PROFESSIONAL PPS PRICING SOCIETY™
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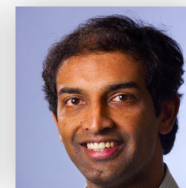
Something's Coming: How US Companies Can Build Resilience, Survive a Downturn, and Thrive in the Next Cycle

by: Stephan Görner, Arvind Govindarajan, Ezra Greenberg, John Kelleher, Ida Kristensen, Linda Liu, Asutosh Padhi, Alex Panas, and Zachary Silverman

The U.S. economy continues to throw off mixed signals. But one thing is becoming clear: executives should prepare for an extended period of higher interest rates. This article was originally published on September 16th, 2022. This article represents views from McKinsey's Risk and Resilience Practice, Strategy and Corporate Finance Practice, and McKinsey Transformation. Stephan Görner is a senior partner in McKinsey's Vancouver office. Arvind Govindarajan is a partner in the Boston office, where Alex Panas is a senior partner. Ezra Greenberg is a partner in the Stamford, Connecticut, office. John Kelleher is a senior partner in the Toronto office. Ida Kristensen is a senior partner in the New York office, where Linda Liu is a partner. Asutosh Padhi is a senior partner in the Chicago office. Zachary Silverman is a partner in the Atlanta office. The authors wish to thank Mélanie L'Heureux, Sebastian Kohls, and Derek Schatz for their contributions to this article. This article was edited by Mark Staples, an editorial director in the New York office.

Stephan Görner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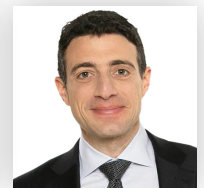
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Since our July 28 article, the U.S. economy has produced another confusing batch of signals. Start with the good news: Q2 GDP was revised higher, consumer sentiment moved a touch higher, Q2 corporate profits rebounded (rising 6.1 percent in the quarter, after falling 2.2 percent in Q1),[1] headline and core inflation moderated slightly, and two new regulations (the Inflation Reduction Act and an executive order to forgive student loans) were signed, aimed at helping companies and households.

But it's not all sweetness and light. An August survey of CEOs found that 81 percent of leaders expect a recession.[2] And while the upward revision in Q2 GDP is welcome, the –0.6 percent reading is precisely in line with McKinsey Global Institute's downside scenario. The latest report on job openings showed that the labor market remains

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white hot. While more people are rejoining the workforce, that's both good and bad news: more workers could ease labor shortages but also create more demand, stoking inflation.[3] In addition, the Bureau of Labor Statistics' latest consumer price index indicated that core inflation has increased. For a complete wrap-up of all the US and global economic news, see "Global Economics Intelligence executive summary, August 2022."

Amid all the uncertainty, one trend has been consistently clear: the U.S. Federal Reserve's stated commitment to fighting inflation, using the tools at its disposal—higher rates and "quantitative tightening." As Fed chair Jerome Powell said, the Fed's "overarching focus right now is to bring inflation back down to our 2 percent goal. Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy. Without price stability, the economy does not work for anyone."[4]

The clarity and commitment may have reassured some executives. But not all have yet come to terms with the scale of the effort required. It might take years to reduce inflation to the Fed's target level. Consider these comments from the head of the Federal Reserve Bank of New York: "I think inflation expectations are well anchored. We've communicated over and over and over again our commitment to achieve that 2 percent goal... Today we're very clear on that ... the situation is very challenging. Inflation is very high. The economy, like I said, has a lot of crosscurrents. I do think it'll take a few years, but we're going to get that done."[5]

What does that mean for U.S. companies? It's likely that the private sector is entering a new era of "higher for longer" interest rates and cost of capital. The good news, such as it is, is that higher rates, while unpleasant and potentially painful, are becoming less of an uncertainty and more of a sure thing. Companies need to draw on the proven playbook for success in a world of slower growth, higher inflation, and more expensive capital. That's a big switch from the activities of the past several months, when many management teams have been putting out fires, so to speak—finding fixes for problems like rapidly rising costs for raw materials and labor. And as Fed chair Powell indicated, it won't be easy—the switch to a higher-for-longer environment "will bring some pain to consumers and businesses."[6]

In this update, we'll look at two new McKinsey research efforts (one on consumers, one on corporates) that point up the ways that consumer behavior is affecting corporate profits and will likely continue to do so. We'll close with some notes from the field on what we see companies doing today and four strategies that can help companies thrive in a higher-for-longer world.

Higher for longer: The risk of entrenched inflation

How high, and for how long? Those are quickly becoming the questions of the day. On the first, our recent work with hundreds of U.S. companies suggests that executives should not worry about whether the next rate hike is 75 basis points or something else. It's the terminal rate that counts, and how long rates remain there since a quick pivot seems unlikely. Many economists currently expect the Fed's key lending rate to top out at about 4 percent or slightly higher, which equates to a prime rate of about 7 percent.[7]

On the second question, history provides some guidance. Alan Blinder of Princeton University notes that of 11 rounds of Fed tightening since 1965, one lasted three years, most lasted from one to three years, and only one was over in less than a year.[8] All but three resulted in an official recession, and only one qualified as what Blinder calls a "perfect soft landing."

The difference between one year and three or four is enormous, of course. The key distinction between a quick resolution and a drawn-out battle is the degree to which inflation has become entrenched in consumers' and business leaders' minds. Two new McKinsey research efforts point up the challenges some companies face in a higher-for-longer world.

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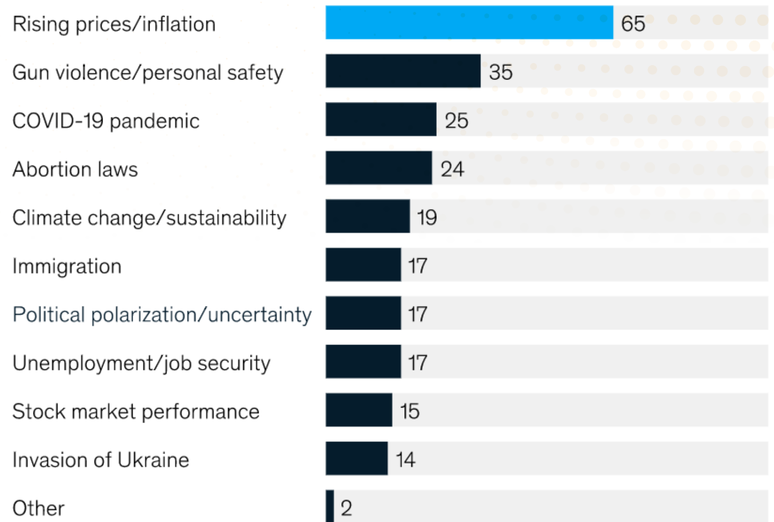
Consumers: Seeing inflation everywhere

When we surveyed 4,000 U.S. customers in July, they were alarmed at the rapid onset of inflation **(Exhibit 1)**.

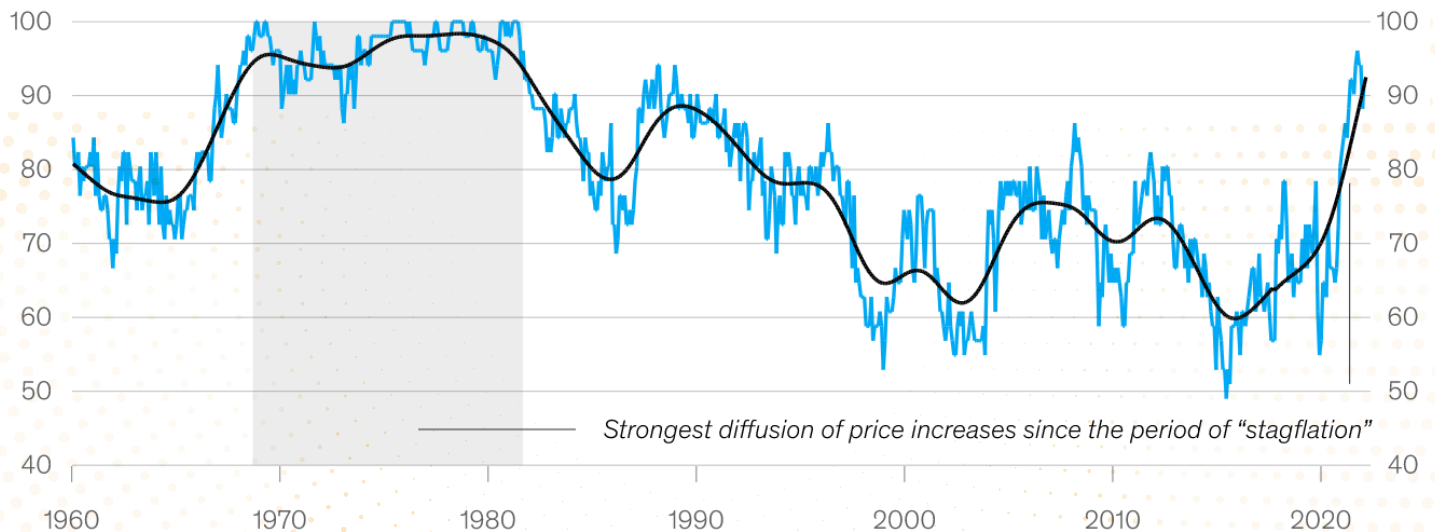
[1]Question: What are the greatest source(s) of concern for you right now? (Choose as many as 3 from provided list of options.) Source: McKinsey US Consumer Pulse Survey, July 6-10, 2022; n = 4,009 sampled and weighted to match the US general population 18+ years



It's no wonder that consumers are somewhat shell-shocked. When we look across the broadest measures of consumer spending on goods and services, we see that inflation is widespread. Over the past 12 months, prices have increased in more than 90 percent of categories, a rate of diffusion not seen since the 1970s **(Exhibit 2)**.

Pricing pressures have spread across more than 92 percent of consumer spending categories.

Consumer spending categories with price increases over previous year through June 2022, % share (3-month moving average of 12-month inflation diffusion indices)



Source: US Bureau of Economic Analysis, Federal Reserve Board of San Francisco, SGH Macro Advisors; McKinsey analysis

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Not only does this create challenges on its face, but, as our colleagues identified in their **recent consumer survey**, consumers' perceptions of inflation may even exceed the rate of inflation itself. One potential implication of these facts and perceptions is that higher inflation may become entrenched in consumers' outlooks—precisely the phenomenon that the Federal Reserve seeks to avoid.

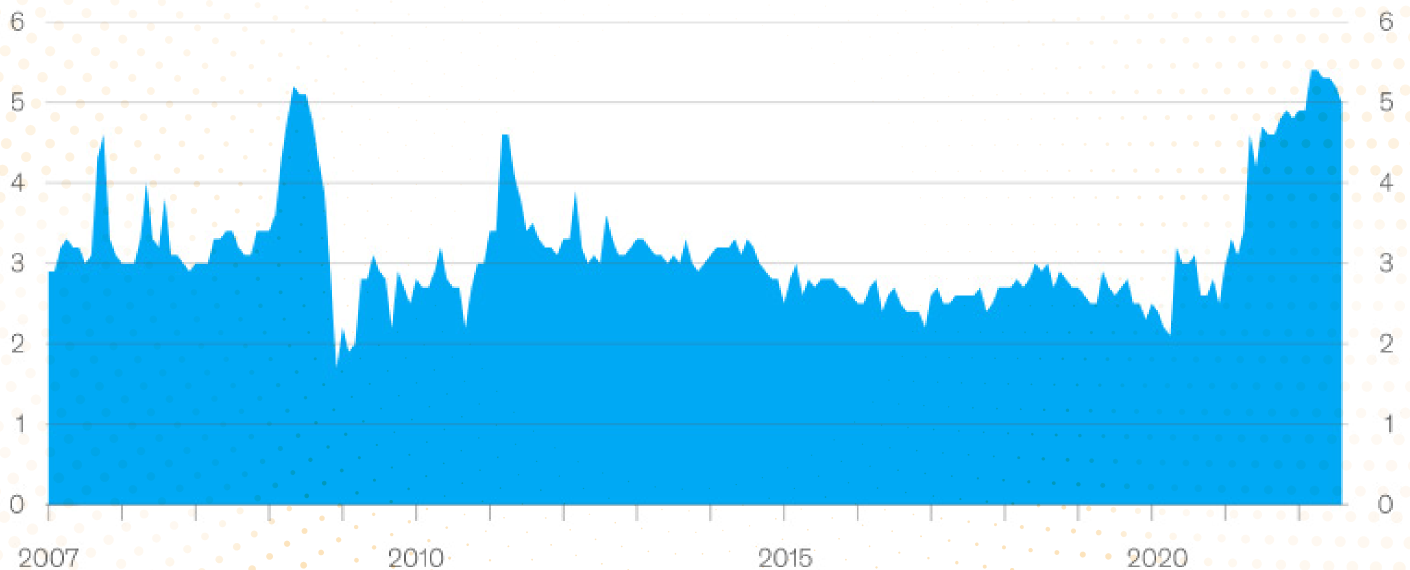
All in all, it's a daunting outlook. Consumer sentiment rose very slightly in August but remains at an all-time low **(Exhibit 3)**.[9]

Consumer sentiment remains at an all-time low; expectations of inflation remain near an all-time high.

Consumer sentiment and consumer expected inflation rate through August 2022

Consumer sentiment, index (2005 = 100)

Consumer expected inflation rate, next year, %



McKinsey & Company

Source: University of Michigan; McKinsey analysis

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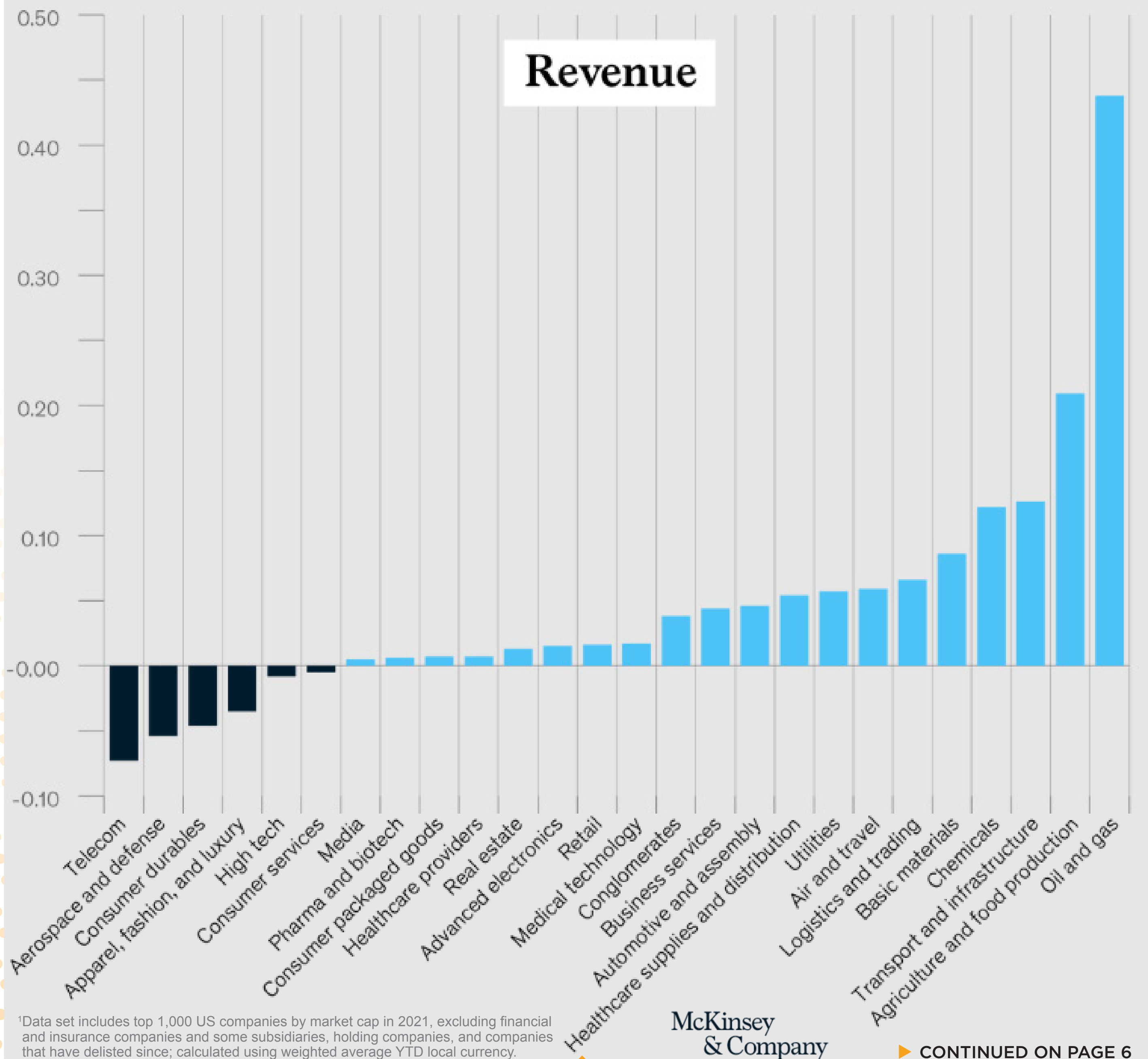
Corporations: The forward-looking view on profits

As companies reported their earnings from the second quarter, it was evident that changing consumer behaviors are hurting results, especially among consumer-facing sectors. What comes next? We looked into equity analysts' most recent estimates of both revenue and earnings for the full year 2022 and compared these to their estimates from the beginning of the year (Exhibit 4). On the revenue side, we found that the median analyst expects the trend (materials and commodities up, consumer companies down) to persist. Since equity analysts think about this in nominal terms (that is, not adjusting for inflation), this also held true across many other industries, perhaps as pass-through inflation costs outweigh volume declines.

The story on earnings, however, is far bleaker. The median analyst expects EBITDA margins to decline in all but a handful of industries. Not only do analysts expect that consumer-facing industries will face pain, but they also expect that this pain will ripple through most other industries as well. Making matters worse, this measure of earnings does not even account for higher borrowing costs.



[1]Data set includes top 1,000 US companies by market cap in 2021, excluding financial and insurance companies and some subsidiaries, holding companies, and companies that have delisted since; calculated using weighted average YTD local currency.

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Operating in a higher-for-longer world

We've seen companies take many of the short-term moves our colleagues outlined in their playbook for inflation. Some of the most common include pricing adjustments and managing exposure to input costs. Some companies are also taking action on operating expenses. These short-term moves can help many companies. But they're more like firefighting than putting in fire-resistant materials—and in a higher-for-longer environment, companies should also be thinking about more structural solutions that not only manage costs but also build resilience and can drive long-term value creation. Here we offer four themes that business leaders can consider. It's a complex and difficult program and will require leaders to build new strengths to see it through, but the payoff will be worth the effort and investment.

Growth: Opting in. Growth is always a top priority for C-level executives but remains elusive for many. In fact, about a quarter of companies don't grow at all, often because leaders don't look widely for growth opportunities and then hedge their bets, often zeroing in on just a couple of initiatives. Inflation and the rising cost of capital have made it even harder to know where to invest. In an economic moment like this, a structured approach to growth is paramount.

Outperforming executives break the powerful force of inertia by prioritizing growth, a choice that shapes behavior, mindset, risk appetite, and investment decisions across the organization. Intriguingly, our research shows that growth-oriented leaders react decisively to shorter-term disruptions that can be turned into opportunities—what we term "timely jolts"—and build organizational resilience and agility to respond to change and leverage disruption. A higher-for-longer environment is exactly the kind of jolt to growth that leading companies recognize and take advantage of.

GROWTH IS ALWAYS A TOP PRIORITY FOR C-LEVEL EXECUTIVES BUT REMAINS ELUSIVE FOR MANY. IN FACT, ABOUT A QUARTER OF COMPANIES DON'T GROW AT ALL, OFTEN BECAUSE LEADERS DON'T LOOK WIDELY FOR GROWTH OPPORTUNITIES AND THEN HEDGE THEIR BETS, OFTEN ZEROING IN ON JUST A COUPLE OF INITIATIVES.

Talent: Closing supply-demand gaps. Even in this environment, many companies are still hiring. But our research indicates that talent pools in many industries are drying up as employees quit to enter other sectors, go after nontraditional opportunities such as gig-economy work, or leave the workforce altogether. Shortages of digitally savvy workers are especially acute: in our recent survey, nearly 90 percent of C-suite executives said they don't have adequate digital skills.

Leading companies are taking several approaches to strengthen their workforces. Many have sought to motivate workers with more meaningful assignments and better opportunities for career advancement. Often, these approaches go hand in hand with training in skills that are hard for companies to find. Some companies are choosing to deemphasize (or discard) requirements for education and relevant experience and hire people from unconventional backgrounds—other industries, adjacent majors, overlooked colleges and universities—who are ready to learn. We're also seeing businesses streamline their hiring processes and enhance candidate experiences to attract more applicants and lift conversion rates.

Evidence also suggests that improving workers' emotional experience on the job can do more for retention than employers might expect. McKinsey surveys of managers and employees found that employers often fail to understand just why workers leave their jobs. In particular, employers tend to overrate "transactional" factors such as pay and development and underrate the "relational" elements—a feeling of being valued by managers and the organization, the companionship of trusting teammates, a sense of belonging, a flexible work schedule—that employees say matter most. Companies that successfully create this kind of meaningful purpose can benefit from greater organizational cohesion and resilience.

Sustainability: Staying the course. In a slowing economy, with margins under pressure and the cost of capital sharply higher, should companies invest in sustainability? Our answer is yes. In an economically constrained environment, a through-cycle view on sustainability can be a lever for companies to build resilience, reduce costs, and create value.

Companies in hard-to-abate sectors can protect their core by building resilience against transition risks. Putting an accurate price on the current volatility of fossil fuel prices could make sustainability

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investments more economical, and transitioning to greener asset and product portfolios can protect against customer attrition as standards continue to tighten. Further, in a slowing economy, a strong sustainability strategy can accelerate growth by creating value. Companies may adjust their business portfolios to capture larger shares of segments with major green growth potential, while others may launch new green businesses altogether. Green products and value propositions may also allow companies to differentiate themselves and gain market share or seek price premiums.

Supply chain: Rebuilding for resilience and efficiency. For many leaders, the COVID-19 pandemic revealed a painful truth about modern approaches to managing supply chains: engineering these vast systems for high efficiency had introduced vulnerabilities. Operational weaknesses such as overreliance on certain suppliers, scant inventories of critical products, and overstretched production networks left companies exposed to shortages and disruptions. Many supply chain leaders declared intentions to make supply chains more resilient, and many did so—though often in the most expedient way possible, by building inventories. Companies can take other, more complex moves to build resilience. For example, our experience suggests that reconfiguring supply networks cut costs by 4 to 8 percent.

Moreover, companies can both build resilience and extract additional savings from already-lean supply chains. We've found that a careful assessment of supply chain vulnerabilities can reveal opportunities to lower spending with high-risk suppliers by 40 percent or more. Adjusting transportation modes and routes and distribution footprints around trade tensions, tariffs, possible customs-clearance problems, and likely disruptions can also lower transportation costs by some 25 percent. Then there are the benefits of refreshing products with modular designs that involve easy-to-find components rather than highly customized ones. This can result in margin expansion of 25 percent, while lessening the risks that come with depending on just a few suppliers.

The plot thickens. As contradictory evidence pours in, the U.S. economy remains too tricky to forecast easily. Companies should rely on scenario planning and prepare a set of long-term moves that will help them thrive in a higher-for-longer environment.

What Happens to Pricing When Demand Falls?

by: Kirk Jackisch

Over the last three months, we've begun to see revenues rise and demand flatten as the pricing decisions made a year and a half ago work their way down to customers. How can companies manage rising inflation and a shortfall in goods without experiencing degradation in margins or revenue (especially when products can't be produced due to commodity shortages)? We recently met with pricing executives from around the globe to discuss pricing strategies in light of current inflation and the looming threat of recession. Here are six key takeaways from those discussions. Kirk Jackisch is President of Iris Pricing Solutions. He can be reached at kjackisch@pricingsolutions.com..

Over the last 18 months, businesses have been faced with three major challenges. Labor shortages, procuring materials, and the inflation in their cost of goods, which for some specific products has hit numbers in the low to mid-double digits – increases that have been unprecedented in the last fifteen years. How can companies manage rising inflation and a shortfall in goods without experiencing degradation in margins or revenue (especially when products can't be produced due to commodity shortages)? Over the last three months, we've begun to see revenues rise and demand flatten as the pricing decisions made a year and a half ago work their way down to customers.

We meet regularly with the world's top pricing executives to discuss these problems and other pricing challenges associated with the current economic climate. The biggest question is "how should we think about managing pricing strategies as we deal with high inflation and brace for the

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possibility of a recession?" Here are six key takeaways.

1. Plan for All Scenarios

Of course, no one has the power to forecast inflation or a recession. Like interest rates and currency rates, these things are just too unpredictable to be forecasted. The next best thing is scenario planning, a critical step to ensure your company is as prepared as possible for any combination of these uncontrollable scenarios.

The volatility of market conditions belies any clear or definite solution. However, as C-suite executives place an increasing emphasis on profitability, there are a number of pricing strategies businesses can implement to deal with falling demand, commodity increases, supply chain strains, and the need for agile pricing practices.

2. Keep an Eye on Key Pricing Indicators

Backlog is an early indicator that's important to watch during this uncertain time. For most businesses, demand isn't necessarily going down. However, the backlog for products caused by supply shortages is starting to shorten. A healthy backlog can provide a lot of cover to raise prices but remember to look for orders that are extended or canceled. These are early indicators that demand has peaked and is now coming down.

When backlog shortens or returns to "normal" levels, be mindful of price increases, which will be subject to and more directly impacted by changes in demand. With backlog down and no one in the queue to pick up the next order, financial performance may take a hit.

3. Pricing Transparency

The age of annual cost adjustments is over as many businesses have come to realize that customers will accept multiple price increases throughout the year. Customers don't like unpredictability, so pricing transparency is critical when navigating these increases. Make the connection between pricing decisions and input costs visible during times of inflation, especially in a climate where companies are experiencing tightening liquidity and rising costs. Sales teams must be prepared to discuss why surcharges and price adjustments are being made - and why they are "fair."

WHEN BACKLOG SHORTENS OR RETURNS TO "NORMAL" LEVELS, BE MINDFUL OF PRICE INCREASES, WHICH WILL BE SUBJECT TO AND MORE DIRECTLY IMPACTED BY CHANGES IN DEMAND.

4. Increase Pricing Agility

While some companies are able to act quickly when reacting to business opportunities, there's usually little-to-no agility when managing pricing. Some businesses now find themselves in a troubling situation as they see demand flatten even though they still have cost increases that they haven't passed through to their customers. Pricing agility is critical right now as customers are experiencing "pricing fatigue." Companies who wait too long to increase prices risk customers rejecting the increase altogether.

5. Understand Your Customer Segments and Know Your Value

With customers shopping around due to market volatility, understanding each customer segment and how the economic disruption is affecting them is more important than ever. Now, more than ever, companies must identify the unique value they offer each customer group, relative to competitive alternatives, and then use that knowledge to make surgical pricing decisions.

6. Take a Surgical Approach to Price Increases

Companies must move away from broad pricing increases and instead use the knowledge around customer segments and unique value offerings to make surgical decisions about pricing in three core areas:

- **List prices:** Use your understanding of financial value to determine which products will receive greater list price increases.
- **Discounting:** Reduce or eliminate discounts for objective factors like terms, volume, and loyalty. A company can avoid having to increase list prices by adjusting these types of discount policies down - positively impacting net price.
- **Fees:** Know where the business incurs costs and delivers value and charge accordingly. Scenarios like small orders, change orders, and express orders are areas where companies incur costs and deliver significant value. Companies can add or increase fees in these areas without impacting list prices or discounts.

Businesses that can maintain a surgical approach in these areas will be more prepared to weather the storm of economic volatility.

Costco Prices: Bargains, Brilliance & Brand Consistency

by: Robert Ribciuc

Understanding Costco's messaging code embedded in its price point endings can be dramatically useful for consumers looking for bargains and further inflation-fighting opportunities. For pricers and marketers, it invites admiration and respect for a brand that is immensely successful because it thinks the details through, as the author explains. Robert Ribciuc, Managing Partner at EBITDA Catalyst, is a pricing expert specializing in pricing for consumer and software brands. He can be reached at robert@ebitdacatalyst.com..

Costco Prices: Can Consumers Get Bargains Off of Bargains?

Most consumers don't know that Costco uses a "secret code" of price endings to communicate (though some astute shoppers and reporters figured this out long ago). Did you know that prices ending in .97 signal clearance, deep markdown, and generally a bargain even by Costco's very bargain-focused standards (sometimes as much 60-80% off Costco's "normal" price)? Did you know that on any given day in any given store you may find a few dozen such clearance prices, spread throughout the store?

If you're a typical consumer shopping at Costco primarily because of "unbeatable prices," it pays to know Costco will occasionally take even those prices down. Training that 6th or 7th sense on the quick cheat sheet below will pay dividends for the pocketbook, and maybe even impress the neighbors as they complain of yet another pocket-punishing trip to the regular grocery store.

If you are in the pricing or brand strategy profession, however, you would likely notice some seemingly strange and "different" ways Costco goes about this business - and ask a lot of "Why?" questions.

COSTCO WHOLESALE

$ Price Point Endings

EBITDA CATALYST
Your Opportunities. Our Insights. EBITDA, Catalyzed.

	$ .99	$ .19/.49/.79	$ .00/.88	* (asterisk) next to price	$ .97
"Translation"	Regular Price	Sale / Promo	Manager Price	Last batch / no restock	Clearance / Markdown
Driven by	Costco Corporate / National or Regional Price	Manufacturer (+ Corporate) / National or Regional Price	Store Issue / Price may be only in given store(s)	Costco Corporate / National or Regional Price(*)	Store Mgmt / Price may be only in given store(s)
Implication	Business as usual, successful item	Item could use more traction, regular price bakes in solid margin that can be traded for volume	Something is probably slightly off w/ item, you get good value to take it off Costco's hands	Either Costco didn't renew, or (rarely) manufacturer no longer happy to sell at Costco terms, or seasonal item	Unsuccessful item (not enough sales), or Costco ordered too much, may be perishable / near expiration / seasonal
Bargain Level	EDLP ("Every Day Low Price")	15-35% off "EDLP"	Discount Varies	Discount Varies	40-80% off "EDLP"
Advertised?	No need	Heavily	No Thanks!	No Thanks!	Never!

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Why Does Costco Heavily Advertise Some of These Discounts, but NOT the .97 Clearance?

This seems highly counter-intuitive. Costco's other sales are often advertised way in advance through its ubiquitous coupon books and emails. Then of course, once in store, those sales items are typically in prominent end-of-aisle locations, with price signs using a phosphorescent green highlighter color to make sure they're easy to find. The customer is visually triggered, with the signs designed to elicit a nearly Pavlovian response (often successful!), driving both purchases and store traffic patterns. Basically, what you'd expect from a retailer that decided to use a promo (for a limited time) to move a lot of volume and generate a lot of brand awareness for the manufacturer of the item in question. This is great price execution, but so far not necessarily different from other top-flight retailers.

The .97 items, by contrast, take a sharp eye and focus to find. Were it not for .97 signal, only people who memorize prices, pay attention to comparable items one shelf over, or have an outsized mental map of what countless items "generally cost/should cost" could detect there is even a bargain. Does Costco not really want to move these items priced super-low and ending in .97, or what?

Sure, they do. They would just like the least amount of fanfare and awareness and behavioral impact while doing so - a bit of a hush-hush "bury the not-on-message sales" operation of sorts. This is brilliant brand management through price strategy through price execution in its own right!

Let's consider what Costco's brand strives to stand for, and what the items carrying the .97 price point could do for that brand image and consistency (and Costco's pricing prowess/ customers' willingness to pay).

IF YOU'RE A TYPICAL CONSUMER SHOPPING AT COSTCO PRIMARILY BECAUSE OF "UNBEATABLE PRICES," IT PAYS TO KNOW COSTCO WILL OCCASIONALLY TAKE EVEN THOSE PRICES DOWN.

What Does Costco Want Customers To Associate With Its Brand?

I'd guess these are both on Costco's messaging list and on most of its shoppers' minds:

1. Every item in the store is already a bargain: you should have peace of mind that buying at Costco's "normal" price is already an "unbeatable bargain."
2. Every item in the store is rigorously selected by one of the best merchandising teams on the planet: you better believe each one is top quality/value.
3. Costco is on your side: they will use their awesome negotiating power with suppliers to get consumers incredible prices.
4. Costco wins on volume, not on price: implication - they signal they don't make high margins.

How Do The Various Price Endings Support Costco's Brand Image?

Let's start with that very hush-hush bargain: the 97 cents clearance item. To see why Costco's "unorthodox" practice of not advertising such clearance sales at all is in fact brilliant, let's imagine the opposite. There would be a corner of each Costco warehouse (or even better real estate) dedicated to CLEARANCE. There would be signage all over that area making it impossible to miss (like they do with the 49 cents and 79 cents sales, but maybe even more distinctly marked). Customers who shop at that specific store may even get, when possible (remember this is a store-level price decision, and it is often not consistent with long advance notice), emails reminding them to "get them while they last" for the doomed items (but such emails would need to be clear that those prices are only available at Store X).

How would this "fully advertised" 97-cent list of clearance items go with Costco's brand messaging?

Note: I recognize the majority of shoppers may not care or think about the items below at all. They would just be happy with the lower prices and move on without additional "inferences." However, over time, whether explicit inferences are made by more sophisticated shoppers or behaviors are formed by less sophisticated ones, store shoppers may infer, or worse, develop habits based on inferring that:

- Costco's regular "unbeatable bargain" prices can in fact be lowered, by a lot, and some of them regularly are.
- Costco's item selection is hit-or-miss since there are always items that seem to be requiring clearance/markdowns.
- Costco may have had some much higher margins than it likes its customers to believe if it makes sense to lower prices that much. It may not have really been so much on your side as to drive down both its own and its supplier's margins.

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- It's always worth checking out the Clearance corner (this would cannibalize time in the rest of the store and weaken on the margin the propensity to purchase at full price).

In effect, any such inference would be diluting Costco's intended brand image. Note that some of these inferences might well be wrong in specific situations. For example, the items may be sold at a loss, as deep markdowns can be, so the discount doesn't necessarily imply the margins in the regular price were THAT fat! But Costco is unable to educate every customer. In fairness to Costco, not even the best merchandising team should be expected to have a 100% batting average with every product selling through all the time.

Customers' perceived value drives willingness to pay (WTP), and Costco's money is made from customers whose perceptions support WTP both for the "regular price" merchandise and for the all-important membership fee, paid precisely because "regular price" at Costco is believed (in many, but not all cases, accurately) to be "unbeatable prices" compared to everywhere else. By NOT advertising these Clearance sales, Costco may make a small sacrifice in the very few cases where not enough shoppers notice the bargain prices/nearly unbelievable comparisons with competitor products nearby. It may end up with some unsold inventory, and for perishable items that means a full loss of COGS (cost of goods sold). But that is peanuts in dollar terms against the giant value Costco drives by preserving the WTP for its "regular priced" items untarnished by the "undesirable" 97-cent fallout.

But why then are those "regular sales" items in the $0.49 or $0.79 bucket being advertised so diligently?

It may appear at first blush that Costco's actions in these two situations contradict themselves and can't both be consistent with its brand message. But they are both examples of excellent price execution. The motives, and more importantly, the "sponsor" for the cost of each type of sale are quite different and warrant the different (indeed, opposite) treatment in messaging.

For the "regular sales", it is usually safe to assume:

- They will be time-limited for the exact period Costco advertises in advance in its mailer.
- The consumer brand/manufacturer of the product is bearing most of the cost of the discount (75% or more).
- Costco may have used its negotiating power, especially with products that sell well but not exceptionally well, to press for a (deeper discount) promo.
- Everybody understands the product will go back to regular price and there is no indication/sure way to tell that it's not doing quite well at that price already (in fact I know from my own work with some consumer brands selling into Costco of products that did exceptionally well at the regular price and Costco had them on promo anyway).
- There is a "good rationale" for the sale/bearing the cost of the discount: driving more volume, more brand awareness, and more store traffic with magnet offers.

The one thing that carries over from the 97-cent situation is the (warranted) inference that there is enough margin in the product to still make a bit of money or break even at the discounted price. But recall from our chart that discounts here are much less than in the 97-cent situation so that inference would be less alarming. And of course, recall our caveat that few shoppers walk around thinking about Costco's margins!

These "regular sales" then, leave the consumer with intact confidence in items 1-4 of Costco's brand message we outlined above. Promoting them makes both pricing and branding strategy sense!

Conclusion

Understanding Costco's messaging code embedded in its price point endings can be dramatically useful for consumers looking for bargains and further inflation-fighting opportunities. For pricers and marketers, it invites admiration and respect for a brand that is immensely successful because it thinks the details through. When you see Costco do something differently, if it doesn't immediately seem clear why, chances are they've figured something out before the rest of us rather than the other way around.

Final caveat: There are exceptions to some of the price point ending "rules" above. For example, sometimes a "regular" sale price can also end with 99 cents, as you can see in the images above. While some of the ideas above are based on a limited sample of observations, I would welcome and incorporate comments from Costco if any of the facts above can be improved with source information.

Pricing Missives

by: Tim J. Smith, Ph.D.

In the currently unpredictable, post-COVID, inflation-plagued economy, companies are being tested on their pricing strategies and their pricing decision-making "spine." In this article, the author analyzes recent pricing decisions by six organizations in diverse industries and outlines the potential strengths and weaknesses of each pricing approach.

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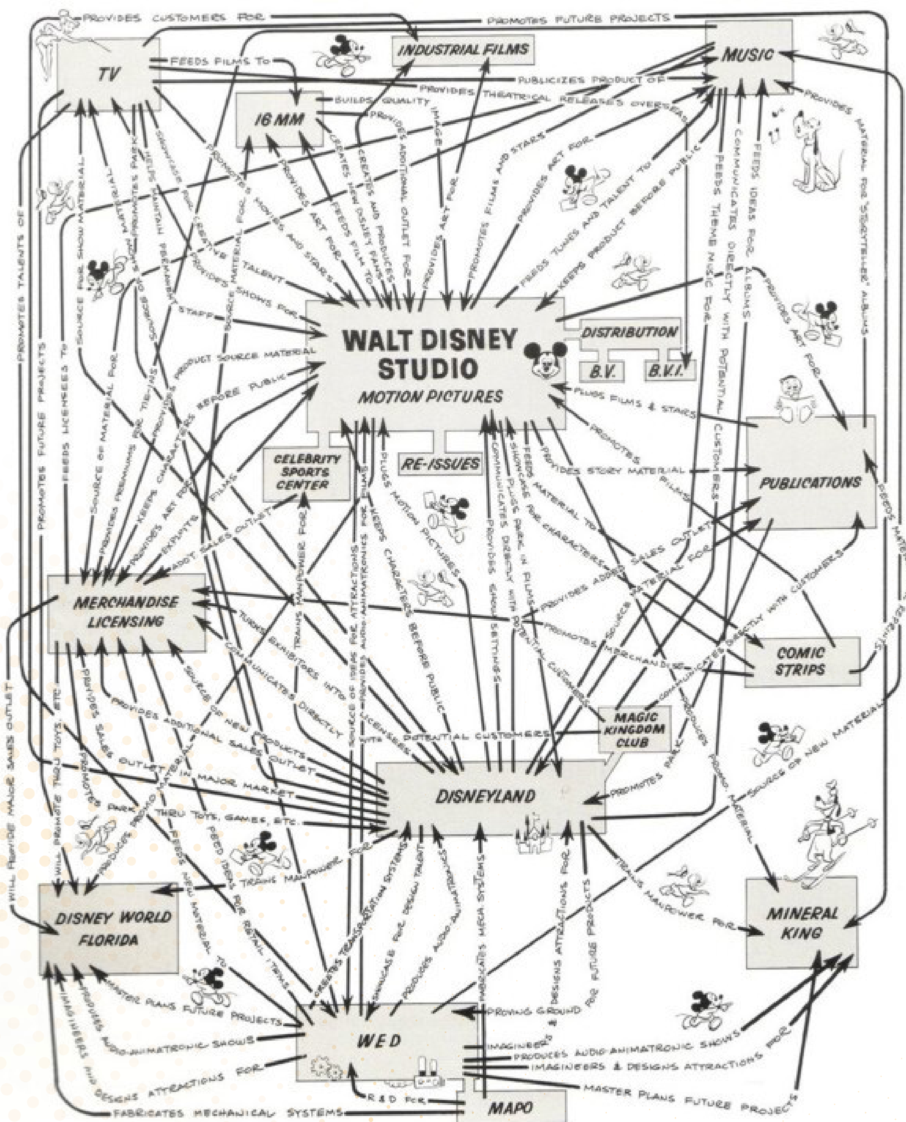
Disney Membership Pricing Decision Spine: Unknown of 5 Vertebrae



In 1957, Walt Disney sketched the "Synergy Map" (shown above) as a way to connect the many different properties and revenue streams within the larger Disney ecosystem. The concept has evolved since those early days and is now going through a refresh.

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Today, in 2022, Bob Chapek, the current CEO, is exploring the rollout of a new membership program that could further support the cross-selling of Disney merchandise, parks, and experiences with Disney+ streaming customers.

Membership programs, such as those at REI, Sam's Club, or Amazon Prime tend to attract the segment of the market which are likely to be both heavy purchasers within the category and also price sensitive. They act like a two-part tariff in that the entrance fee (membership) provides discounts on the metered offering (in Disney's case, merchandise or other experiences). Two-part tariffs can be highly profitable and have been deployed and studied since 1920. (Two-part tariffs are a one hundred-year-old pricing strategy that many have never heard of.)

Disney has long impressed me with their strategic pricing decisions. At the same time, this too sounds promising. However, this strategy cannot be fairly evaluated yet because we do not know its price point nor what membership would imply. That is, a decision hasn't been made.

Disney's Pricing Spine: Unknown out of 5 vertebrae for this decision.

DIS (Walt Disney Co.) has been relatively unchanged in the weeks following the news at 112. 2022 revenue of $67 billion with a 3% margin and P/E ratio near 64.

Toonkel, Jessica and Krouse, Sarah (2022, September 1). Disney Mulls Member Benefit Program. Wall Street Journal, B1.

Campbell's Pricing Decision Spine: 2 of 5 Vertebrae

Campbell's recently reported a 6% revenue increase. Drivers include higher prices, greater amid greater promotional spending, and lower volumes. Profits decreased despite the higher prices partly due to the higher promotional spending but also largely attributable to variable cost increases driven by pandemic-related supply chain restraints and Russia's invasion of Ukraine.

On the plus side, Campbell's market share has increased despite higher pressure from store brands in stock and other kitchen basics.

MEMBERSHIP PROGRAMS, SUCH AS THOSE AT REI, SAM'S CLUB, OR AMAZON PRIME TEND TO ATTRACT THE SEGMENT OF THE MARKET WHICH ARE LIKELY TO BE BOTH HEAVY PURCHASERS WITHIN THE CATEGORY AND ALSO PRICE SENSITIVE.

For many executives in consumer-packaged goods (CPG), market share is more important than other business performance metrics. The primacy of market share among many possible metrics is largely due to Profit Impact of Market Strategy (PIMS) studies first released in the 1970s and highly marketed by the Boston Consulting Group (BCG). The PIMS study concluded that market share and profits are strongly correlated. Despite the numerous economic, finance, and marketing studies that have challenged the PIMS study and its conclusions, market share remains a priority for many executives that cannot be threatened by a price increase.

Moreover, sales and marketing executives are often biased toward pursuing volume over price to drive profits. Mark Clouse, CEO of Campbell Soup Company, comes from a background in sales and marketing of consumer package goods (CPG) after serving in the U.S. Army. (Thank you for your service.)

Due to the shrinking profits among higher variable costs and promotional spending, and due to known industry biases favoring market share over pricing quality, we have come to the following conclusion.

Campbell's Pricing Spine: 2 out of 5 vertebrae for these decisions.

They should have raised prices faster and reduced their dependency on promotions.

CPB (Campbell Soup Co.) fell in the weeks following the news from 51 to 48. 2022 revenue of $8.6 billion with an 8.8% margin and P/E ratio near 48.

Kang, Jaewon and Seal, Dean (2022, September 2). Campbell's Profit Slides as Shoppers Rethink Spending. Wall Street Journal, B3.

Dollar Tree Pricing Decision Spine: 3 of 5 Vertebrae

Dollar Tree Inc., after raising prices, saw a revenue increase 4.9% over the same quarter last year from comparable sales.

If revenue increases following a price increase, the company was priced in the inelastic range. No profit-oriented company in a mature industry should price in the inelastic range because it leaves money (profits) on the table. Dollar Tree was in this position. Therefore, their price increase was appropriate.

Dollar Tree reported fewer customer expenditures on high-margin items. This mix shift

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should be attributed to an exogenous factor of inflationary pressures on consumers in the current economic environment rather than an endogenous factor of management decision-making.

Dollar Tree also reported fewer store visits but higher expenditure per visit, and also that they are attracting more households with income of $80,000 or higher thus bringing in above median-income families into what is perceived as a low-priced outlet. While these facts provide interesting insights into the dynamics of consumer behavior during this inflationary period, they do not provide great insight into managerial decision-making and its business outcomes.

The management team at Dollar Tree is demonstrating pricing competence.

Dollar Tree Pricing Spine: 3 out of 5 vertebrae for these decisions.

DLTR (Dollar Tree Inc.) fell sharply in the weeks following the news from 165 to 142. 2021 revenue of $26 billion with a 2022 5.0% margin and P/E ratio near 20.

Nassauer, Sarah (2022, August 26). Higher Prices Lift Dollar Stores. Wall Street Journal, B2.

Dollar General Pricing Decision Spine: 3 of 5 Vertebrae

Dollar General Corp., after raising prices, increased revenue 4.6% over same quarter last year from comparable sales.

As I previously stated, if revenue increases following a price increase, the company was priced in the inelastic range. Dollar General was in this position, and therefore their price increase was appropriate.

Dollar General also reported that customers lowered spending on apparel, seasonal goods, and home products and raised spending on consumables such as food. This mix shift should be attributed to the exogenous factor of inflationary pressures on consumers in the current economic environment rather than an endogenous factor related to management decisions.

The management teams at Dollar General demonstrated pricing competence.

IF REVENUE INCREASES FOLLOWING A PRICE INCREASE, THE COMPANY WAS PRICED IN THE INELASTIC RANGE. DOLLAR GENERAL WAS IN THIS POSITION, AND THEREFORE THEIR PRICE INCREASE WAS APPROPRIATE.

Dollar General Pricing Spine: 3 out of 5 vertebrae for these decisions.

DG (Dollar General Corp.) fluctuated in the weeks following the news, starting at 240, falling to 237, then rising to 247. 2021 revenue of $34 billion with a 2022 7.0% margin and P/E ratio near 25.

Nassauer, Sarah (2022, August 26). Higher Prices Lift Dollar Stores. Wall Street Journal, B2.

Sony Pricing Decision Spine: 4 of 5 Vertebrae

Sony is increasing the price of a PlayStation 5 console in select markets including the Middle East, Africa, Europe, Asia-Pacific, Latin America, and Canada. However, they are not raising prices in the U.S. Inflationary pressures were cited as a driving force behind this decision.

The price increase will be market-dependent. A 20% price increase is expected in Japan. A 10% price increase in Europe. And again, 0% in the U.S.

Supply chain issues impacted this decision. Sony has had silicon chip challenges, similar to its competitors, as well as other supply chain challenges related to COVID restrictions and production in China. As a result, sales of PlayStation 5 plunged 26% in Q2 of 2022 over the same quarter last year.

Sony also reported demand is outstripping supply.

The market specificity of the price increase, the factors influencing the decision, and the industry concentration of the gaming console industry all lead to the following conclusion.

Sony's Pricing Spine: 4 out of 5 vertebrae for these decisions.

SONY (Sony Group Corp.) fell in the weeks following the news from 84 to 74, yet it is highly doubtful that the price of the PlayStation 5 alone impacted this performance. 2022 revenue of $882 billion with an 8.9% margin and P/E ratio near 14.

Vipers, Gareth (2022, August 26). PlayStation 5 Prices to Increase as Much as 20% in Certain Markets. Wall Street Journal, B4.

Kraft Heinz Decision: 2/5 Spines of Pricing Backbone

Organic revenue grew 10.1% in Q2 2022 over the same period year prior. Price increased 12.4% while volume decreased 2.3%.

Miguel Patricio, CEO of Kraft Heinz, stated "We are mindful of the current inflationary environment and how it affects consumers."

If the magnitude of price increases exceeds that of volume decreases,

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the company is priced in the inelastic range. Kraft Heinz was in this position. Therefore, their price increase was appropriate, despite the small loss of volume.

Kraft Heinz executives revealed their strong pricing performance with announcements about increasing promotions.

Should Kraft Heinz increase promotions today?

- In support of increased price promotions: industry volatility, consumer price expectation theory, and price segmentation.
- Against price promotions: profit impact and alternative investment decisions.

Regarding industry volatility and price promotions:

- During the pandemic, Kraft Heinz, like many of its peers, decreased promotions. This was wise back in 2020 when supply chains were snarled, production plants were short on labor, demand shifted from industrial to grocery channels, and simply offering consumers a familiar and useful product was sufficient to drive sales. (Recall, there was once even a shortage of dried beans.)
- After the pandemic crisis period, the industry challenges changed. Today's economic environment is one of high inflation and an uncertain economic future. Plus, low-cost competitors are able to reliably supply once again. Today, CPG companies are experiencing increased brand betrayal towards lower-cost store brands.
- As competitive pressure has returned, we should expect a return to promotional activity.

Consumer price expectation theory warrants price promotions during moderately high-inflation periods (1).

- Research into behavioral economics demonstrates that consumers strongly anchor their price expectations based upon the price point they last purchased at, not the price currently required to purchase.
- When prices are above consumer expectations, demand decreases. Consumers often respond with thoughts like "I will wait for the price to come back down" or "they are trying to rip me off."
- Moderately high inflation drives noticeable price increases above that expected by consumers.
- To soften the blow of a large price increase, temporary coupons and promotions can give consumers the feeling that they are "getting a deal" and beating the system while the new list price adjusts the expected price to pay upwards.
- Thus, when taking a large price increase on branded goods, increased promotions may be expected on a transitory basis.

PRICE PROMOTIONS AND COUPONING ACTIVITY IS A FORM OF PRICE SEGMENTATION BECAUSE NOT EVERYONE WILL MAKE THE EFFORT TO USE COUPONS OR CHANGE THEIR BEHAVIOR TO PARTICIPATE IN A PRICE PROMOTION.

Price promotions can be a good form of price segmentation.

- Pricing fundamentals state that price segmentation can increase profitability.
- Price promotions and couponing activity is a form of price segmentation because not everyone will make the effort to use coupons or change their behavior to participate in a price promotion.
- As such, price promotions can increase profitability.

Repeatedly, research has demonstrated most price promotions harm profits.

- At the most basic level, promotions lower prices in the hopes of gaining volumes to improve profits. The volume gains are rarely sufficient to overcome the price losses.
- In 1990, Scott Neslin published a model for estimating the impact of promotional activity on profits. This and similar modeling efforts repeatedly reveal that most price promotions harm profits.

Price promotions are not the only choice.

- While a price promotion may drive volume growth temporarily to the cheers of many sales and marketing executives, it is not the only choice. That same budget can be used for branding.
- Across the consumer packaged goods industry, companies find the branding elasticity is around 0.2 on average. This means that a doubling of the advertising and branding budget should drive a 20% increase in sales volume.
- PepsiCo made the decision to decrease promotions and increase brand advertising with positive outcomes during 2019 and before the pandemic.
- Miguel Patricio, CEO of Kraft Heinz, stated a need to nurture national brands in early 2020 right before the pandemic. Hence, we are aware Patricio and his team are aware of the alternatives. We just wish they had taken them.

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Weighing the pros and the cons, we are skeptical.

Kraft Heinz Pricing Backbone Demonstrated in the Decision to Increase Prices: 4 out of 5 Spines.

Kraft Heinz Pricing Backbone Demonstrated in the Decision to Increase Promotions: 2 out of 5 Spines.

KHC (Kraft Heinz Co) fell from 38.6 to 35.6 on the day of the announcement and has since recovered. 2021 revenue of $26 billion with a 2022 P/E ratio near 37.

Gasparro, Annie (2022, July 28). Kraft Heinz Raises Outlook, Plans Promotional Items. Wall Street Journal, B3.

(1) Inflation of around 10% is only moderately high in my judgment. Given the experiences of currencies across the globe in my professional lifetime, I think of 20% as high and 100% or greater as entering the hyperinflation territory. Comparing the relatively recent experiences of people in Turkey or Argentina versus Yugoslavia or Zimbabwe, we conclude that the current inflation felt in Europe and North America is painful and unpleasant but should be categorized as merely moderately high.

GM Pricing Decision Spine: 4 of 5 Vertebrae

GM is setting a $30,000 price target for an electric (EV) vehicle version of the Chevrolet Equinox SUV to be released in the fall of 2023.

Is $30,000 a good price target?

The Equinox is currently GM's second-best seller behind the Silverado pickup. This will join GM's current EV offering lineup that includes a $110,000 GMC Hummer and a $62,000 Cadillac SUV. The EV Equinox will help GM meet its goal of selling one million EVs in North America by 2025. An EV Equinox will compete most directly against the Volkswagen ID.4 EV starting at $37,500, the Kia EV6 and Toyota bZ4X starting around $40,000, and the Tesla Model 3 starting at $47,000, given current prices. Regarding the lower price point, Doug Houlihan, an executive engineer on the program, stated "the more volume we can get, the lower we can get the price."

To evaluate, consider the reality of this price target, how it might be set, and the role it plays.

Is the price target real?

Any price target set today for an offering that won't be released for at least 12 months is likely to be missed, especially in a rapidly evolving product category such as EVs. Battery prices, chips, and other component costs are likely to vary as are the prices of the competing alternatives. Both of these factors will greatly impact the price of the EV Equinox when it is actually released. As such, it is best to realize this is a target and no more. It is not a promise nor a final decision. It is just a target and one that is likely to evolve. On the plus side, the price target is not unrealistic considering the highly favorable and asymmetric role of federal incentives to purchase a largely U.S.-produced EV.

ANY PRICE TARGET SET TODAY FOR AN OFFERING THAT WON'T BE RELEASED FOR AT LEAST 12 MONTHS IS LIKELY TO BE MISSED, ESPECIALLY IN A RAPIDLY EVOLVING PRODUCT CATEGORY SUCH AS EVS.

Yet how might this target have been created?

For starters, GM has an internal "Good-Better-Best" product lineup between the Chevrolet, Cadillac, and GMC Hummer brands and price points within the EV category. Versioning is a proven profitable value proposition in auto manufacturing. Moving beyond this high-level directionally appropriate strategy, we get to the detailed challenge of defining a price point. Why around $30,000 and not higher or lower? The best practice approach to get to that level of accuracy, even if we are talking about ballpark accuracy and not a single specific price point, is to use conjoint analysis. Adding different GM models and price points to the Volkswagen, Toyota, Kia, and Tesla models and price points currently on the market, one would test the attractiveness of an EV Equinox that currently doesn't exist through conjoint analysis and define the profit or strategy optimizing price point. If this wasn't done at GM, I would be greatly surprised.

And why is the price target important?

For over 30 years, Ron Baker and other pricing strategy leaders have called on executives and brand managers to start with the customer to define the price rather than the other way around. That is, ditch the process which calls for marking up costs to define a price that you demand customers to pay (Product >> Cost >> Price >> Value >> Customers) and replace it with a process that calls for working from the customer's needs and desires to identify the price that matches their willingness to pay and then engineer the cost and product to deliver to that need profitably (Customers >> Value >> Price >> Cost >> Product). GM's price target could play that role. It provides a boundary to engineer the EV Equinox for delivering an offering that meets customer needs and desires profitably.

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The above arguments lend towards a highly strong decision-making process until we get an executive's dubious claim regarding higher volumes and lower prices. To my current understanding, the average variable costs of producing an EV do not decrease nearly as quickly as those of producing an internal combustion engine (ICE) automobile, hence the correlation implied in the statement is questionable or at best weak. I suspect that statement is a red herring.

After considering the above, we have come to the following conclusion.

GM's Pricing Spine: 4 out of 5 vertebrae for this decision.

GM (General Motors Co.) rose the day following the news from 40.5 to 41.4. 2021 revenue of $127 billion with a 7.9% margin and P/E ratio currently near 7.7.

Colias, Mike (2022, September 9). GM Sets '23 Release of $30,000 Electric SUV. Wall Street Journal, B1.

How Many Vertebrae Are in Your Pricing Decision Spine?