs. However, it is surprising how few businesses track the current and expected supply/demand balance for critical raw materials or determine what pressures their suppliers are facing to change prices – either up or down. Supplier's profit levels, growth expectations, and even public announcements can reveal the pressures they are under and help predict their actions. In this environment, a surprising number of material prices are not declining because suppliers are removing significant capacity from the market. In these situations, you may find that your raw material prices are not going down despite the fact that some of their component costs are going down very rapidly. Obviously the final factor impacting your own raw materials supply situation is what your switching costs are in relation to alternative suppliers and other materials.

Company information

The final piece of information needed to determine your pricing strategy on a go-forward basis is fact-based insight about your own current situation. A powerful way to understand where you are positioned is to create a curve showing the level and timing of changes in your cost of materials over the past 2 years compared to the changes in your product prices over the past 2 years. This analysis allows you to understand and quantify whether you are ahead or behind in total dollars. With these data you can present a persuasive case to customers about your need to defer reductions in price until you have recouped your lost margins and at the same time make the point that you have protected your customers from the full impact that you have seen in raw material cost increases. Also, understanding specifically what has been said to each individual account at the time that you have made price changes cannot be given too much priority. Surprisingly, many businesses don't document what their sales force tells individual accounts so that they know exactly what their accounts' expectations are on a go-forward basis. The trap many companies find themselves in is that they have told customers that they have raised price strictly because of an increase in a specific raw material, like oil. This creates a solid expectation in customers' minds that when the price of oil goes down, their prices will come down. Companies that have implemented fuel or raw materials surcharges are especially subject to this loss of power relative to their customers.

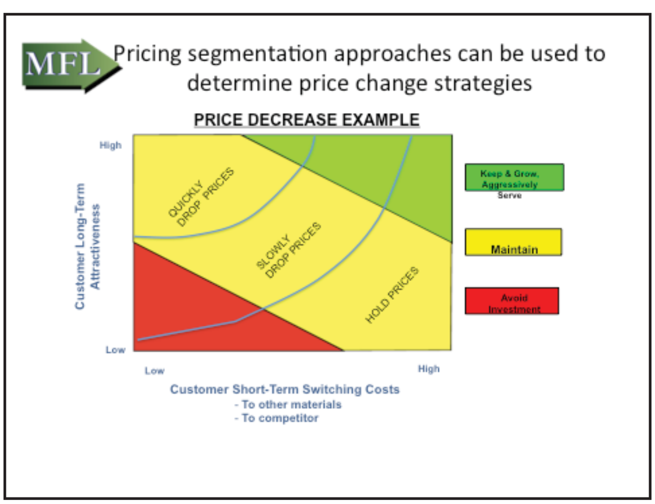
2. Decide Your Pricing Goals

Before specific pricing decisions are made its very important to agree with your entire management team on your pricing goals. This includes: How much impact you want or expect to have on your customers' growth and profitability; What perception you are trying to create in each of your external audiences; shareholders, customers, banks, competitors, and suppliers; What changes you expect to make in your market share and mix relative to competition; And finally, your goals for your top line and margin dollars.

3. Develop Detailed Tactics

One of the toughest challenges is to avoid making across the board moves - dropping prices the same amount to all customers at the same time. Across the board price actions are nearly always wrong for every customer; too much, too soon, too little, too late, or some combination. This is a challenge because organizations tend to avoid (or say they don't have time) to do the hard work necessary to analyze each individual piece of business and make a definitive decision on when and how to change price and how to describe that change to customers. Chart A is an example of how one company differentiated individual customers and individual pieces of business to determine where, when, and how to change prices. Every business needs to develop its own choice of factors on the 2 axies, but the ones shown, customer long-term attractiveness, customer long-term switching cost have proven useful for a number of businesses that we have seen.

CHART A



With the goals in hand you can then work with your organization to determine, on an account by account basis, what amount of price reduction you think best meets your goals and when you should change your price relative to competitor actions, customer demands, supplier actions, or even your current inventory cost situation. Finally, goals help you determine what messages to deliver to each target audience and how to manage the messages so they are properly and effectively understood.

4. Carefully Communicate Price

Choosing the right words and making sure the right people in your organization communicate – both verbally and on paper - price changes at the right point in time to the right people with the customers' organizations are critical decisions. Although there are scores of different ways to describe your pricing decisions and actions, a key that we have found is to make sure that when you reduce price, you find and ask for a quid pro quo in return for your lower price. This could be anything from an opportunity to acquire additional pieces of business from the customer to a specific reduction in service level or part of the offering you provide.

Despite the challenges we face during these uncertain times, profit opportunities can be created by carefully managing your price in a declining raw material environment. We have seen a number of companies that have improved their margins and solidified their market position by using detailed, fact-based analyses to develop account-by-account price moves with the right information effectively communicated to the right audiences.

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MFL's Consulting practice focuses on helping our clients build margins and volume by capturing their fair share of the value they deliver to their customers. We have found that pricing, while often managed in isolation, can be a powerful and integrating lever to drive a necessary shift in mindset and capability.

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