Facing the Commodity Price Bullies

The global economic recession has affected business pricing strategies in numerous ways, including planning for and adjusting to rising costs from suppliers. Pricing has become very dynamic, and suppliers now price with confidence—and even arrogance –creating what the author refers to as "pricing bullies." In this article, the author explains how to face price bullies, and to organize yourself to protect your profitability and pricing power in your market. Stephan Liozu, CPP, is President & CEO of Ardex America Inc (www.ardex.com), a CPP Faculty Member and a frequent PPS contributor and presenter. He is also a PhD candidate in Management at Case Western Reserve University and can be reached at sliozu@case.edu.

Beginning in 2008, our global and local economies experienced a structural break as we faced one of the most formidable recessions since the Great Depression. It seems that the business world as we knew it, with its predictable demand/supply cycles, expected post-recession recoveries, and rational commodity pricing, has changed for the long term. Today's business leaders face a dynamic, unstable and less-than-predictable economic environment. It is becoming difficult to project ahead. Investment and operational-expense decisions have never been so short-term-oriented. For the past three years, companies have restructured their activities, strengthened their balance sheets and prepared for better times. The thing is, better times are not coming, and there is only so much cost-cutting one can do. So what comes next?

The purpose of this short essay is to highlight some of the dynamics that will change the business game for years to come. The game is changing indeed. If you are on the receiving end of these changes, you need to be ready to face inflationary pressure for years to come. You also need to prepare for them, estimate the impact on your P&L, take actions to mitigate the potentially dramatic impact on your profitability and, most of all, adopt pricing strategies that will allow you to protect your business and your pricing power in the market.

Changing Business Dynamics

Skeptics might argue that business changes constantly and that this is not the first time we've experienced these economic pressures. I agree with this position in some respects, but I also feel that levels of uncertainty and unpredictability have never been so high. Managing a business today under these conditions requires breakthrough thinking, leadership resilience and a certain level of paranoia. I have chosen to highlight three changing dynamics that are critical drivers of business profitability if you are in the industrial space and if your business consumes commodities. Some of these points might also apply to nonindustrial sectors, as they may also rely on packaging, plastics, and energy.

Irrational Cycles of Commodity Pricing

Most commodity prices have been up and down, driven mainly by the combined effect of speculation, growth in emerging countries and the risk of shortage. Let's focus on oil for a minute. Much has been written on peak oil theory and the depletion of our oil reserves. From the apocalyptic views at one end of the spectrum (Olduvai theory) to radical denial on the other (Cornucopian theory), an abundant number of references and theories are readily available on the subject. Experts argue that traditional oil production has peaked, although large reserves remain. Peaking means that the global oil-production rate can no longer increase. From there the rate of production will decrease over time, while oil demand continuously increases, with a world population of over 7 billion and emerging economies in boom mode. Obviously, there are profound disagreements between the two schools of thought. Our civilization is driven by an economic system that expects continued and limitless growth. However, during the summer of 2008 when the price of a barrel of oil reached $147, we reached a tipping point for our global economy. The impact on the transportation system and on micro economies and the collapse of the global financial system created a worldwide wake-up call.

During the summer of 2008, I personally heard the wake-up call and asked my top leaders to gather in our executive conference room. I had a simple "what if" question for them. What will happen to our business when the price of a barrel of oil reaches $250? What do we look like in terms of raw-materials costs, supply and profitability? The results of our analysis and relevant contingency planning showed that the business would collapse and most likely disappear if we adopted a "wait and see" strategy. If you run a business today or sit at the executive decision-making table, have you run this analysis? Do you know how reliant on oil and fossil fuels your business is across the board (transportation, packaging, production formulation, travel, etc.)? Have you projected your costs, sales prices and profitability for when oil does reach $250 a barrel? Oil and its derivatives represent just one example. The same analysis could be conducted for mineral resources, wood, rubber, cocoa, and so forth.

New Capacity-Management Philosophy

Over the past three years, the impact of the crisis has forced another realization on many companies. As demand level collapsed, they understood that they were facing a severe overcapacity situation. In 2008, many economists and consulting firms concluded that the nature of the structural break was so profound that the golden years of the US economy were behind us and predicted only modest growth for years to come. Beginning in 2008, many industries experienced a shift in capacity-management philosophy. Companies moved away from trying to manage the supply-and-demand cycle using traditional pricing and commercial strategies and simply idled and depreciated a large number of assets. To support their cost-cutting programs and the right-sizing of their manufacturing footprints, these assets were shut down at a very fast pace. Airlines idled or retired large numbers of aircraft to keep yield utilization at an acceptable levels. Chemical companies restructured assets and transferred production capacity around the globe to take advantage of currency effects and to be closer to the regional demand pockets.

As experts were predicting a long period of stagnation and low growth, capacity management became the name of the game. As a result, when modest demand started to recover in the second half of 2010 and as oil prices began to creep up, commodity prices also showed signs of recovery and began to increase at a faster rate than inflation. It is clear now that thousands of plants, production lines and other assets might be gone for a while. As companies depreciated them and "cleaned up" their balance sheets, they paid for their impairments and depreciations by keeping supplies tight and by managing price levels in the market. Mathematically this approach does make sense. If you can hike your prices by 20, 30 or 40% on current sales volumes and keep your fixed cost base stable, the leverage on your income statement is extremely large and allows for quick recovery of these restructuring charges. Thus payback for asset shutdowns and ROI are extremely attractive.

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In some industries, like the chemical industry, which is already very consolidated, it appeared that this phenomenon was widely understood by all the major players and that the combination of all the asset shutdowns led to severe increases in prices of basic and specialty chemicals. The reality is that it is easier for these industrial giants to announce asset shutdowns and capacity restructuring than to announce or signal price increases. The consequence of this sequence of events and of this structural break is that companies have become much more sensitive to capacity management. They will think twice about bringing assets back online and about adding capacity again based on that experience. They have broken the traditional cycles of demand and supply by removing large amounts of capacity from the market in a very short time. As demand starts to resurge and the recovery finally happens, commodity prices will rise abruptly due to capacity shortage until new capacity comes online. This is a very serious situation, as many industries have undergone consolidation in the last few years (chemicals, airlines, banking, cement, financial services, oil, transportation). The chemical industry, for example, is now composed of half a dozen chemical giants that have in essence formed an OPEC-like cartel. Some of them are fully integrated, from oil exploration to fuel distribution and B2C products. As consumers we face not only the cartel of the oil-producing countries but also the supply cartel of the oil-processing giants. This does not bode well for the future of our global economy.

Aggressive Pricing Strategies

The combination of irrational commodity prices and the supply-management style along the value chain is deadly for businesses that rely on chemicals, plastics, and other commodities in their operations. Add to this an increased realization of the power of pricing, and you have an explosive situation. In recent years, large companies, mostly, have grown increasingly smarter in the area of pricing strategies. They have realized that price management can bring huge leverage in the P&L. They have invested resources in pricing software and price-optimization tools as well as in the organizational design of strong pricing teams and capabilities. This is excellent news for the pricing profession.

These companies have an increased level of price sophistication and have displayed bold pricing strategies characterized by the following:

- Advanced formula pricing methodology with mostly automatic pass-through of raw-materials increases.
- Global price management with well-established price corridors and protection of regional pricing.
- Controlled pricing discount and a focus on the pricing discipline of their sales force.
- A move from cost-plus pricing to ROS-driven pricing and sometimes value-based pricing.
- Training in management and implementation of price-increase and decrease processes.
- Separation of responsibility between transaction and strategic pricing activities.
- Price-driven asset management with increased ROI expectations for new asset projects.

The focus has been on increased price discipline and greater price realization. As consumers of chemicals and commodity products, we have seen pricing strategies change dramatically over the past three years. The combination of supply tightness and increased pricing realization has allowed these companies to strongly increase their pricing power down the value chain of many industries. Pricing has become very dynamic, and suppliers now price with confidence—and even arrogance. Pricing power in consolidated industries with tight supply situation lead to that sense of arrogance. I call these companies the new "pricing bullies." In 2011, for example, we have already received four double-digit price increases in some of the resins used to produce our finished products. These increases were not negotiable and were executed with just two weeks' notice. Suppliers refused to sign any agreements or to commit to longer advanced notice. Their sales managers walked into our offices with great confidence, explaining that their raw-materials prices had gone up and that they needed to protect their margins. They displayed a "take or leave it" attitude, which was despicable. I recently shared some of my views with an American top executive of a large chemical firm and tried to explain to him the difference between price confidence and price arrogance. I also explained to him that, generally, short-term wins damage customer relationships and create a willingness to open the doors to new entrants. Obviously, I could not win the argument, but I got my point across.

Now you have it. This phenomenon is bound to spread to other industries, and you already see signs of change in the airline industry. Other sectors have benchmarked the chemical industry and are now implementing dramatic changes after undergoing tough economic times.

Organizational Design & Sense of Urgency

While managers in firms cannot control their external environment or the behaviors of their suppliers, there are many actions and programs that can be designed and implemented internally to address this potential deadly factor combination. These actions and programs require strong management support and an increased organizational sense of urgency. The natural tendency will be to focus on cost-cutting initiatives and to try to generate internal efficiencies in manufacturing, R&D and administration in order to mitigate the raw-materials cost increase. Most firms will not design and implement purposeful pricing programs to respond to these external threats. We posit that pricing teams have a critical role to play in this situation. We propose a list of eight areas where pricing professionals can have a strong influence in mitigating the potential impact of these upstream price bullies on firm performance.

1) Help purchasing and sourcing teams with negotiation tactics. Pricing professionals can be strong allies to purchasing and procurement professionals, who bear the brunt of the relationship dynamics. Pricers are able to decode pricing tactics, unbundle complex offerings and packages, and cut through suppliers' negotiation tactics. In fact, pricers and purchasers should collaborate prior and post negotiation via joint brainstorming sessions. Being able to decode the "rule book" from these commodity giants might provide more room for negotiation as well as a sense of economic rationality.

2) Learn as much as possible from the suppliers and their pricing strategies. Pricing professionals might be able to assist their purchasing colleagues by conducting specific research on the supplier's pricing strategies, by identifying the economic drivers of their business, and by studying the suppliers' industry health. Showing up to negotiation sessions armed with this wealth of information will demonstrate the level of sophistication and preparation of the joint negotiation team as well as reduce the risk of misinformation and abuse.

3) Modify your contractual frameworks. The latest changes in business dynamics also require a greater level of sophistication and structure in pricing contractual agreements. With aggressive commodity-cost increases and the speed of these increases, "business as usual" in long-term contractual arrangements might lead to serious financial pains. Long-term agreements and contracts with suppliers and with customers must be aligned. They need to include mechanisms for regular renegotiations of pricing conditions, exit clauses and emergency price increases. Most of all, the price-modification notice period needs to reflect the reality of the business world. Receiving price increases from suppliers with one or two weeks' notice when one's customers require sixty to ninety days' notice is a serious issue. Equally, suppliers should support the need for price increases with factual and detailed information that can be shared later on with customers as well. Finally, emergency renegotiation clauses with suppliers and customers are essential to engaging partners in sharing the burden of commodity-cost increases. The reality is that, when they accept them, price bullies are inflexible with contractual arrangements. In turn, pricers should modify their agreement frameworks to reflect the changing nature of relationships by including emergency and exit clauses.

4) Increase communication in the value chain. When dealing with price bullies, communication is key. Strong signals related to commodity-cost pressure, difficult supplier behaviors and changing industry dynamics can be communicated via traditional communication media (website, newsletter, conferences, press releases) as well as via social media (industry groups, LinkedIn groups, Twitter and blogs). This is essential to sharing critical information with customers and to signaling that price increases are on the horizon. The key here is to communicate consistently. Sharing industry knowledge and trends cannot only be done when commodity prices are rising. Customers will be suspicious that these are tactics to prepare for price increases. Systematic, sustainable and transparent communication educates customers and trade partners for the long term. They will become used to receiving statistics, trends and signals and therefore become more sophisticated during price negotiations.

5) Organize internally for faster decision making, and create a sense of urgency. The most critical variable in dealing with price bullies and commodity inflationary pressure is creating a sense of urgency and an organizational mobilization to mitigate it. A pricing task force must be put into place quickly to track the progress of implementing price increases one customer at a time. Price-tracking tools might be needed to communicate to upper management, who will be reassured that the organization is mobilized not only for cost reduction but also for price management. Upper management also needs to participate in strategic account visits to discuss price increases and to explain the phenomenon their firm faces upstream. Large strategic accounts also need to be "blitzed" at all levels and across all functions. Finally, while Six Sigma methodologies have traditionally been used for continuous-improvement initiatives in manufacturing and engineering, they can also be applied to the field of pricing to identify potential price rationalization, SKU price improvements, customer attractiveness measurement, and so forth. Ninety-day Green Belt joint projects supported by the pricing and Six Sigma teams might lead to quick gains in the bottom line.

6) Train all relevant internal agents on the changing dynamics. Sales-force members and marketers might not be aware of the cost-pressure situation, but they need to be fully informed to create that sense of urgency. Preparing the sales force with the right industry and economic facts can only help to give them the confidence to implement price increases with their customers. Information on raw-materials prices, industry trends and supplier's behaviors might be included in pricing manuals, FAQs and other training programs. Implementing price increases can lead to dramatic internal discussions and to emotional situations. It is critical to bring the conversation with the sales force and with marketers to a rational level by giving them the right and latest facts.

7) Raise confidence and boldness in managing customer pricing. Facing price bullies and the tremendous inflationary pressure on raw materials can be very disheartening for managers. The loss of control over costing matters and these raw materials represents a significant portion of the variable costs and might create frustration and a sense of "throwing in the towel." Facing price bullies requires courage and strength. It requires a different engagement of the pricing team in supporting price-management initiatives with customers. Because most firms will focus on cutting costs and improving efficiency, pricing teams need to boost organizational confidence with commercial teams. The rise of commodity prices and the shortage of critical raw materials is an industry problem that needs to be shared down the value chain. Increasing prices when the value chain is not used to it or when downstream industry dynamics are not favorable is a difficult proposition, one that requires boldness and confidence. The role of pricing professionals is essential for both.

8) Convince top management to get involved. Upper management needs to be involved in order to support the organization in facing price bullies and their impact on firm profitability. They mobilize troops to be involved in task forces and energize teams to fight on and to be courageous. They need to be involved in negotiations with suppliers and to reach out to their top management to demonstrate their engagement to push back. They need to become involved with strategic customer negotiations in order to assist key account managers and to deflect unnecessary tensions. Finally, as firm ambassadors, they represent the company in industry professional organizations and must use this position to share industry information with industry actors and partners.

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The content of this article is not the result of a strong methodological and theoretical search. It is the result of facing price bullies for the past five years. During this time, I have used my pricing teams as strategic weapons to fight back, to become more sophisticated and to mitigate the impact of very aggressive raw-materials cost increases. It is not a question of winning or losing the fight but rather a discussion of facing reality, having confidence in our business model and protecting the profitability of the business. Many firms turn to cost cutting and efficiency improvements. I conjecture that pricing teams can strongly assist in protecting the sustainability and profitability of the business. If you are working for a firm that has tremendous supply and pricing power, I encourage you to train your sales force on the difference between pricing with confidence and pricing with arrogance. While it might be acceptable to protect your pricing power and profitability, how your sales force manages pricing with customers is key to protecting your long-term customer relationships and your reputation in the market.