Pricing in Times of Inflation and Rising Factor Costs

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In several countries, you can observe inflation rates that are higher than the ones in the 1950s: an all-time high within the last 70 years! This requires quick adjustments to leadership and management practices and to the way pricing and revenue models are managed. the authors propose 6 core topics to shape your strategy to succeed in these turbulent times. Thorsten Lips (tlips@horvath-partners.com) is a partner at the global management consulting company Horvath and a seasoned advisor in commercial excellence topics. He advises both B2B and B2C companies, supporting them to increase profitability on the revenue side. Dan Zatta, Ph.D. (danilo.zatta@horvath-partners.com) is the author of the international pricing best seller "The Pricing Model Revolution" (Wiley, 2022), which will be translated into 12 languages, and "Revenue Management in Manufacturing" (Springer, 2016). He also is the CEO of Horvath Italy and has a global role as leader of the Pricing & Revenue Models Practice at Horvath. As a management advisor, he helps companies grow their revenues and profits. He led over 600 successful TopLine transformations in the last more than 20 years.

We are in very turbulent times. The global and domestic economy is characterized by inflation, disrupted supply chains, raw material shortages, volatile prices, and increasing speed. As a result of expensive and scarce raw materials, prices for many products are having to be adjusted. This requires clear strategies and professional execution.

Raw material prices and supply chains under pressure

Supply chains can be disrupted by many external influences. Containers are piling up in ports because they have been held up due to the COVID-19 crisis or the war in Ukraine. Cities with millions of inhabitants, such as Shanghai, were in lockdown for months, severely restricting production. But other reasons also cause logistics problems – for example, blocked trade routes, such as the Suez Canal in March 2021.

These events not only bring logistical difficulties but also result in shortages of raw materials or supplier products. According to the Ifo Institute, 74.1 percent of companies complained of shortages of raw materials and intermediate products in June 2022. Urgent action is needed for cobalt, boron, silicon, graphite, magnesium, lithium, niobium, rare earths, and titanium. At 91.5 percent, mechanical engineering was particularly hard hit, closely followed by the electrical and automotive industries.

Low stocks are encountering an equally low supply of some goods. Demand is also increasing due to rising world markets. Consumers are increasingly investing in electrical and DIY products, which means that the raw materials needed for them are becoming scarce. In addition, rising energy costs are making the production of primary products more expensive.

Higher demand combined with low supply undoubtedly leads to higher prices for raw materials. For example, prices for pig iron and steel rose by more than 33 percent in May 2022 compared with the same month a year earlier. Further double-digit price increases are expected, although prices have fallen again significantly in the meantime in some cases. Wood is also significantly more expensive.

Most importantly, companies have little time to adapt their strategy to increased prices or ruptured supply chains. New materials are being added almost daily, making them more expensive and affecting previously stable supply chains. In addition, political, climatic, or economic changes influence the economy. These constant changes act as a major threat to many companies. With the right strategy, however, the current situation can also be an opportunity – for greater profitability.

Strategies in volatile times

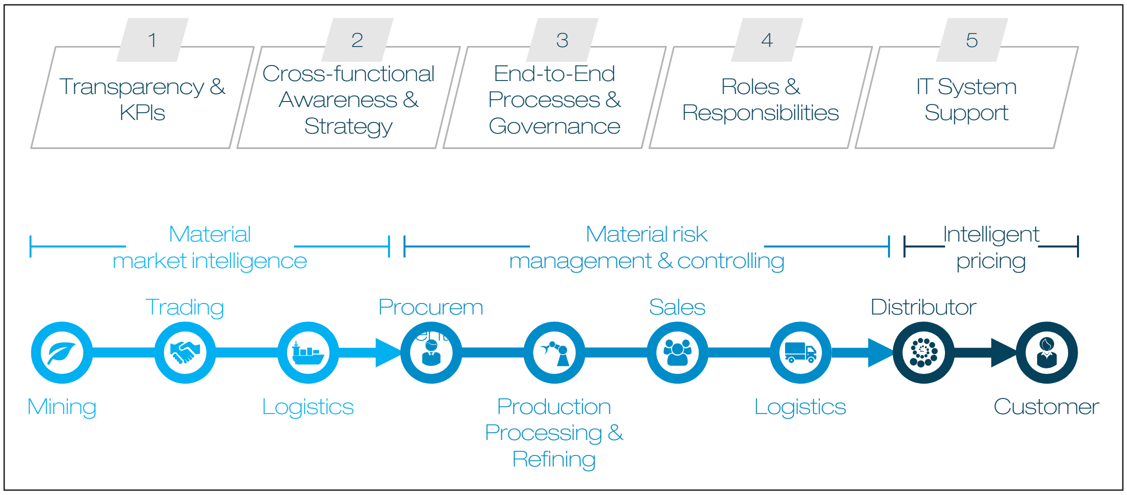
The basis for a sustainable strategy for manufacturing companies is built on these core topics:

- Permanent monitoring
- Price controlling and KPIs
- Digitization and automation

- Realignment of internal processes
- Selective price increase
- Effective customer communication

See Figure 1.

Figure 1: Integrated process for factor cost and price management



Permanent monitoring

When prices, availability, and delivery times change rapidly, monitoring is indispensable. Costs and price developments must be permanently monitored. Reacting to a price increase for an important raw material, for example, only three weeks later costs the company a lot of money. Companies need widespread visibility into what is changing. Then they can adjust their prices in time and also adjust sales accordingly.

Cost and price trends should be closely monitored to plan for appropriate price adjustments. It is important that monitoring is planned and implemented in a targeted and systematic manner – for example, which raw materials or energy prices are relevant and at what intervals and for which markets the data is retrieved. In this context, it is crucial to not only apply monitoring once, but also to continue monitoring permanently. Industrial companies in particular should implement a continuous monitoring system with early alerts for signs of price increases. The early warning system incorporates internal costs and prices as well as customer and market data. End-to-end information that fully covers all areas is important.

Decisions have to be made right from the start of this early warning system – for example, what influence prices and costs will have on production and sales, what goals will be pursued with the monitoring, and what activities will be derived from the results. This also includes the definition of clear and transparent price increase approaches for specific segments. Product-specific targets should be set and specific price increases defined for individual product clusters. Knowing the price of raw materials at any point in time is one thing – but it must also be clear what those responsible can do with this information. What is the minimum increase that must be enforced for certain products or customer groups to avoid a loss?

Therefore, not only is the early warning and monitoring system important, but also the definition of clear roles and responsibilities. Equally necessary are clear instructions on what to do in the event of changing prices and who must be informed. It is not enough that data exists. It must be absolutely clear who is checking them, at what time, and what derivations are to be made.

Price controlling and KPIs

An early warning system can never stand alone. It is not enough to recognize the increased raw material costs in time and adjust the product prices once. Prices and availabilities change rapidly and therefore need to be monitored continuously. Even if the price increase is enforced with the customer, the efficiency of this measure must be constantly evaluated.

A suitable system must be able to simulate sales and earnings effects and their impact so that it is transparent what the consequences of adjusting prices by a certain percentage will be in specific product clusters. On this basis, target and minimum increase definitions can be set for individual customers.

For this purpose, price control must be implemented to monitor all phases of the price management process and to ensure efficient price realization. Price control makes it possible to identify sales potential, measure the sustainability of pricing initiatives and manage their implementation. For this, clearly defined control information including the level of granularity, i.e., the accuracy and level of detail of the available data, is indispensable.

In order to proceed in a targeted manner, key performance indicators (KPIs) must be defined to measure target achievement and variance. Concrete KPIs, for example, help to measure the success of the price increase. The indicators can be the list price (price enforcement), the average price changes, the maximum discount usage, and the percentage of transactions above, at, or below the maximum discount, for example. Other suitable KPIs also include the respective share of sales with increased and reduced prices compared to unchanged prices. It is important to have a small number of actionable, easy-to-use metrics and a synchronized performance measurement approach. Managers must be committed to optimizing metrics in line with responsibilities and spheres of influence.

A price waterfall model is fundamental to the control. The model should begin with the starting price (often the list price, but it can also be the global or regional reference price,) and result in the "pocket price", the effective price paid by the customer in a given transaction minus all relevant discounts and promotions. At each stage of this model, it is important to define what factors influence the price points. Only through consistent and actionable information can concrete price actions be planned. Any monitoring and controlling must take place continuously in order to gain insights for future price adjustments.

Digitization and automation

Given the prevailing dynamics and volatility, Excel data sheets are no longer up to date. Today, digitization, automation, and data analytics not only make a much better pricing strategy possible, but the use of these tools is imperative. Completely digital processes are the basic prerequisite for this. This starts with the procurement of internal data: the figures from different departments, such as purchasing and sales, must flow automatically into a system in real time and not have to be searched for in separate files for a long time. Market data is also highly relevant and must be processed in combination with other information and interpreted to guide action. A good digital tool enables automatic notification in the sense of an early warning system.

When selecting suitable tools and systems, several criteria are important: future-proof technology, good user guidance, and easy integration into the system landscape. Monitoring and controlling systems need user-specific report views to provide the right information to the right recipient.

Realignment of internal processes

Regular alignment of purchasing and sales targets is a new requirement as a result of volatile prices and rapid changes in supply chains. To achieve this, purchasing and sales must grow together within the company – with short information paths and integrated processes and systems. So far, both departments are still very much stuck in their silos in many companies. Purchasing concludes purchasing agreements for purchased parts, for example, and sets the purchase prices. In the past, these have rarely changed during the year. Up to now, the sales department set the sales prices – often still quite simply on the basis of the manufacturing costs – including these purchase prices for raw materials and preliminary products – subdivided according to specific products and customer groups. Purchasing and sales worked separately and did not have to coordinate during the year.

This has now changed fundamentally. Today, there are permanently significant price changes. The prices for raw materials and intermediate products quickly rise or fall again, and those who react too late may already be risking losses during this time. This makes close and regular cooperation between the departments imperative. There must be an end-to-end process from purchasing to sales – with defined roles, clear responsibilities, key performance indicators, and, of course, an appropriate data and IT foundation. Temporarily, companies can even operate with a task force with representatives from departments to increase speed and effectiveness. The new requirement is to realign purchasing and sales targets on a regular and synchronized basis.

Transformation in mindsets is essential: Purchasing and sales must understand that they are two parts of a common process – even if each department still has its own tasks. This requires adjustments to leadership and management practices. Companies should introduce a clear and anchored operating model here that leads to established responsibilities.

Selective price increase

Price increases should not be implemented across the board but in a differentiated and selective manner: for example, differentiated by market segments, sales channels, or product groups. One might be inclined to increase price across the board due to inflation or due to an increase in the price of the predominantly used raw materials. A ten percent increase in procurement costs could also result in ten percent higher selling prices for the range. However, this approach is not advisable, if only because price sensitivity varies from one customer segment to another. Certain products also contain fewer raw materials and demand may also vary. Instead, the price must be adjusted individually according to product type and customer segment (incidentally, this also applies to periods of low volatility). Identifying suitable products and customers for price increases is crucial and the basis for a successful price increase. This is a big challenge; the decision can only be made on the basis of valid data and their correct interpretation.

For a selective price increase, companies must segment their customers according to their buying behavior, willingness-to-pay, and other criteria. A pricing strategy is also needed. This requires analyzing price elasticity, setting up bonus and promotion management, and considering multi-brand pricing or an ABCD account strategy. The pricing strategy regime then enables specific discounting and effective bonus management.

Approaches to selection in the event of a price increase:

- **Profitability** must always remain in focus when it comes to price increases. Negative or low-margin products are therefore prime targets for price increase initiatives.

- **Turnover** can also be the basis for selection. For example, it may be advisable to raise prices on low-turnover products first, as these are obviously not currently a customer focus.

- **Sales figures:** Products that sell less frequently and do not belong to the A-items can be made more expensive.

- **Product type:** For example, a manufacturer needs only one semiconductor for one of its products and two for another. The increased price of semiconductors thus has a different effect on the respective product price.

- **Unique selling points** are also a criterion, as price increases are more likely to be implemented for products with a unique selling point (USP) than for standard goods.

- In general, **customer groups and sales channels** are suitable differentiators.

In the case of significant adjustments to relevant product groups, the impact on volume, sales, and earnings should always be simulated. Mechanisms to prevent undercutting of minimum price increases should also be in place prior to enforcement.

Communication strategy

It is clear that price increases are essential in the current market conditions. But how can they be communicated to customers? After all, a positive sales effect is primarily generated by operational excellence in price enforcement.

It is important that customer communication about upcoming increases takes place early and transparently. The most important customers, in particular, should be well informed about the reasons and the amount of the increase. For this, it is necessary that the sales staff also have access to important information from customers, markets, and from price monitoring.

Clear and fact-based price increase communication for customers should be prepared in advance. The right mindset must not be missing in the sales team. Companies need to empower and support their sales team and provide them with the necessary skills and information. This maximizes the chances of successful price realization. Providing expertise and training for the sales team to argue price increases to customers is one component of this. Negotiation preparation is particularly important because the objective of the price increase must be clear. Incentives during price enforcement help the sales force maintain the necessary motivation. Training in sales and negotiation techniques can also pay dividends. The art of negotiation is half learned craft, half psychology. For example, the better negotiator is the one who does not break the silence first. The climate in the negotiation room and even the seating plan also have an effect on the chances of success. Once initial communication has been successful, the immediate effects must be constantly monitored via price controlling so that countermeasures can be taken quickly in the event of negative customer reactions.

Conclusion

Volatile procurement markets will continue to affect companies in the future. This requires adjustments to leadership and management practices. It's a cross-functional, operational challenge that affects purchasing, sales, and overall management alike. After a quick reaction to the current situation, strategic decisions have to be made to produce sustainable success. This requires digital processes, analyses, and monitoring functions in the sense of holistic performance management. Employee expertise and digitization must go hand in hand. In that case, the current situation may even offer opportunities for sales increases. With these five levers, companies can use volatile prices as an opportunity in the future:

- Speed
- Provision of targeted information
- Customer knowledge
- Mindset/implementation mentality
- Management commitment ❖