

The ups and downs of pricing

How to improve commodity pricing in good times and bad.

When you're being chased by a bear, you don't have to outrun the bear. You just have to outrun your buddy.

— Hiker's proverb



Over the past four years, commodity producers have had it pretty easy when it comes to pricing. Economic growth — including growth in China and other emerging markets — meant that demand generally exceeded supply, steadily driving up most commodity prices. In addition, sharply rising costs for inputs such as energy and feedstocks had the pleasant side effect of conditioning customers to think of price spikes as a normal part of doing business.

Unfortunately, it looks like the party may be coming to an end. Declining growth threatens to reduce demand for many commodities, which could lead to excess capacity. This problem is likely to be made worse in that many industries are now seeing their capacity ratchet up as construction projects launched at the height of the boom start to come on line. Both of these forces will tend to drive commodity prices down.

At the same time, customers are getting smarter. Many are using strategic sourcing and other advanced techniques to improve their buying power and secure much better prices. To protect their margins, commodity producers need tools and techniques that are at least as sophisticated as what their customers are using.

In general, there isn't much a commodity producer can do to change overall market price levels. However, there are a number of specific actions you can consider taking to stay at the high end of the range and help cushion your landing — and to improve profits over the entire price cycle.

Choices, choices

In recent years, the big question for commodity producers was how to get prices and margins up as high and fast as possible. Now, the question is how to preserve those margins for as long as you can.

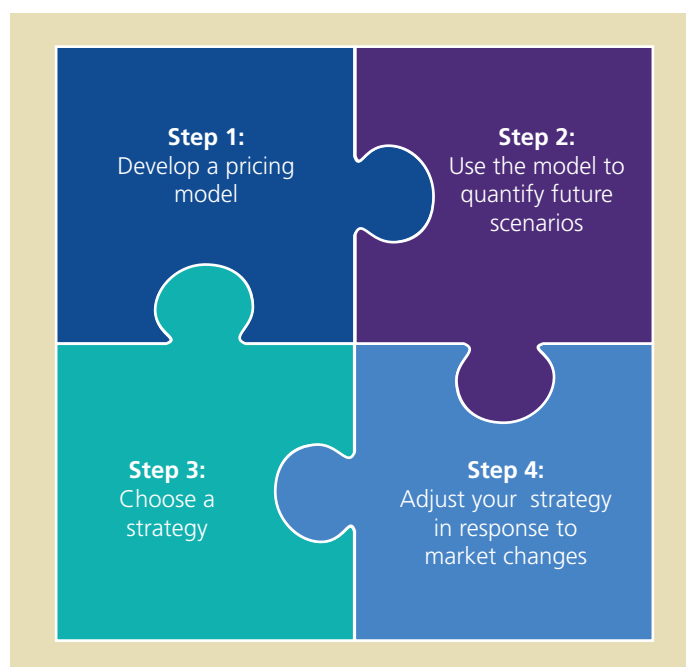
Many commodity producers resign themselves to simply follow the market, dropping their prices in line with general price levels. We think you can do better.

One obvious strategy in the face of softening prices is to lock in your gains by shifting customers onto longer-term contracts with price collars. Of course, that's easier said than done. Most customers recognize that commodity prices are likely to fall and will be reluctant to make a long-term commitment. As is often the case in business, "the devil is in the details."

We believe the key to improving prices and profits in a declining market is to stay a step ahead of your customers and competitors. How? By understanding the underlying factors that drive market prices up and down, and by developing in-depth insight into how prices are likely to change in the future. This insight can help you set the right prices early on and make your moves at the right time. It can also help you quickly identify and respond to subtle changes in the marketplace — allowing you to outmaneuver the competition and improve the structure and mix of your prices with customers.

A four-step approach to better pricing

Rather than simply following the market price roller coaster, a disciplined approach to setting price levels and price structures can help a company achieve much better prices across the full cycle. Consider the following four-step approach to help you improve prices and margins in good times and in bad.



Step 1: Develop a pricing model

A comprehensive econometric model that links price fluctuations to specific cost and margin drivers can provide a mechanism to help develop effective pricing strategies. Such models are very good at modeling price movements in markets that exhibit typical commodity behavior. (Note: in markets where price levels are significantly affected by non-market forces, or where there is significant specialty or value price activity, these models would require significant revision.)

The models are built around the fundamental logic of commodity pricing by which producers set product prices on a cost-plus basis to try and achieve returns that meet or exceed their cost of capital. Also, the models typically assume that — absent external constraints — if price levels rise to a point where returns exceed the required minimum ROI for a sustained period, new investment will be attracted and price premiums will be competed away until it is no longer attractive to keep investing. Further, if costs increase and margins decline, producers will attempt to pass through the cost increases to the full extent market competition will allow.

Based on this logic, models containing two basic sections can be constructed. The first section is the cost module, which considers all of the costs to produce and deliver the product. An effective cost module looks at every cost driver — including production and distribution costs for all product/service inputs (e.g., diesel fuel, electricity, total depreciation) — and traces each cost back to its source to identify and quantify the major cost drivers.

The second section is the *margin* module, which estimates the profit margin that the competitive environment will permit. An effective margin module considers all variables that drive margins (e.g., supply and demand, industry capacity, new plant construction) and shows how those variables have affected margins over an extended period of time (ideally, at least a full business cycle). Understanding the correlation between margins and these key variables — as well as the associated lag or lead time — can help you predict where prices are headed and when the move will occur.

Although the cost module is generally straightforward to build, the margin module presents a number of challenging questions.

- How does the industry really compete?
- How does it react to internal rivalry and external stimuli?
- How do you model the market's future behavior?

The good news is that history usually provides strong clues about the future. Barring major structural changes (e.g., radical consolidation, government regulation, major technology shifts), commodity industries tend to exhibit consistent behavior over very long periods of time. Because most industries evolve rather slowly — and because disruptive occurrences are relatively easy to spot — it is possible to iteratively develop models that are useful for scenario modeling.

Using this technique on a recent project, we helped a client develop a model that was able to predict 93% of the market price changes over the preceding 10 years — a level of accuracy that gave management the confidence to take decisive action when they applied the model to anticipated market conditions in a key European country.

Step 2: Use the model to quantify future scenarios

A pricing model helps convert broad assumptions about the future into objective scenarios that business leaders can use to make decisions. In some cases, this conversion is pretty straightforward. For example, it is relatively easy to predict and quantify how manufacturing plants that are currently under construction will affect industry capacity over the next two years. However, other factors — such as energy costs, new competitors, and end-market demand — are more difficult to nail down and typically require a broader range of scenarios.

In general, a pricing analysis should focus on the scenarios that are most likely to occur. However, it should also include a sensitivity analysis that looks at the variability and risk associated with each scenario.

It's important to note that this technique does not rely on predicting the future. The key is to continually update the scenario models as external conditions change so you can always stay a step ahead of your customers and competitors. By understanding the future sooner and better than they do, you can make smarter, faster decisions and beat them to the punch.

Step 3: Choose a strategy

The scenario analysis provides a backdrop for choosing your business strategy. Will you focus on increasing market share or improving near-term profits? Increase or decrease capacity? Outsource production and re-purpose your plants, or find new markets and reach out to new customers?

Once the overall business strategy has been established, you can choose a business and pricing strategy that fits. Create a matrix showing the strategic options for each major scenario, then outline the major investments required, estimate the benefits, and identify the actions necessary to execute the strategy within the given timeframe.

This strategic approach to pricing can produce some surprising insights. For example, one of our clients found that it could improve profits in the face of a slowdown by raising prices, rather than lowering them. This gave customers more incentive to sign a long term contract, enabling the company to lock in favorable margins before the market started to slide.

Step 4: Adjust your strategy in response to market changes

Unlike a diamond, a pricing strategy — like any strategy — does not last forever. It needs to be adjusted as conditions change. The strategy matrix created earlier is especially helpful in this regard because it shows effective strategies for different scenarios and can help you recognize market shifts and take corrective action before your customers and competitors even realize the market is changing.

Conclusion

As a commodity producer, there isn't much you can do to stop overall market prices from declining. However, there are some things you can do to stay at the high end of the range and improve or sustain your profits for as long as possible. The four-step approach presented here is designed to help you understand what drives prices up and down, and how prices are likely to change in the future. These types of insights could help you stay one step ahead of your customers and competitors. In a changing market, that's the key to profitable results.

Case study: Locking in the gains

Any discussion of a "rational" global steel industry has to take A global industrial manufacturing company had benefited from increased pricing and global economic expansion and was at a high point in the economic cycle. However, it faced a variety of looming challenges, including a slowdown in housing and associated products, falling automobile sales, declining industrial production, and volatile feedstock and gasoline costs. These challenges, coupled with growing customer resistance to further price hikes and a competitor's announcement of increased manufacturing capacity, drove the company to fundamentally change the way it approached the market.

Following the steps outlined in this article:

- 1) A pricing model was built to predict future profitability based on internal and market conditions. The model was designed around the principle of cost-plus pricing (major production and distribution costs such as electricity and diesel costs were included). Anticipated capacity and demand growth were factored in so the company could observe changes to the projected capacity balance.
- 2) The regression model was used to quantify various scenarios, resulting in a forecast that direct profit would fall by over four percentage points.
- 3) The scenario analysis was used to select a pricing strategy. The chosen strategy was to raise prices, which seemed counter-intuitive in the face of a downturn; however, the analysis showed that this would help the company lock customers into contracts for a three year period that would extend beyond the expected capacity increases, and also would result in higher negotiated rates because any discounts would be taken starting from a higher base price.

Although it is too soon to determine the results, the company is confident in its strategy and has a process in place to make adjustments in response to market changes.

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