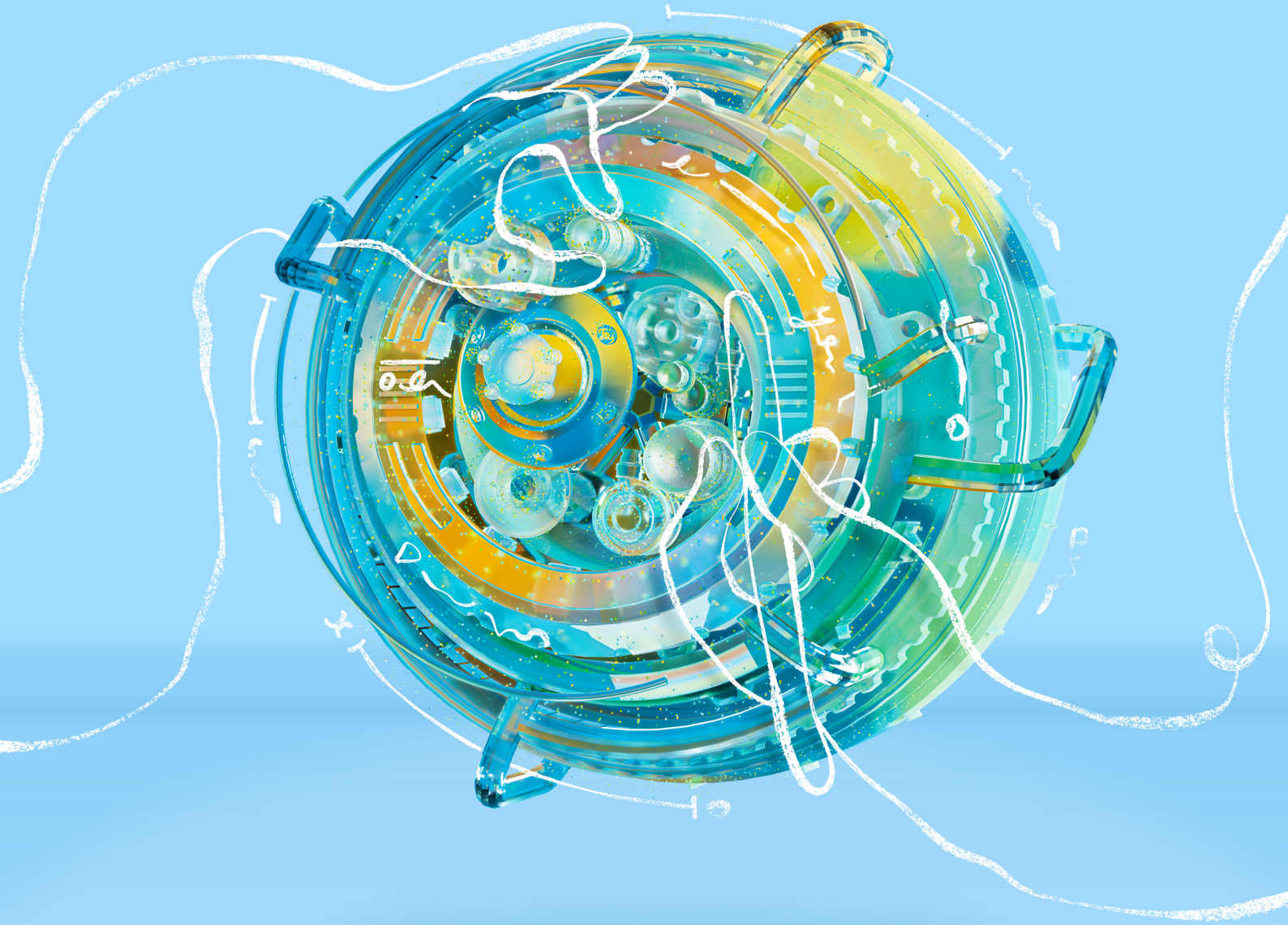


**Deloitte.**  
Digital



Making hay  
with inflation

“With building inflationary pressures, an economy recovering from a pandemic, and supply chains disrupted, effective pricing is the need of the hour.”

U.S. companies are being confronted with inflationary cost pressures from many sides. The cost of raw materials - including copper, steel, lumber, plastics, and many agricultural commodities are on the rise, while investment in plant capacity has not kept pace with demand, according to a Deloitte analysis. At the same time, wage rates and shipping costs have soared, and COVID-related supply disruptions are on the rise. While some increases like shipping costs may be temporary, others like wage increases are likely permanent. All of these cost changes are real and contribute to both near-term and long-term margin erosion. At the same time major economies around the world have increased the money supply to unprecedented levels, leading to low capital costs and higher consumer savings rates; in the US, personal savings rate quadrupled during the pandemic.

Taken together, these factors are creating an inflationary environment, one that has not been seen in over two decades. While CMOs and other C-suite leaders recognize the need to raise prices to protect margins, they also worry about volume losses and customer retention. Done well, now is the time to adjust prices to not only address cost pressures, but also harness new margin opportunities.

Unfortunately, many firms find it easier to pass on the rising cost of raw materials via broad-brush price increases—a strategy that tends to dilute the efficacy of new prices. Additionally, it is important to understand that not all inflation is created equal and any pricing action requires a careful examination of the underlying inflation trend.

A recent WSJ report<sup>1</sup> explained that while inflation is being driven by items for which prices have increased for the long run, there are also items for which prices fell sharply during the pandemic and are now returning to their past levels, such as air travel and hotel prices.

In other instances, prices have temporarily risen above their pre-pandemic levels due to supply constraints and may come down, such as new and used cars.

And, on the other end of the spectrum, there are also items where price increases have slowed (such as real estate rent) rather than accelerated because of COVID-19. By reassessing past business decisions and updating pricing with a targeted approach, organizations can take advantage of the current environment to clean-up mistakes of the past, and drive long-term growth.

Our experiences indicate that a majority of companies realize the need for price increases in the current environment, yet they run into challenges when acting upon them. Common pitfalls include:

- Using cost inflation as THE benchmark: Companies often anchor on their largest raw material cost increases to determine the size of price increase, and do not consider whether this input will govern long-term profitability.
- Passing broad-brush price increase: Typically, price increases are made in a broad-brush manner — same/similar across all products and customers; the reality is that in most cases some products are much more able to sustain higher prices than others.
- Failing to communicate appropriately: The mere idea of price increase creates trepidation and push-back from Sales; yet when positioned properly, customers often accept— and even expect!— price increases.
- Losing momentum over time: Limited effort on tracking and measurement leads to leakage through discounts and promotions over time.

# Navigating the storm with pricing actions

So, what separates success from failure? Deloitte has a structured way of managing input cost inflation. Our experience has been shaped by 100s of projects in a multitude of industries, and while the specific tactics across industries may differ, these guiding principles do not. The managers who are successful at raising prices with positive results take these four specific steps:

## **ONE: Correct the 'less-than-optimal' commercial decisions made in the past**

For years, it has been a buyers' market. All of us, in sales roles, have traded profitability to meet sales goals in the past. The present-day situation calls for taking a step back and re-evaluating this trade-off. Take this as an opportunity to clean-up your transactions including:

- Low profitability transactions
- Unwarranted volume discounts
- Frequent small orders
- Unearned volume discounts
- Unproductive rebates

- Free packaging
- Expedited shipping
- Unfavorable index pricing

## **TWO: Be structured and targeted in your price increases**

Anchoring on cost inflation of largest raw materials to pass broad-brush price increases is usually the norm. However, in our experiences, it has limited efficacy. Typically, we see companies only realizing ~40—60% of their intended price increases in the first year due to the broad—brush approach, which gets further diluted over time through discounting and promotional activities.

Instead, an effective strategy leverages the differences in product, channel,

and customers to drive targeted price increases. Clearly understand your product's value proposition vis-à-vis competitors' — not every product is the same; and understand customer buying behavior and their price sensitivity—not every customer is created equal. Good pricing strategy is anchored in value, price sensitivity and costs-to-serve (in addition to raw material cost inflation). Price increase strategies that are built on a granular and well segmented understanding of product and customer result in higher actual price realization and customer retention along with even supporting a targeted volume growth. The considerations when building strategy need to span from product through channel to customer<sup>2</sup>.

- **Product** attributes to consider include level of commoditized vs. differentiation, intensity of competition, and expectations of growth in addition to underlying bill of materials and cost pressures.
- **Channel** attributes should consider the size, type of channel, and value you provide to the channel vs. what the channel provides to you.
- **Customer** attributes such as buying behavior are additional considerations to price sensitivity and costs-to-serve.

**THREE: Communicate effectively, both internally and externally**

Given the range of potential market reactions, it's no wonder that sales teams tend to treat price increases with trepidation. By nature, humans tend to feel more strongly about losses than they do about gains—and businesses worry that by raising prices they will lose customers. And there are many prominent examples of price increases gone wrong.

Customers may not want to receive price increases, but in the current environment, they expect to receive them. And price increases are only effective when executed by a sales team that understands, accepts the reason, internalizes the change, and is equipped with the right information. Here are a few things to keep in mind:

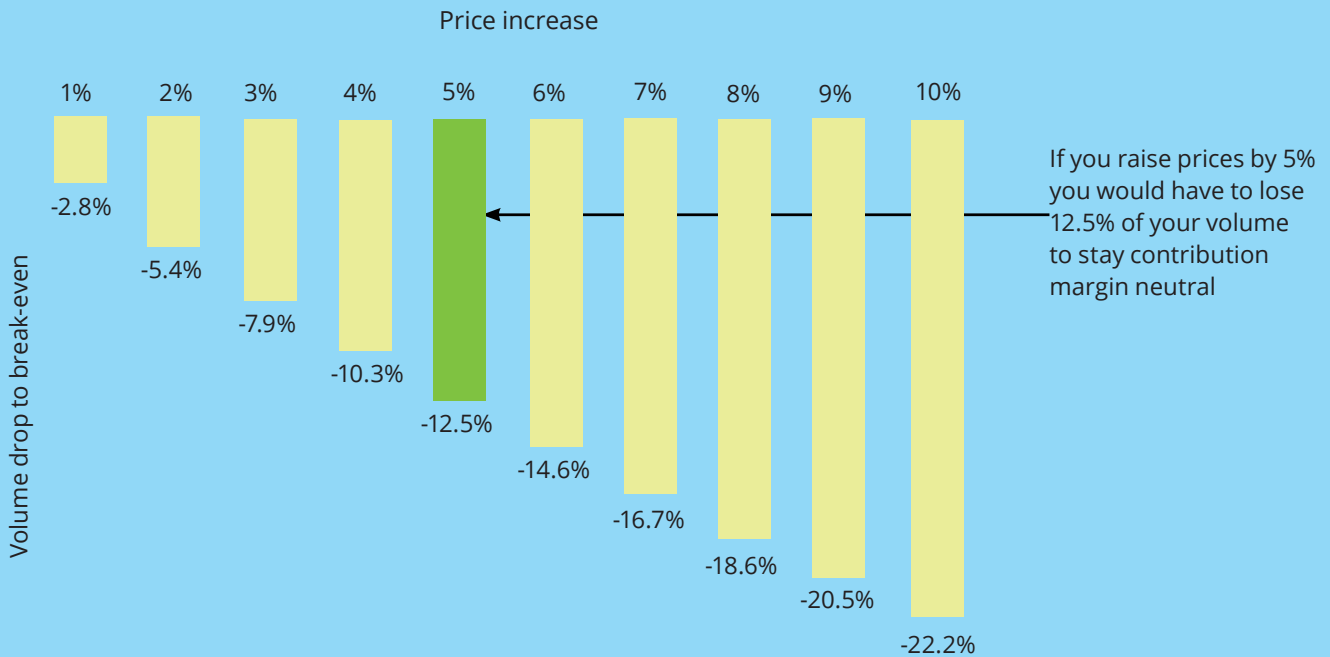
- **Lead the change with effective communication:** Ensure that you anchor the conversation in the value that you provide to the customer, and complement communication around price increase with the right macro-economic and industry specific inflationary insights.
- **Arm your sales teams with the right data and analytics:** Provide analytics and insights on customers' profitability, cost inflation, and price benchmarks to drive data-backed decisioning.
- **Drive sales teams' behavior change through social proofing:** Behavioral economics shows that the concept of fairness weighs heavily both on customers and on the sales force—people take cues from their peers on how to behave. Share with sales teams what other similar customers in same/similar region are paying for similar products.

- **Dynamic customer centric thinking:** Design and customize communication based on behavioral insights of different customer segments, gathered from available data and inputs from existing sales relationship. One customer may not be as sensitive to price change as long as value is communicated effectively. Another customer, however, may require more detailed discussions on the scope of price change and its impact on their portfolio of purchases. Distributors/resellers may also look for manufacturer support for end customer communication.



**It's not as scary as it seems!**

**Imagine, for an average 35% GM business, how much volume do you think you would you have to lose to stay contribution margin neutral when passing x% price increase?**



Here's a simple exercise that you can do with any sales representatives today: Ask them, how much volume do they think they are going to lose if they were to raise prices by 5%?

For an average 35% gross margin business you would have to lose 12.5% volume to stay contribution margin neutral.

Do they really think they are going to lose over 12% volume with 5% price increase?

And if demand is really that elastic, then ask them, where are the opportunities to go and win more volume and gain overall contribution margin through targeted price decreases?

**FOUR: Re-think your commercial positioning**

The COVID-19 pandemic has created deep and far-reaching impact on what customers value and how they live their lives. Now is the time to understand how customer needs have shifted (some permanently) and use all of the weapons that you have in your commercial strategy arsenal to tackle inflationary pressures. This is the time for you to not just think about pricing but use this as an opportunity to re-think your brand, positioning, and packaging strategy and tactics in the market. Also, consider whether cost increases can be passed through using non-price mechanisms, for e.g.,

- Offering lower-cost brand to price-sensitive customers can help cover both ends of the spectrum of customer budgets.
  - Incentivizing low-cost behaviors (such as online ordering) can make customers perceive savings.
  - Adjusting product formulations to create low cost variants can appeal better to price-sensitive customers.
  - Piloting innovate pricing and contracting models can help drive revenue and better align your pricing structure with customers' value drivers.
- Finally, remember that it's easy to leak away price/profitability through discounts, promotions, and other non-price actions over time. Invest in the right tools, analyses, and processes to prevent leakage over time:
- Set and maintain target prices—without a goal, it's easy for pricing to fall off track.
  - Assess whether you are hitting price goals at least once a quarter.
  - Evaluate your price structure every three to four years, or as market conditions change.

# The Time to Plan for Price Increases is Now

The current economic climate presents a situation not seen in decades for companies yet brings opportunities for companies to capitalize on the new dynamics present in the marketplace. But it takes time and preparation to effectively implement a price increase. The economic recovery and recent inflation in costs has caught many companies off-guard and exposed weak, or worse, missing pricing strategies. The result has been a scramble to action, hastily planned pricing moves, and in the worst cases, outbreaks of ineffective pricing actions (sometimes multiple actions in the last few quarters) as pricing strategy was not well thought through.

However, with some forethought and care, price increases can be managed effectively, responsibly, and profitably. Addressing cost increase is part and parcel of managing any business. It takes courage to raise prices, especially when markets are fickle, and the economy is still in recovery mode.

However, many companies manage to do exactly that, with positive results. The goal should be to determine how and where opportunities exist to pass through the increases, and when discretion is advised. The most successful firms are also the most profitable, and they remain profitable by carefully managing price and margins.



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## Endnotes

1. Harrison, David. "Inflation Hits Some Prices More Than Others." *The Wall Street Journal*, July 13, 2021
2. For Deloitte's detailed perspective on making pricing decisions for a manufacturer or distributor operating in a B2B2C environment refer to "Pricing in B2B2C Environment".



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