Pricing in the Chemical Sector

Automated Pricing Optimization: Creating the Best Scenarios for Everyone

Enhancing Profitability – Chemical companies have to face a breathtaking list of business pressures today. Worries around the continuous volatility of raw material costs and increasing fluctuations in the financial markets are squeezing company profits to a painful level. The reality of this economic situation leaves executives with little room to breathe when adapting to short-term rises in commodity prices. That's why market leaders use automated pricing solutions to help their companies maintain their competitiveness both now and in the future.

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Chemical companies also have to operate in an international economic environment. In stark contrast to the downturn in the European economies, boom regions like China and India have increased their demand for valuable raw materials. From a business perspective, such industrial commodity price changes made a bad situation worse. This year alone, the market price for nickel has varied by 30 per cent. This has an impact on all organizations involved in the chemical sector, as they face huge variations in pricing across their own supply chains as well as the challenge of managing their sales consistently in these international markets.

The Ups and Downs of Raw Materials

It is an up-hill battle for companies when dealing with frequently changing raw material costs that threaten business growth. Setting up business plans and making predictions about the chemical market's future have become even more difficult. Business executives from different backgrounds share these frustrations, as there does not seem to be an effective way of tackling the complexity of raw material fluctuations. A recent survey of the chemical sector conducted by Germany's Commerzbank revealed that 40 per cent of entrepreneurs could not assess whether their companies' supply of resources was adequate. Hence, there is tremendous need for data analysis and understanding.

However, an astonishing number of chemical companies still base their sales and pricing decisions on results generated by spreadsheets, individual databases, paper reports and analyst intuition. Instead of collecting all of the available data and agreeing on a mutual strategy, every department reaches its own conclusion. Marketing often sets prices that sales teams believe are too high, whereas the finance department would like to see some extra profitability. Sales teams are also under pressure to meet their own targets and can resort to selling by discount rather than the value of their products to the customer. In a high-pressure business environment these traditional pricing techniques fall short and cannot grasp the complexity and speed of global market developments.

Pricing optimization software enables decision makers to make more use of their existing investments and apply scientific analytics to this data. By consolidating all this internal and external company data and applying data science to this mass of information, company leaders can get a thorough overview of what is really happening across their markets and how this affects sales and pricing decisions.

Consequently, chemical companies gain a powerful tool that delivers consistent and substantial profit improvement. The obvious analogy is the success of Customer Relationship Management (CRM), Business Intelligence (BI), and Enterprise Resource Planning (ERP) systems supporting vital business processes. In similar fashion, automated pricing optimization provides enterprises with better insight resulting in better pricing decisions. Today's pricing solutions use repositories of "big data" containing valuable transactional information and buying patterns. Based on this volume of data, pricing optimization software can segment customers and determine the right sales and pricing strategy according to an individual customer's willingness-to-pay.

Another advantage of pricing software is that sales organizations are equipped with pricing guidance enabling them to price products with far greater confidence when negotiating contracts. Sales and pricing staff are provided with better quality information as part of their decision process, such as the true profitability and cost for each customer, information about the wider market trends and the impact of commodity price changes in real time. Based on this information, companies can evaluate their own prices much more effectively and ensure they are meeting their targeted margin and demand levels.

The Right Pricing Decision

Each day, chemicals companies make a myriad of pricing decisions, and getting it wrong directly results in a loss of profitability. Every time commodity costs vary, the market prices impact companies that now have to absorb cost increases or raise its own prices to maintain margins. By assessing the impact on the business from a cost and profit perspective, automated pricing software supports executives to make the right pricing decision. Pricing optimization technology also factors in the market's ability to withstand price increases, calculating the likelihood of customers seeking better deals elsewhere when prices are raised.

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With support of modern pricing technology, decision makers can be much more proactive in changing prices as the cost of goods goes up or down, utilizing specific threshold levels that can automatically trigger price alerts. Simultaneously, this creates opportunities for improved margins based on the scarcity of product, or the ability to respond to potential challenges ahead of the wider market. When taking advantage of the automated power of pricing software tools, companies can integrate competitive market information into their price decision-making and respond to changing conditions as fast as possible.

Pricing is a complex discipline within any organization as multiple commodities or products have to be tracked. Chemicals companies need to avoid the pitfall of eroding their margins when changing their price tags. While companies may be in the good position to pass on some cost increases, others may be offset by other commodity prices falling or currency fluctuations, so they effectively cancel each other out. Through pricing optimization software, companies have an effective and powerful way of balancing their price changes and improving their overall business and financial performance.

Keep The Customer Satisfied

Pricing optimization technology also makes it much easier to see where keeping prices the same could be beneficial for customer stability and when to prioritize longer-term revenue performance against short-term profit goals. When negotiating contracts with key customers, pricing optimization software can be used to support modeling around price adjustments. If a customer requests extra discounts, these reductions and their impact on profit can be properly assessed and managed against minimum profitability guidelines in real time, in the field. Similarly, proactive approaches such as discount campaigns, service surcharges or rebate offers can be evaluated in advance for their impact both on demand for product and cost of sale, and integrated into the negotiation process.

Sales and finance departments benefit from pricing optimization software as it helps them to collaborate and set up rules for discounting and sales packages. Following a consistent strategy is especially useful when preparing and negotiating longer-term contracts. By working together with sales on pricing strategies via price optimization technology, finance can help ensure that sales activities avoid less profitable deals, while protecting against the volatility created by economic uncertainty.

This pays off — McKinsey & Company have found that as little as a one per cent improvement in price can yield up to an eight per cent increase in profit. For organizations faced with finding new opportunities to improve results and make sales more effective, the combination of big data and pricing can reveal substantial returns.

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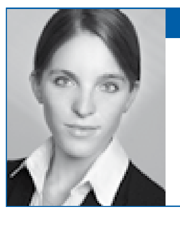
Pricing Strategies

A Basis for Systematic Profit Generation

When the Price is Right – Pressure on margins, strong competition and high quality expectations of customers are typical determinants in the chemical industry. The Chemical Monitor of Homburg & Partner, a half-yearly survey among deciders in the chemical industry, confirms the importance of a pricing strategy: More than 50% of respondents attach a high value to having one. But many companies still do not create and implement a well-developed pricing strategy.

Alexander Lüring
Homburg & Partner



Simone Staudt
Homburg & Partner

Recently, we experienced the margin of a newly launched product lagging far behind its potential because of the absence of a thorough pricing strategy. The initial list price was based on an insufficient analysis of the willingness to pay. As a result, the quoted price for the product was too low, and because of unexpectedly fast competitor adaptation, the company was unable to increase the price.

Why Is a Pricing Strategy So Important?

Companies should develop an effective pricing strategy for several reasons. With regard to the previous example, a thorough pricing strategy, including the relative price/value positioning in the market, is indispensable for skimming customers' willingness to pay — a pricing strategy helps keep a company's margin up. As another example, if a pricing strategy is developed as a response to relevant impact variables, it enables long-term planning of profitability — offering a better overall strategic positioning of the company in the long run. Without a pricing strategy, a consumption of the market potential would happen just by chance.

However, there is more than one correct strategy. The "right" pricing strategy for any situation can be derived based on an analysis of the individual market and business conditions.

How to Develop a Pricing Strategy?

A pragmatic approach and hence recommendations for a well-founded pricing strategy can be based on a top-down/bottom-up approach — a combination of vision and target setting (top-down) and internal and external factor analysis (bottom-up) creating the pricing strategy framework.

Although the needed information for a thorough pricing strategy is typically available within the organization, our impression is that few companies systematically take advantage of it. Often pricing strategies have grown from historical roots and are based on sales force experiences, but an intuitive approach is not sufficient for such important decisions. To ensure the success of a pricing strategy, a systematic approach with defined objectives involving all relevant analysis items is essential.

Which Aspects to Consider?

Both perspectives — top-down and bottom-up — can be subdivided into specific factors of interest, which need to be analyzed systematically. In the first step, the vision and the targets of the pricing strategy need to be defined. In the second step, major internal and external factors affecting the development of the pricing strategy should be analyzed focusing on three main criteria for each factor.

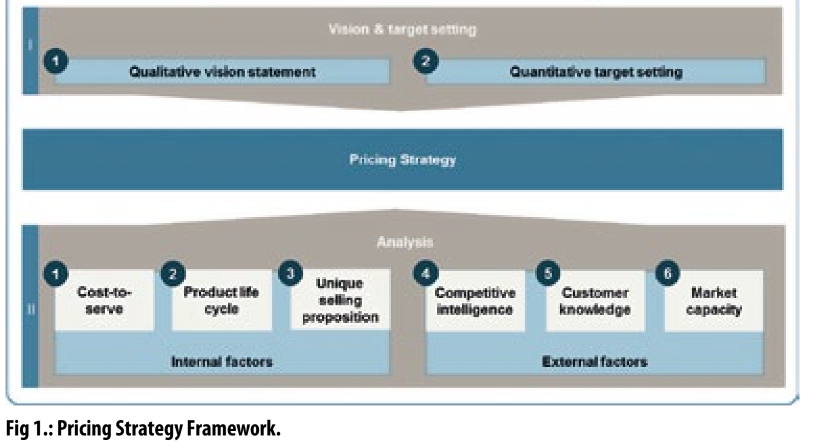


Fig 1.: Pricing Strategy Framework.

Step 1: Define the Vision and Targets Driving the Pricing Strategy

Vision and targets have to be strictly aligned with the overall goals and the strategy of the company — thus, it is a top-management responsibility. A vision builds the qualitative pillar of the pricing strategy, reflecting the overall goals of the business. For example, a company that is the market leader based on a high level of quality might state its vision as follows: "We act as the pricing leader in the market, focusing on our high level of quality, and do not participate in price competition." Pricing targets create the quantitative pillar of the pricing strategy, supporting the target values of the overall business strategy. Exemplary quantitative targets could be to establish an absolute price level of, e.g., €3.50/kg for a specific product group or to reach a minimum contribution margin of, e.g., 50% for all product groups.

Step 2: Analyze the Internal and External Factors Affecting the Pricing Strategy

To analyze the internal factors, the three major aspects — cost-to-serve, the product life cycle (PLC) and the unique selling propositions (USPs) — have to be considered. Knowing a company's relative cost-to-serve gives must-have insights into the range of possibilities to respond to competitive pricing pressure. Also, for the different PLC stages, different strategies are recommendable and can be evaluated with regard to a company's PLC structure. Additionally, knowing and carefully quantifying USPs is essential in order to skim customers' willingness to pay.
Three key aspects for the analysis of the external factors should be considered — competitive intelligence, customer knowledge and market capacity. By gaining comprehensive knowledge about competitors (e.g., strategy, price position, pricing role) and customers (e.g., customer value, perceived value, willingness to pay), niche markets can be identified for successful positioning. Last but not least, knowledge about existing and planned production capacities in the market must be obtained to understand the effects of supply and demand on prices.

What Is The Outcome?

Combining the insights of the bottom-up/top-down approach helps capture a well-developed, thorough picture of the relevant internal and external determinants. Based on these insights, all relevant criteria for the determination of the pricing strategy are given; they identify the most appropriate individual pricing strategy, such as premium, skimming or penetration.

Overall, price strategic decision-making, if based on a substantial information base, enables systematic profit generation and supports the realization of a company's full earnings potential.

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