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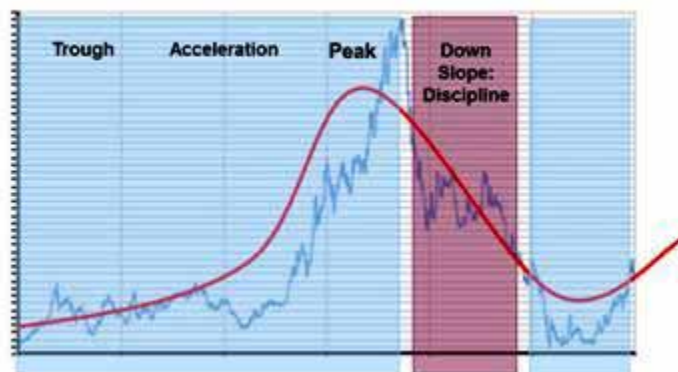
Disciplined Pricing on the Downslope

Challenging Market Conditions

For most of 2011, news of broad economic uncertainty and low consumer price inflation belied significant wholesale price inflation. Polymers, primary metals and other globally traded intermediate products saw multiple price increases through the first half of this year. But the chemicals sector has turned. Inventories are up. August saw the beginning of broad downward pricing pressure across the chemicals sector.

After an extended period of price increases, it is time for organizations to plan and prepare for requests for price concessions. On the downslope, pricing discipline is critical. A loss of pricing power does not mean conceding to every discount request, chasing volume or lowering prices in an ad-hoc fashion. Even in a challenging market, disciplined price execution and pricing best practices can help to preserve margins; limiting price and margin erosion while preserving the ability to extract maximum margin benefit from the next upturn, however gentle. This article lays out a number of near term, tactical steps that organizations can take to resist downward pricing pressure and to minimize margin destruction in a period of volatility, economic uncertainty and downward pricing pressure for late 2011 and early 2012.

Price per Unit



1. Beware of Averages

Where to start? The first step to limiting price leakage, particularly in an eroding market, is to aggressively manage customer profitability at a very precise level. Certainly measuring profitability at the customer level is a start. But customer-level profitability is an average metric and can be hiding valuable insights. Do you have vis-

ibility into customer-product profitability? Or customer ship-to profitability? For many customers there will be one or two products that are clearly less profitable than they should be. Or one Ship To destination that has significantly higher freight costs than others. This very specific level of precise customer profitability is required to identify price leakage and suggest corrective actions.

2. Analyze Understand Root Causes

Having conducted in depth analysis of customer profitability, you will have found some issues. What's next?

First, establish organizational consensus on what metrics and measures define a poor performing customer, for this quarter or for this declining market. One might choose to focus on the 25% of volume that is the least profitable, or focus on all transactions with contribution margins below 12% as an example. Define the criteria for 'outlier' or 'poor performer', and then do the analysis necessary to compile a list.

For each customer on that list, earner of the poor performer designation, identify the root cause. For low margin customers, root causes might be as simple as a low price, a high rebate, high freight or material costs. Identifying the root cause is important, of course, for helping to identify corrective actions. How does one identify the root cause? One way is to compare that poor performer to its peer group. Compare a low margin customer to other customers in that region, or SIC code...how do they differ? Is an invoice price difference driven by volume discount? Is a net price differential driven by different payment terms, or freight costs, or packaging costs? What pricing element explains the margin differential? A pocket-price waterfall is an excellent tool for this kind of root-cause analysis. This level of analytical visibility is required to take expedient corrective action.

3. Taking Corrective Action: The Downturn Playbook

Having identified poor performers and each root cause, your pricing organization can define and execute a 'Downturn Playbook'. The role of the Pricing Team is to define this playbook, and to monitor playbook execution. If your organization doesn't have an explicit Pric-

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ing Team, this function is often falls to Product Management.

For poor margin performers with a root cause of “high rebate”, the playbook might look like this:

- Reduce rebate, if possible, or
- Increase invoice price, if possible, or
- Change rebate mix and volume targets, or
- Reduce service costs

You are unlikely to want to exit this customer in this market, but identifying a range of corrective actions helps to at least push back against downward pricing pressure, or at best to reduce price leakage.

For poor performers with root cause of “high fulfilment costs”, the playbook might look like this:

- Reduce service costs or freight allowance
- Change freight mode from truck to rail, or
- Increase invoice price, or
- Refrain from paying rebates on shipments with freight cost exceeding \$x/ton

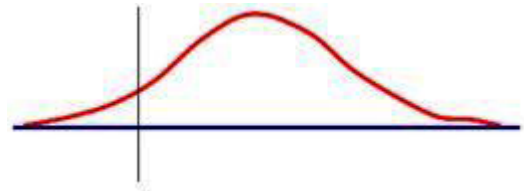
Only you can define the list of root causes and the appropriate corrective actions for each, but this playbook concept will help you to avoid ad-hoc responses and to avoid fighting the same fires over and over again.

Playbooks leverage the best of your organizational knowledge and best practices, and create repeatable structured processes. But how do you make these corrective actions stick? Corrective actions are enforced by setting a policy that can be measured and enforced.

4. Enforced Improvement: Policy Definition and Enforcement

The Pricing Team has defined a corrective playbook, but how do we make it stick? By defining and enforcing a policy. But setting a policy and making it stick are a different matter.

A policy example would be to set a margin floor of 12% on a particular material. On all quotes, or price reduction requests, or competitive situations, if the customer requested price, net of freight, rebates and other costs would deliver a contribution margin of less than 12%, well, then that quote must be approved by the Pricing Director (or someone with that kind of authority). Setting this escalation policy gives clear direction to the organization, and makes sure that the Pricing Director is using his or her time to review the most important quotes.

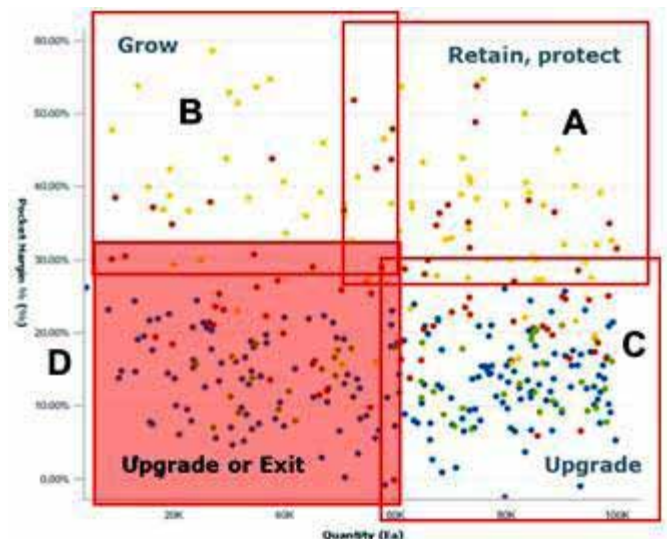


Automating the enforcement and escalation of policies like these is a pricing best practice; a way to consistently respond to discount requests in a systematic and disciplined fashion. This also ensures that how your company’s actions appear in the market place will be consistent and – to astute buyers – communicate the appropriate market prices. Monitoring the effectiveness of policies and refining them will drive improved margin realization in any phase of the cycle.

5. Write The Discount Concession Playbook

In this market, you will continue to receive lots of requests for deep discounts, or additional discounts on business you already enjoy. How do you respond to these discount requests in a systematic manner, limiting price erosion without putting too much volume at risk? You can ensure disciplined discount responses with a Discount Concession Playbook and strategy.

First, segment your customers. You have A customers, B customers, Cs and Ds. Or you have strategic customers, key, preferred, value and price seekers. Your segmentation model can be simple, a function of volume and margin, or multidimensional, driven by a number of key metrics and strategic attributes or even the output of a statistical pricing science analysis. It is important to have a segmentation model; to treat different customer types differently, especially when fielding discount requests.



Your A customers are 'Retain and Protect' customers. These are the customers that you want to keep throughout the cycle, and the customers competitors will seek to pick off. Upon receiving a discount request from an A/Retain Customer, take these steps:

- Offer an increased service bundle
- Position value, reminding the customer of the benefits of your product/service bundle/supply relationship
- Offer a similar product or product that will still meet their needs (a flanking product), but has a lower price or floor; this communicates a willingness to work with them, but reaffirms the value of key products.
- If these steps don't work, make a price concession, but offer less than requested.
- Last, concede to Floor Price. These are customers to keep, even if you have to concede margin on some products for some phases of the cycle.

For B Customers, customers with whom you would like to grow, subject to getting the right margin, respond to a discount request by:

- Offer an increased service bundle
- Can you extract additional volume for this concession? Can you bundle products together?
- Can you avoid the discount by instead using a rebate tied to growth or mix objectives?
- Offer a service wildcard? E.g. One free rush delivery per quarter?
- Offer a flanking product; this communicates your willingness to work with them, but reaffirms the value of your key products.
- Concede to floor, but positioning value all the way

Skipping to D Customers, those customers you sought to upgrade in the tight market, respond to a discount request by:

- Consider the strategic value of this product volume
- Treat Ds as price buyers, with the price buyer discount and service offering
- Reduce service costs wherever possible: enforce lowest shipment mode
- Withhold allocation rights
- Offer a flanking product; this communicates your willingness to work with them, but reaffirms the value of your key products.
- Set and enforce a walkaway price

The most aggressive price seekers will be in this D customer category. Don't play price poker with price buyers unless you can afford to lose the volume. But don't spend a penny more on service costs than absolutely necessary.

Having defined and enforced price and margin targets and floors for each segment, a best practice in any market, you will be well positioned to respond to discount requests in an orderly, systematic and disciplined fashion.

Are you responding to discount requests in a structured and pre-defined manner like the examples above? If the answer is no, you could actually be creating your own (self-inflicted) downward pricing pressure.

6. Be Wary of Changing Customer Needs

As you define your customer playbook, consider that your customers' economics may change in the downturn. In any difficult market, and especially in the uncertain climate of 2011, your customers are also facing cost pressures, reducing headcount and looking to push service costs to their suppliers.

Understanding your customers' economics is critical, and understanding how the downturn changes those cost and revenue drivers will help you respond systematically to these changes. Seeking to outsource functions in a downturn, your customers will ask for extended payment terms, or for vendor managed inventory. Will you accept these new service requirements? For A customers, probably, and you might even pro-actively offer an increased service bundle. But for D customers, you might not accept a higher cost burden.

Summary

Prices follow operating rates downward, and always have in the chemicals sector. But that doesn't mean chemical suppliers are without tools to mitigate downward pricing pressure. You will likely be busy – if not already – responding to requests for price concessions. Handling these requests in a systematic, disciplined fashion will enable the best run chemical companies to minimize price, margin and cash-flow erosion on the market's downslope. A penny per pound in price clawed back has a disproportionately large impact on margins and resultant cash flow. It's up to you: ad-hoc fire-fighting, or disciplined, systematic discount management?

Pricing Best Practices and Playbooks can help every organization to increase the strategic impact of the pricing lever, even in a volatile and challenging pricing environment.