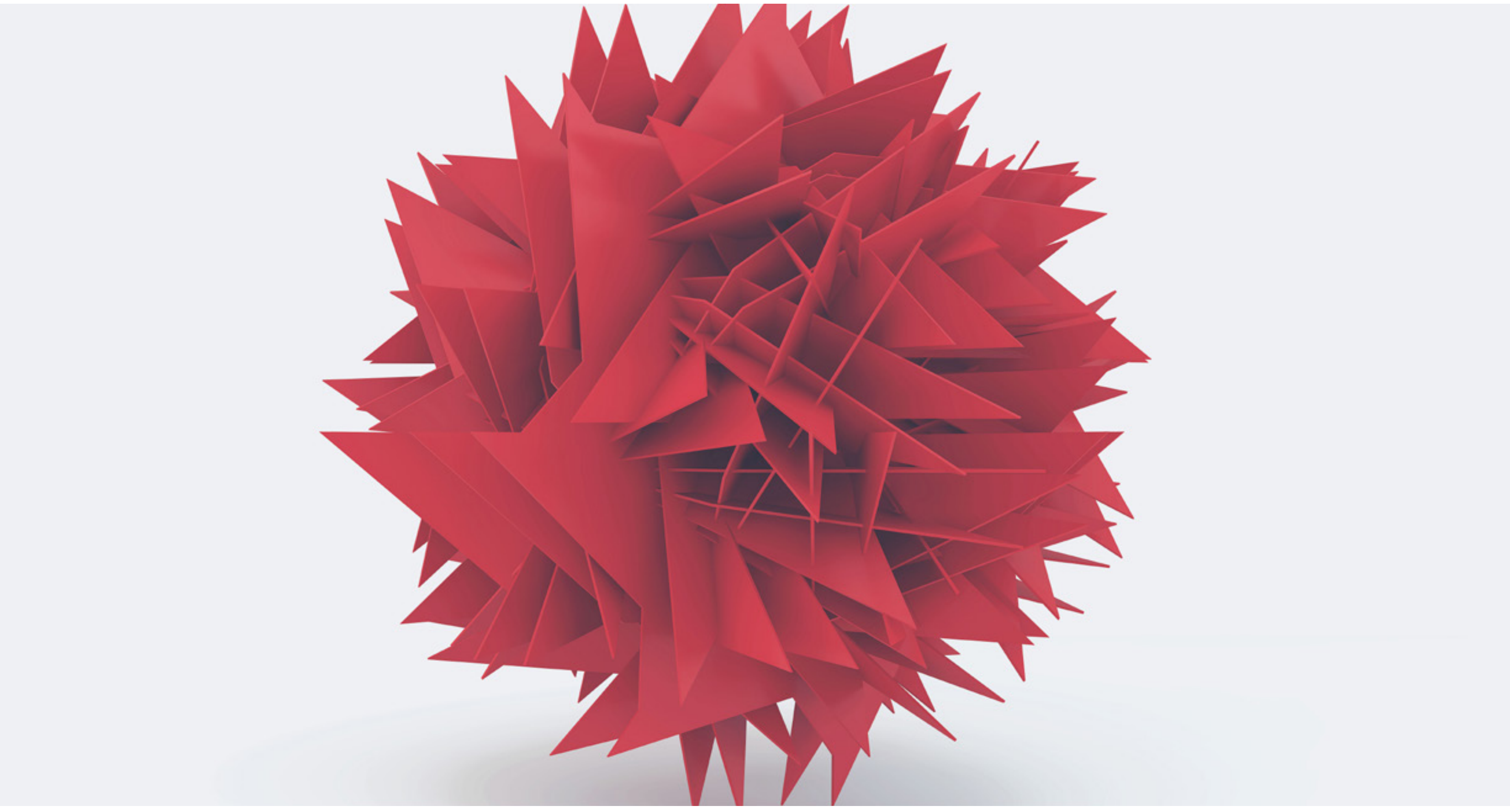
Marketing & Sales Practice

The commercial response to cost volatility: How to protect margins against inflation and tariffs

For companies that respond strategically, input-cost increases can be an opportunity to restructure pricing, upgrade sales skills, and improve account management.

by Alex Abdelnour, Christopher Angevine, and Jeremy Seeley



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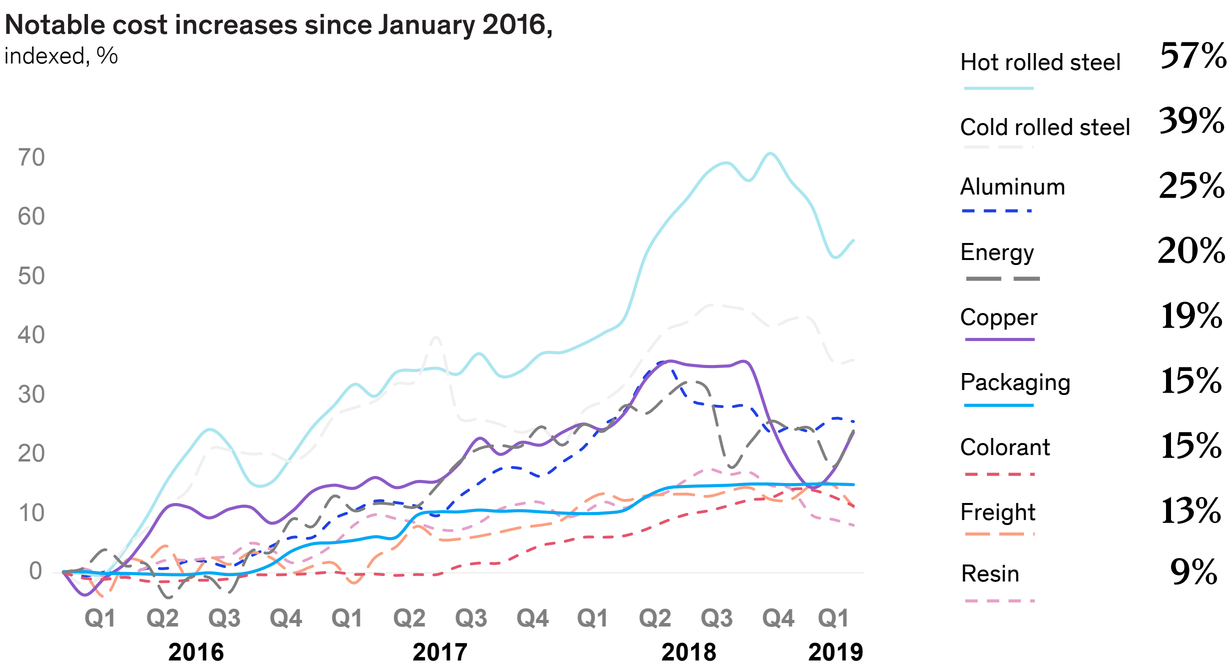
Most businesses are prepared to withstand a modest spike in input costs. But for manufacturers and distributors, these are not normal times. After years of deflation, prices of raw materials have risen sharply since 2016. Over the past three years, businesses reliant on metals have seen many costs surge by well over 25 percent. Industries where resin and colorant are key inputs also have seen costs rise by double digits. Likewise, energy and freight, inputs that affect virtually all manufacturers and distributors, jumped significantly (exhibit).

The tariffs on steel and aluminum that were recently imposed by the US government, combined with ongoing trade wars, have added to these cost pressures. Despite the volatility, many commercial leaders have hesitated to take the logical next step: raising prices. Because costs can be cyclical, some hope that if they simply wait, costs will return to previous levels and they can avoid ever needing to address the issue. As a result, many delay exploring commercial measures until the company sees no other option available. Ill-prepared sales organizations can botch this delicate process, at great expense to both the top and bottom lines.

Businesses cannot afford to wait for a downturn to reset the tables. In inflationary environments, such as the one we are in now, some companies hit by soaring input costs have experienced margin declines of well over 10 percent. A North American packaging company, for instance, saw its raw materials costs rise 20 percent over a 12-month period. Desperate to stop the bleeding, they pushed through a sweeping price increase, but the broad-brush response and failure to

Exhibit

Raw-material prices have risen sharply since 2016.



Source: U.S. Bureau of Labor Statistics, Producer Price Indices adequately prepare the sales force caused the initiative to backfire. Within three months, the company had lost double-digit market share, and the leadership team limped away from the attempted increase with margins worse than ever.

Pricing changes don't have to be this painful. With the well-planned, strongly executed approach that we will describe, manufacturers and distributors can effectively pass on input-driven cost increases while creating healthier pricing practices and stronger customer relationships. However, to carry this out, most decision makers need to first challenge old ways of thinking in their organization to enable effective action.

Overcome traditional pitfalls with new mind-sets

Tariffs and their impact on trade have recently put commodity costs in the spotlight, but raw-materials costs have been rising for years. So why has it taken this long for companies to adjust their prices? In our experience, executives and their commercial teams tend to be hindered by a common set of challenges that contribute to or arise from a mind- set of reluctance to think strategically about price increases.

Many businesses don't track raw-material costs on a granular basis. Instead, they aggregate them under broad product or operational expense headers that mask underlying volatility. One manufacturer in the consumer-goods space learned after the fact that its core component costs had risen 12 percent over 14 months. The company took more than a year to notice the increase because it bundled input costs with other manufacturing expenses. Only when management explored the potential impact of proposed tariffs did the company realize the extent to which it had already been absorbing significant increases in input costs. To stem further margin erosion, the business would have to raise prices by an average of 8 percent, a much greater adjustment than customers were used to. Had the commercial team known earlier, it could have phased in the increases more gradually.

Sales structures often encourage a volume focus. In the aftermath of the global recession, many manufacturers and distributers adopted a "volume is king" mind-set to rebuild their base and capture share. Sales reps were rewarded for growing volumes, and incentive structures reflected those priorities, with product margin and customer value often seen as ancillary considerations. Many sales reps, remembering the lean recessionary period, were only too eager to capture incremental sales to protect their jobs and the business, and they faced little pressure to enforce pricing discipline. Even now at many companies, a salesperson's upside for securing a 1 percent price increase on a key account can pale in comparison to the downside of losing that customer over a pricing disagreement; indeed, the loss could ruin the salesperson's entire year.

Fear of alienating customers can lead to foot dragging. The perception among many sales teams is that customers will rebel if prices are raised. In reality, our research shows this isn't true. Prices can be easy for customers to point to in negotiations, but rarely are they the make-or-break factor in determining whether to continue the relationship. Nonetheless, sales teams are often loath to introduce issues they fear could delay or kill a deal, and pricing remains high on the list of contentious issues to avoid—even when contract provisions allow for pricing changes. At one global industrial company, commercial teams were reluctant to enforce index-driven price increases that had already been agreed upon and were embedded in existing contracts, for fear of potential customer pushback. With no formal process for tracking and enforcing these indexation clauses, the commercial team was giving away hard-won value.

Companies often fail to consider how long it will take for them to benefit from raising prices in response to cost inflation. Although manufacturers feel the negative effects of raw-material cost increases almost immediately (since the price they pay for these inputs are typically tied to indices), it often takes sustained increases over several months for the organization to even consider action. Once it does, changes can take months or even quarters to have a meaningful margin benefit. The impact of a price increase is further delayed for businesses that must provide a notification period to their customers before it takes effect. During this window, customers often front-load purchases under the old pricing scheme to avoid the upcoming price adjustments in the short term. In the meantime, if input costs continue to rise, the announced increase may not fully offset worsening margin erosion. Conversely, if raw-material indices begin to decline, customers may come banging on the door to demand new price reductions, even if the manufacturers have already absorbed the margin hit.

Sellers are unprepared for negotiating with today's well-informed buyers. Backed by ever more sophisticated tools and capabilities in recent years, customers and their procurement organizations have become bolder and more adept at negotiations. Buyers are increasingly well trained on how to rebut price increases and clean-sheet supplier costs. They often come into discussions having tested several alternatives and can use their analyses to threaten a shift of volume. B2B organizations have generally not kept pace with these investments in procurement capabilities, leaving sales reps feeling ill equipped to hold productive conversations around pricing. All of these perceived disadvantages can exacerbate a mind-set that views price increases as too risky to contemplate seriously.

As a consequence, when companies do act, it's frequently when bottom-line pressures have reached a breaking point, at which time they're forced to rush through hikes with inadequate preparation and a skeptical sales force. This approach often leads to disappointing margin impact, share loss, and a management team that is exasperated in the face of dwindling options. But strategic price increases in response to input-cost fluctuations don't have to work this way. Companies that focus on strengthening their commercial strategies can deliver immediate bottom-line results with little or no impact on volume.

The time for action is now

Companies can use the current volatile commodity-cost climate as an opportunity to establish a thoughtful, well-rounded commercial program that can serve them better now and in the years to come. In our experience, companies can successfully pass through input-driven cost increases and defend them, even when indices eventually dip, by following four practices: building a fact base, segmenting customers, training the sales force to negotiate, and managing performance.

Build the fact base to instill conviction. Given the strategic importance of the pricing program and the financial imperative that it succeed, the leadership team must set the mandate, explain the goals of the initiative, and show that the company is serious about holding leaders and their teams accountable. When commercial teams see the tens—or sometimes hundreds—of millions of dollars in cost increases that the company is absorbing, they are more likely to understand and buy into the need for a new pricing approach. In building the fact base, management needs to provide a granular cost breakdown to show how inflation in raw-materials costs affects the profitability of key products. They also need to detail the margin forecast over the next six to 12 months, so that commercial leaders can align their price-increase strategy appropriately. Laying out the case for change with clear numbers and concrete analyses removes abstraction—especially for businesses that have not tracked input costs on an individual basis before—and gives business leaders and sales teams the logic and language they need to communicate the business rationale credibly to customers.

Tailor commercial strategies by customer and segment. Segmentation analysis can help the business prioritize where the need for customer pricing changes is high and the risk of attrition is low. Although simple spreadsheets and qualitative discussions with the sales team can sometimes suffice, many companies are now using big data and advanced analytics to identify where they should be most aggressive while minimizing risk. For example, one manufacturing company analyzed hundreds of thousands of transactions to see which customer ordering patterns and product characteristics were most price sensitive. The company then created a model that allowed them to quickly identify and target granular price increases across thousands of their products. Although the sales team pushed back out of fear that customers would be outraged, the increases identified by the model received hardly a complaint from any customer after they were implemented.

Whatever segmentation approach the company uses, the goal is to size the opportunity and determine, within reasonable limits, which customers they can and can't afford to lose and where they need to walk away if they are unable to achieve the targeted increase. With that information, specific sales targets should be assigned, with all sales managers and, ideally, all reps receiving their own quotas. Holding managers and sales reps accountable forces them to engage in thoughtful, proactive conversations with their customers and avoids the potential for finger-pointing or delays that can come when companies assign group-level targets.

This exercise can serve as an opportunity for sales teams to have strategic conversations about every key account. While pricing is the most direct way to address cost increases, alternative concessions, such as long-term contracts and volume guarantees, as well as more favorable terms and "take or pay," can sometimes be used to help companies close the gap in cases where customer resistance is high or other factors are at stake, such as a key strategic relationship. In such cases, companies need to ensure that concessions provide a commensurate level of value and don't simply perpetuate below-target pricing in a different form.

Boost the sales force's negotiating capabilities. To give sales teams the confidence they need to hold effective conversations with their customers, manufacturers and distributors need to help change mind-sets and provide appropriate training. Commercial leaders should anticipate the range of questions that buyers are likely to have, so reps can feel comfortable going into discussions with procurement organizations. Sales teams should also have the opportunity to role-play conversations and practice different customer scenarios. For example, when executives at one industrial company announced upcoming price increases, they anticipated the concerns that commercial teams might have. In a day-long workshop, company leaders laid out the proposed pricing strategy and distributed comprehensive sales guides that included talking points and answers to likely questions. Sales reps later simulated client discussions and practiced responding to different potential issues and concerns. The walk-throughs put the pricing conversations into context (sales teams learned that for every 1 percent drop in price for a given product, the business would need to raise volumes by 10 percent) and gave sales teams greater confidence in their ability to engage substantively and successfully.

A consumer-packaged-goods manufacturer took a similar approach. To prepare for a sweeping pricing restructuring that affected multiple products, the company created a systematic training program for its sales force. Using extensive role playing and scenario modeling, sellers were able to parlay stronger discussion and mediation skills into a successful company-wide repricing effort that helped the company recover 80 percent of the cost increases it had incurred over the prior two years. Despite the sales teams' initial concerns, reps were able to take the increases to customers without the company suffering any volume loss 12 months after implementing it.

Establish clear escalation processes and performance management. Companies need to determine how customer pushback will be handled, what information and approval steps will be required to make exceptions to a planned increase, and how quickly information and answers will be provided to the decision maker in the account team. Defining processes up front to handle exception requests can expedite pricing changes and help companies see results faster. Those processes should include guidance on how to manage situations when sales teams and the customer cannot come to a mutually satisfactory arrangement—including when to walk away from accounts if minimum targets prove unattainable.

Regular performance reviews are essential. Management must be able to quickly and easily monitor which customers have been contacted, which are at risk, what price levels have been approved, and if the business is on track to achieve its target. Dashboards and ongoing reporting can be especially helpful for businesses that have long sales cycles. Some businesses may choose to go even further. To support its sales teams, for instance, an industrial manufacturer set up a dedicated pricing "war room" to provide rapid issue resolution, sales guidance, and coaching.

Ongoing performance monitoring helped the company isolate where it was doing well and where further support was needed. Within six months, the company had met its new pricing goal with minimal pushback from customers.

The road to recovery

Companies must ensure they don't become complacent after initial pricing adjustments have been made. Inflation is cyclical, but the pressures won't go away. Should input costs decline—as some indices are beginning to suggest—savvy customers will demand lower pricing. Businesses that fail to implement thoughtful pricing programs and prepare their sales teams effectively will find themselves losing margin on both sides of the index curve. To avoid negative surprises, manufacturers and distributors need to look at longer-term changes that will allow them to track component costs on a granular level, review customer and product margins on an ongoing basis, and improve their overall pricing strategy. The packaging company mentioned at the beginning of this article took that longer-term view.

After their first, hastily conceived attempt to pass through pricing failed, they were determined to address the cost gap more thoughtfully. Applying the four practices described here not only helped offset the original input-cost increases, but also allowed them to address an additional 30 percent spike in input costs that had occurred over the intervening period. The business built on these improvements by developing a holistic, end-to-end pricing approach, with new processes, better-aligned sales incentives, and ongoing training and monitoring. The changes allowed the packaging company to push through two subsequent price increases to better reflect its market and operating conditions, all while holding market share steady—changes that increased its earnings before interest, taxes, depreciation, and amortization (EBITDA) by 40 percent.

The silver lining in an otherwise painful period of raw-materials cost inflation is the impetus it provides companies to get serious about pricing. In the short term, maintaining strong profitability demands it. Yet the long-term benefits of revitalizing pricing practices and increasing rigor across the commercial organization can improve the quality of account planning and empower sales teams to become more effective negotiators.

Alex Abdelnour and **Christopher Angevine** are associate partners in McKinsey's Atlanta office, and **Jeremy Seeley** is a consultant.

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