Pricing in an inflationary downturn

In the current environment, costs are rising as price sensitivity increases. Six tactics can help companies get pricing right.

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Getting pricing right is always a challenge in an economic downturn, as decreasing demand, excess capacity, and greater price sensitivity all conspire to drive down prices. In most downturns, the cost of raw materials, feedstocks, and other upstream supplies—as well as the cost to serve customers (for delivering goods, for example)—tends to stabilize and even decrease as business activity slows. As a result, decreases in downstream prices are at least partially offset by lower upstream costs. But in the current environment, not only is weaker demand from the end user making it harder to maintain prices, but significantly higher and more volatile input costs mean that companies caught in the middle are getting hit from both sides.

What's a business to do? In this unusual downturn, companies need to manage the profitability of individual customers and transactions with greater precision, develop richer insights into their customers' changing needs and price sensitivities, and understand more clearly the microeconomics that shape their own industries and those of their suppliers. We've assembled six tactics aimed at maintaining the best balance possible between sales volume and profit margins in the current challenging environment.

Watch for sudden shifts in price structure

Companies should be vigilant in monitoring pricing policies that reduce revenue—such as volume discounts, rebates, and cash discounts—as well as cost-to-serve, including freight and sales support. In the current downturn, rising costs and declining demand can cause these elements to change more dramatically and quickly than they have in the past. Rapidly increasing fuel prices, for example, are putting intense pressure on delivery costs. Declining demand means that some customers may be collecting volume discounts they no longer deserve. Best-practice companies are reviewing much more frequently their pocket margin waterfalls,[1] which show how much revenue companies really keep from each of their transactions, and adjusting their pricing policies accordingly—for example, by adding delivery fuel surcharges to every order. Without the extra attention and quick action, erosion at all points of a transaction can quickly destroy profits in times like these.

Monitor customer-level profitability

Companies should use transaction-level data to measure precisely the profitability of each customer. By doing so, companies can detect if the cost to serve particular customers or declining order volumes are nudging those customers below target profitability levels. In this downturn, for example, many customer groups are becoming simultaneously smaller and more costly to serve. One industrial company found that more than 20 percent of its customers had fallen below breakeven profitability, forcing it to raise prices selectively and, where possible, lower cost-to-serve by decreasing delivery frequency, reducing sales support, or fulfilling orders through alternate channels.

Adjust to changing customer needs

Downturns always prompt changes in customer needs and in the benefits they value when choosing a supplier. The dynamics of the current downturn mean that such swings can occur even more rapidly. In this environment, the best companies are constantly assessing—through market research and direct contact—how economics are changing for their customers. Even more important, they are reacting quickly by retooling their price and benefit offerings accordingly. For example, one plastic resins supplier that had developed a fast-curing resin (to enhance capacity of injection molders when the economy was strong) has now developed a less costly resin that doesn't cure as quickly. The new resin helps the supplier's customers decrease costs, because molders are not running at full capacity during the downturn. With other supplies raising their prices, many molders see the slow-curing resin as an attractive alternative. As a result, the supplier can maintain its profit margins even while selling the alternative resin at a lower price. The combination of lower demand and higher input costs in the current downturn makes it critical to get these kinds of adjustments to the cost/benefit balance correct.

Update price sensitivity research

Dramatic increases in energy and food prices have made consumers much more sensitive to prices across a wide range of product categories. Each price increase for necessities such as food and fuel has cut a little more from discretionary budgets, sharply increasing price sensitivity. Market price tests become obsolete after just a few months. To get price points right, pricing sensitivity research and market price tests should be rerun immediately to track these changes.

Monitor your industry's microeconomics

Radical shifts in costs and demand have thrown previously predictable market pricing mechanisms into chaos. Responding correctly requires a keen understanding of the microeconomic forces at play at the industry level. In one example, a building materials company found itself in a precarious position as the downturn deepened: a precipitous decline in US housing starts meant diminishing demand, while the costs for raw materials, energy, and transportation were increasing rapidly. In response, the company reassessed the industry's microeconomics, looking in particular at the latest supply, demand, and cost dynamics. With this new information, managers cut capacity at a plant in an area where the decreased supply would not cause a local shortage. The capacity reduction, which would have had little if any effect on market prices a year earlier, brought about a better balance between supply and demand and kept market prices an estimated 10 percent higher than they would have been without the change.

Study your suppliers

The extreme volatility in this downturn demands that companies reexamine not only the microeconomics of their own industries but also the microeconomics of their suppliers' industries. Recently, a specialty chemicals company invested in modeling the current industry supply, demand, and cost dynamics for one of its primary raw materials. By doing so, the company predicted an industry-wide, 15 percent price increase for that raw material three months before it happened—a feat of some significance because there hadn't been an annual price increase of more than 5 percent for that material within the past six years. Suspecting an imminent and unusually large price increase, the chemicals company began adding clauses covering raw-material price increases to its customer contracts, a move that would have met extreme resistance if made after the price increases were announced. Instead, the move established an industry precedent for passing cost increases through to customers. Q

About the Authors
Cheri Eyink is a consultant and **Mike Marn** is a principal in McKinsey's Cleveland office; **Stephen Moss** is an associate principal in the Stamford office.

Notes

[1] For a discussion of the pocket margin waterfall and other pricing tools, see Michael V. Marn, Eric V. Roegner, and Craig C. Zawada, "The power of pricing," mckinseyquarterly.com, February 2003.

Letters to the Editor

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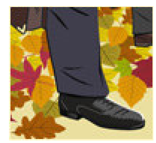
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