

Dealing with Cost Increases: A Matter of Survival

Many industries today are affected by rising costs. Raw material prices have been rising steadily over the last year – especially those connected to the price of oil. Uncertainty about the supply of the “world’s fuel” have inched its price upwards – and with it, the ability of companies to remain profitable has steadily declined.

It’s no wonder that the rising price of raw materials is an urgent concern. In many industries, raw materials price increases exceed buyer’s recent profit margins. Since the customers of these companies also face hard times, they are unwilling to accept unfair or opportunistic price increases that put them at a competitive disadvantage.

So the question arises: what should a company with slim profit margins and tough customers do when facing substantial increases in raw materials? This is not something that can be dealt with passively. It is important to proactively communicate why these increases are different from those that customers have successfully avoided over the past few years. Successful companies must adroitly pass through such cost increases in ways that make price increases “stick.” For the past few months, we have been helping many clients deal with this problem successfully. Here is what we are telling them.

What are the issues?

There are three keys to successfully passing on cost increases:

- Convincing customers that increases are inevitable;
- Convincing customers that increases are fair and equitable;
- Convincing competitors that there is little risk in implementing their own increases quickly.

Price negotiations over the past two years have been focused on reaching a price that would enable suppliers to recover capital costs and earn some return. Since capacity costs are “sunk”, buyers had significant leeway over suppliers, and it was difficult for suppliers to walk away from any business that made any positive contribution. Invariably, this involved price reductions in response to the tough negotiating tactics that buyers employed.

Now, after watching producer prices decline over the past few years, industrial customers are unaccustomed to price increases. At the present time, the difference is that raw materials costs are “avoidable.” At current low or negative profit margins, it is better for suppliers to walk away from some customers, in particular those customers paying the lowest prices, than to buy raw materials at prices they cannot recover in their finished goods.

Still, buyers are also facing tough times. They cannot afford to accept price increases they believe their competitors might not. Buyers must believe that despite accepting a price increase, their relative competitive advantage will not be diminished. To achieve this, everyone will attempt to delay accepting any increase until they see others accepting it. Since cost increases (like a hot potatoes) hurt more the longer one delays in passing them on, successful pricers need to circumvent this delay by convincing customers that everyone will accept it.

Finally, all or part of the price increase will fail if any credible supplier does not go along with it. Fortunately, competitors who were the most aggressive in cutting prices to fill capacity are the ones that now need to recover materials cost increases the most. Having cut margins to the bone, materials cost increases will disproportionately impact profits and cash flow. Consequently, the only thing likely to prevent competitors from raising price is a perception, either true or created by a duplicitous purchasing agent, that they could lose business to competitors who are not fully passing on the increases.

What you can do?

Given these facts, what can you do to prevent being squeezed between rapidly-rising materials cost increases and slow-to-change finished goods prices?

- **Send out a letter, e-mail, or press release to all customers simultaneously that explains the necessity of across-the-board increases.** Relate the increases clearly to the cost increases (e.g., “energy prices have increases 24%, energy accounts for 10% of the price you pay, so prices must increase by 2.4 %”). There are multiple reasons for making this a public, across-the-board communication. First, it is the only way to introduce the increase to everyone at the same time. Consequently, the first customer you talk with in person will not feel they are being singled out or disadvantaged. They will have already heard that others are getting an increase. Second, it communicates the urgency of the message — that you as a supplier cannot delay in passing on such increases. Thirdly, it accurately alerts your competitors to your action. With so many letters going out (a copy to the trade press is also a good idea), competitors will get a copies that explain exactly what you are doing.
- **Don’t get suckered by your biggest customers’ claims that because they pay the lowest prices, they should take a lower increase.** In fact, the raw materials cost increases represent a higher percentage of the lower prices they probably pay. Show the customer the economics. If necessary to gain their quick acceptance, offer large customers “most favored nation” clauses to insure them protection from any of their competitors negotiating better terms than theirs.
- **Be willing to index your pricing to objective measures of raw materials costs.** Customers and competitors are more likely to accept price increases if they are assured that prices will come back down when your raw material costs come down. Moreover, the index makes future increases automatic. The index would involve a “base price” plus a variance based on a weighting of publicly available raw materials prices (e.g., feedstocks such as ethylene). Indexed pricing is especially useful in times of significant price spikes, since indices can be adjusted weekly or monthly, depending on the frequency and degree of price movements. One caution: separate the indexed cost-based portion of your price from the portion that covers your value-

adds. That way, you avoid communicating that the only legitimate rationale for a future price increase is a cost increase. For example, you might tell customers that energy accounts for 18% of the cost to produce your product. Consequently, each 10% change in the cost of energy would trigger a 1.8% change in price. As an alternative to indexing your price, add cost-based “surcharges.” These cannot automatically increase like indices, but they clearly separate cost-based elements from the value-added portion of your price. They also communicate less “permanence” to buyers and therefore seem more acceptable than base price increases.

- **Absolutely, positively avoid any attempt to gain share by compromising on the increase.** Particularly in industries with much excess capacity, it is tempting to waive a 5% price increase for customers willing to give you 20% more volume. Don’t be shortsighted. The competitor from whom you take that volume cannot afford to lose it any more than you can. That competitor will need to find other customers to whom to offer the same deal. The losing competitor at that customer will then need to replace the lost volume at still another customer. When it all shakes out, market shares will be little changed, but suppliers will be a lot poorer as a result of the pricing opportunities forgone.
- **Play hardball with competitors who are opportunistic about the increase.** If competitors cut a deal such as the one described above with any of their customers, make sure that all of their customers learn that some were allowed to avoid the increase. The cost to the competitor of gaining share at one customer must be the inability to win price increases at any of them. Moreover, if the competitor’s economics are weak, help customers and stock analysts understand why only that competitor feels compelled to forgo the increase, and to understand how that competitor’s more precarious finances undermine its ability to supply product reliably.

How Strategic Pricing Group Can Help

Managing tough challenges in pricing is a key source of competitive advantage for many companies. Fortunately, Strategic Pricing Group has the insight and experience to help companies meet these challenges.

Strategic Pricing Group has been very successful helping companies navigate through both good and difficult times with practical solutions. For example, we are well-equipped to help you construct an index that can be used to dictate prices within your company, as well as the industry in which you operate. Although we have helped many companies develop and execute value-based pricing and marketing strategies, we know that this situation calls for a different approach for companies in the situation described. We stand ready to help any company weather current storms with effective and innovative pricing, marketing strategies and tactics tailored to that company’s specific situation – and to these uncertain times, when survival is the focus.

Strategic Pricing Group, a member of Monitor Group, is located in Cambridge, MA.