Calling the Peak of Inflation: Rocketing Up, Parachuting Down

by: Arjen Brasz and Kai Chen

Current macroeconomic conditions represent a once-in-a-decade opportunity to win market share and maintain healthy margins. Across industries, and especially from those players at the top of supply chains, companies are reporting supply chain and wholesale price drops. In stark contrast to the past three years, this represents an opportunity to capture volume while also maintaining strong margins. Companies need to capitalize with price leadership, as the authors explain. Arjen Brasz (arjen.brasz@simon-kucher.com) is a Partner and Kai Chen (kai.chen@simon-kucher.com) is a Manager in the Amsterdam office of Simon-Kucher & Partners.

After three long years, the moment has arrived - standing supply chain problems, fueled by geopolitical conflict and a global pandemic - have finally started to peak. Across industries, and especially from those players at the top of supply chains, companies are reporting supply chain and wholesale price drops. In stark contrast to the past three years, this represents an opportunity to capture volume while also maintaining strong margins. Companies who can quickly pivot behind this market condition and show price leadership will realize a once-in-a-decade commercial opportunity.

Companies need to rapidly shift from defensive to offensive margin-strategy

The period of economic volatility precipitated by the global pandemic has shaped a contemporary business leader who thinks lean, agile, and defensive. Margins have been under pressure for three years, costs of goods sold (COGS) have been skyrocketing, and operational expenditure (OPEX) has been growing due to unprecedented inflation. The news that cost prices are falling should be welcome news in boardrooms around the world. However, a macroeconomic factor that is positive for one company is also positive for their competitors. Consequently, the first-mover-advantage of price leadership in a market with decreasing costs is massive. Rest assured that this is THE hot topic in every boardroom this quarter.

Except for commodities industries, in our experience, there is often a time-lag of 1-3 months between a cost-price change and when it's reflected in gross prices. High inflationary pressures in the second half of 2022 have forced companies to go defensive with margins and execute price-increase campaigns into 2023. When paired with falling cost-prices, this creates the conditions for what we do not want: a price whiplash. As gross prices are still rising to meet targets, the costs rapidly dropping from the bottom of the price pyramid naturally encourage commercial leaders to decrease gross prices equally as rapidly, sending confusing pricing signals to the market and decreasing customer confidence. What is needed is a conscious, graduated approach to managing the inflationary peak.

Price drops are not uniform; nuance will set "good" apart from "great"

Prices are not falling uniformly across product categories or geographies. Initial insights from the market are indicating steep price drops into Q2'23 from East Asian suppliers, and largely transportation cost-driven but still growing, albeit slowing down, cost prices from European suppliers. Consequently, the commercial action to take cannot be broad-spectrum price freezes or decreases, but rather product-assortment-targeted.

To capture the full value of the impeding cost-price decrease, commercial activation needs to be considered. What are your destination categories? Where do you need to be a price-fighter? Does that line up with the cost-decrease expectation? If so, this could be an unparalleled opportunity to gain market share on your peers.

In some situations, we are seeing companies actively lining up multi-disciplinary teams that include Procurement, Assortment, Pricing, and Marketing stakeholders to capture this opportunity strategically along their assortment, pairing it with a marketing campaign around "sharing the deflation." We have high confidence in the success of these types of campaigns.

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Do not trade "good volumes" for "bad volumes"

In this exciting market condition, we leave one note of caution: do not trade "good volumes" for "bad volumes." While the urge to directly decrease gross prices upon news of a cost-price decrease is strong, we encourage discipline. Your business is not what it was pre-pandemic. In most cases, OPEX levels are higher, requiring a high margin base to cover. Moderation is the word of the day and budget margin targets should still be adhered to, but instead of only considering gross price increases to achieve them, start building cost-price decreases into the calculations, reducing and eventually reversing the need to raise prices further.

That being said, due to pricing capability constraints, if the choice was between generally lowering prices to drive-up volumes or maintaining high prices, but with healthy margins, in most cases we would recommend meeting gross profit targets with lower volumes and reducing fulfilment requirements. A cost-price decrease is not an immediate signal to lower gross prices. Actions have to be conscious, measured, and ultimately fit-for-purpose with the overall commercial strategy.

Three margin strategies available

Commercial leaders can choose to embrace three different margin strategies in current market conditions. First, they can choose to go quickly and reduce prices rapidly ahead of the market, which could help them gain market share. Second, they can opt for a margin optimal strategy where they rocket prices up and then parachute them down to optimize margins. The third option is to maintain their current price level and manage for current positioning. While these options have always existed, the impact that this may have on their business in the next two quarters represents a unique opportunity to rapidly grow the health of the business.