DECEMBER 2010
McKinsey Quarterly

CONSUMER PACKAGED GOODS PRACTICE

The commodity crunch in consumer packaged goods

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Packaged-goods companies have been socked by rising commodity prices. Executives in other industries can learn from their experience.

For almost 40 years, the US consumer goods sector was among the safest of havens for investors. It rewarded them with annual returns well above the market average—second only to those of the energy sector—and in a bumper period from 1985 to 2002 outperformed the S&P 500 index by almost 20 percent annually. Since then, the sector has barely outpaced the index, despite persistent attempts by companies to find winning strategies. While inadequate cost controls and a failure to deliver significant value from a wave of mergers and acquisitions haven't helped, one factor is the dominant culprit for the current malaise: the industry's response to changing commodity prices.

Losing control

From 1985 to 2002, consumer-packaged-goods companies regularly passed on to consumers increases in the price of inputs (including aluminum, cereals, oil, and paper) while holding the line on prices when raw-material costs declined. In this way, these companies maintained profit margins when input costs rose and enjoyed expanding margins when they fell. In fact, we estimate that between 1996 and 2002, the strategy of passing on commodity price increases was responsible for two-thirds of net margin expansion in the sector, or roughly $10 billion in value.

The tables turned in 2002. From that year until 2007, industry players passed on price increases of just 15 percent as cumulative commodity costs grew by 40 percent (exhibit). As a result, we estimate that the failure to pass on commodity price increases was responsible, during that period, for 75 percent of the sector's margin contraction, which cost about $70 billion.[1]

A return to the days of passing commodity price increases on to consumers won't come easily. The structural shifts that dampened the industry's pricing power remain: consumers are increasingly value conscious, and large discounters still dominate the retail landscape.

These retailers, using detailed analysis of data available from their point-of-sales systems and shopper research, today have a sophisticated understanding of the prices they want and of their ability to demand those prices.

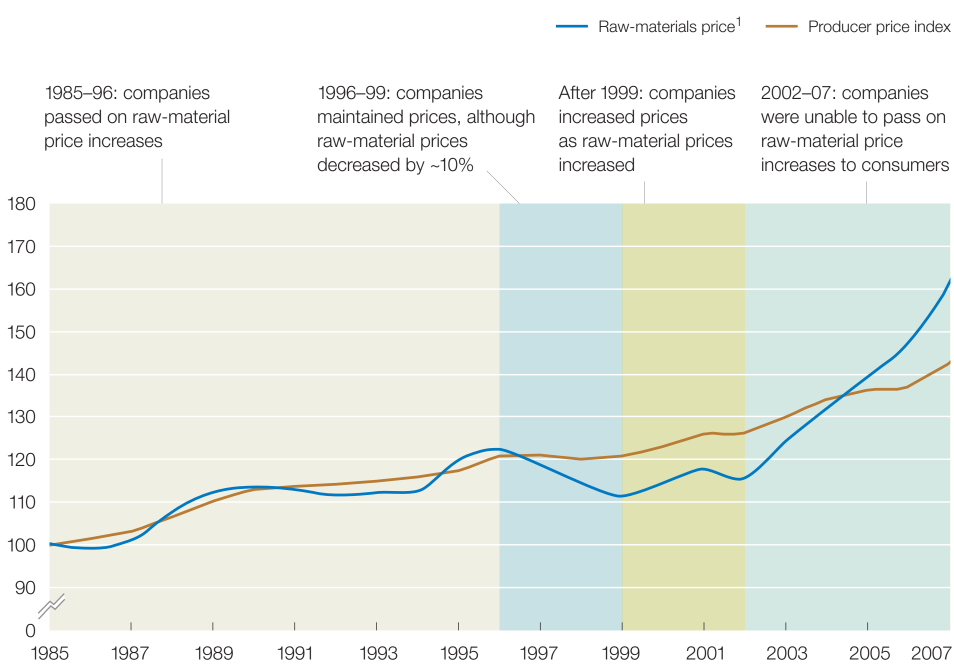
The net result is that the industry continues to face downward pressure on prices. Some of the solutions aren't complicated, but they are extremely difficult to implement and probably hold lessons for companies—in sectors ranging from consumer electronics to industrial chemicals to medical devices—currently facing an unfavorable and volatile environment for raw-material costs and pricing.

Regaining the initiative

Many economists and financial-market forecasters believe that continued price volatility amid a general rise in commodity prices is likely as the world economy recovers, so companies across many sectors may easily destroy

Since 2002, industry players in packaged goods have been less able to pass on input price increases to consumers.

Consumer-packaged-goods industry,
index: product price index and raw-material price in 1985 = 100



[1] Average weighted by sector-specific indexes for raw-material inputs—eg, aluminum, plastics, and raw sugarcane as inputs for soft drinks—and by weight of sector in overall consumer-packaged-goods market.

Source: Standard & Poor's Compustat; US Bureau of Labor Statistics; McKinsey analysis value in the years ahead. Suppose that in consumer packaged goods, commodity prices increase by about 20 percent during the next five years, and companies hold prices constant in a quest to maintain market share. In that case, up to 4.5 percentage points of margin could be lost—or about 33 percent of current earnings before interest, taxes, depreciation, and amortization (EBITDA). Avoiding this fate will require iron-willed pricing resolve, which may be richly rewarded if the environment turns slightly more favorable. If commodity prices fall by 5 percent in the next five years but companies hold product prices steady, for example, we estimate that industry margins will increase by around 1 percentage point, and EBITDA will jump by 8 percent, reversing the current trend.

Conceiving, developing, and marketing category-changing products that consumers crave has long been the lifeblood of leading consumer-packaged-goods companies—and, for that matter, a priority for companies in a great many industries. An important question for all is how to capitalize on the opportunity that such innovations present to reset prices upward across relevant product categories, as P&G managed to do when the company introduced its Swiffer cleaning product.[2] Capitalizing on innovations isn't easy. But in an industry like packaged goods, it's probably critical for companies that aim for a financially sustainable innovation pipeline, for consumers who seek a steady stream of new products that satisfy new needs, and for retailers that hope to benefit from greater demand for new and existing products.

[1] Our analysis excludes 2008 and 2009, when the global recession and dramatic market fluctuations skewed the data.
[2] See Walter L. Baker, Michael V. Marn, and Craig C. Zawada, "Do you have a long-term pricing strategy?" mckinseyquarterly.com, October 2010.

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