Price management

Profits under stress: Price your way out of the New Normal

Implications for business and profit growth in the construction sector

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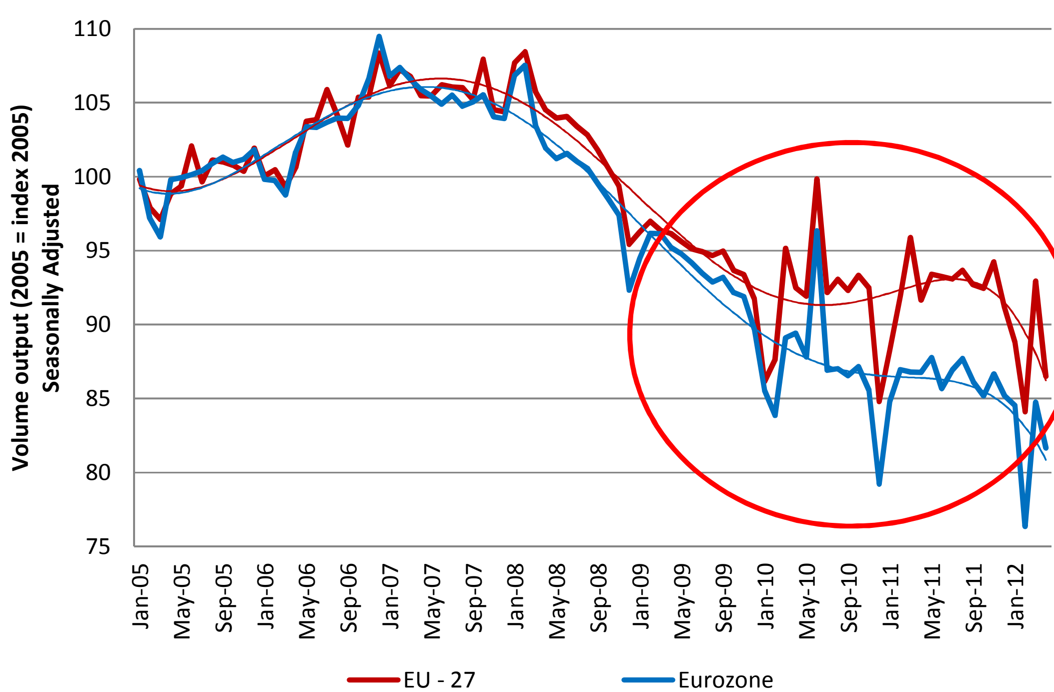
As Europe is still suffering from the effects of the European economic crisis, the construction sector must adapt to the 'New Normal' business environment that accompanies it. Cost inflation along with volatile peaks and troughs in a stagnant market characterize the New Normal in what seems to be a structural realignment (see Figure 1). What many had initially hoped were signs of a recovery is turning out to be a great strain on profitability management in the construction material sector. As one global bank puts it, "in a world of low nominal GDP growth (due to excess capacity) and rising commodities, pricing is abnormally important." [1)]

For some EU countries, output levels have recovered from the 2008 - 2009 crisis. Poland and Romania are within this club of best performers, with production levels over 50% above 2005 levels. Similarly Sweden and Finland (30 to 40%) alongside Germany (above 20%) seem to have emerged from the crisis with a healthy demand for construction works. This is not the case for the rest of Europe, especially for countries such as Spain or the UK.

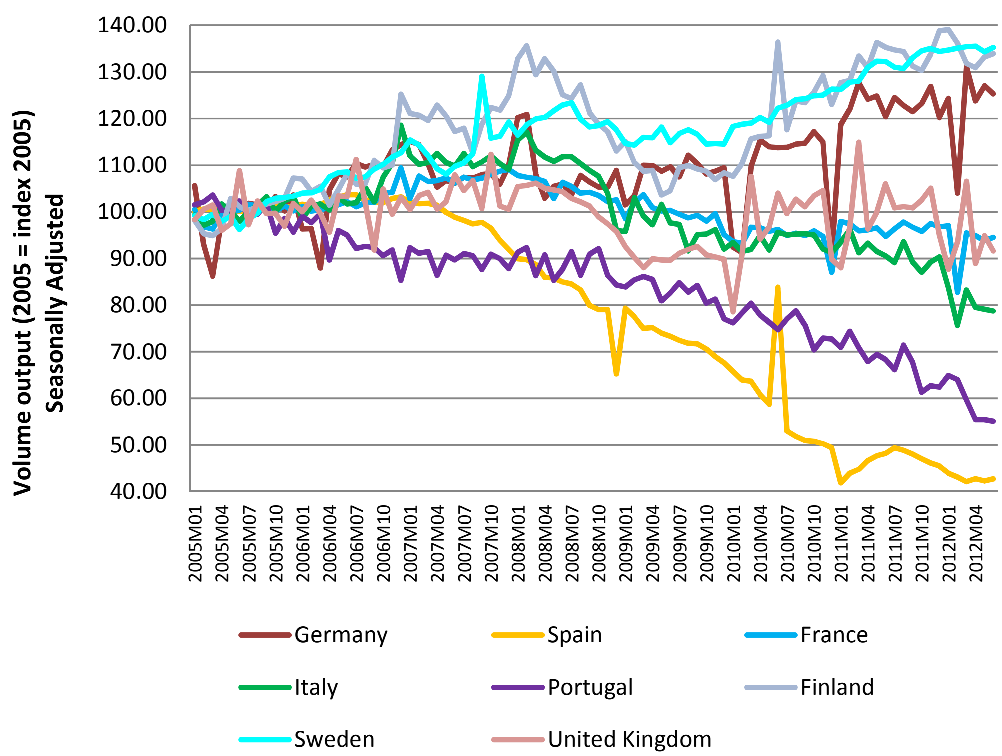
Figure 1: Construction Output in Europe - The New Normal



Source: Eurostat

While the EU 27 average stands at output roughly 10% under 2005 levels, the Eurozone countries are currently struggling with output between 14 to 24% below 2005 levels. While this gap is in no small part due to differences in structural growth levels, the financial crisis topped with the current debt crisis has had a significant impact on southern countries. While construction output in Portugal is below 60% of 2005 levels, the Spanish construction sector has virtually halted and is below 50% of 2005 levels (See Figure 2).

Figure 2: Construction Output in Europe by country - The New Normal



Source: Eurostat

Characteristics of the New Normal

With lower volumes come fewer and smaller projects. Also, despite catching up to pre-crisis output levels, Northern Europe is subject to the same symptoms as the South. In the New Normal, customers are better informed, more price sensitive and possess higher performance expectations. Price competition gets tougher while costs increase further, driven by inflation, putting pressure on industry margins. The challenge for construction material manufacturers is to protect their position and grow in profit at the same time. Smart pricing strategies help to counter the margin pressure and profit threat.

Regardless of output levels, EU countries are subject to peaks and troughs which make it difficult for analysts and businesses alike to accurately forecast short-term market movements in the construction sector.

At the same time, according to a recent Simon-Kucher Outlook Survey[2)], almost 300 managers in European construction, chemicals, and technology sectors expect double digit profit growth in 2012. The highest expectations were recorded among building technology and construction suppliers. Growth on this scale, despite difficult economic conditions, requires pricing power.

Price, not volume, will be the critical driver for future profit growth

The profit formula has only three components: volume, price and cost. Construction output is still below pre-crisis 2008 levels and capacities have been adjusted in the downturn. Still, the hunt for volume with lower prices to fuel growth and support capacity levels is a dangerously pervasive issue for sector profitability. Decreasing price or omitting price increases to further recover volume puts the construction sector at risk of a price war. Instead, one should aim for flexible capacity in order to maintain healthy profits in the face of increased volatility of the New Normal. And if volume is flat, only margin improvement can increase profit; if costs are inflationary, only price remains to drive margin and profit.

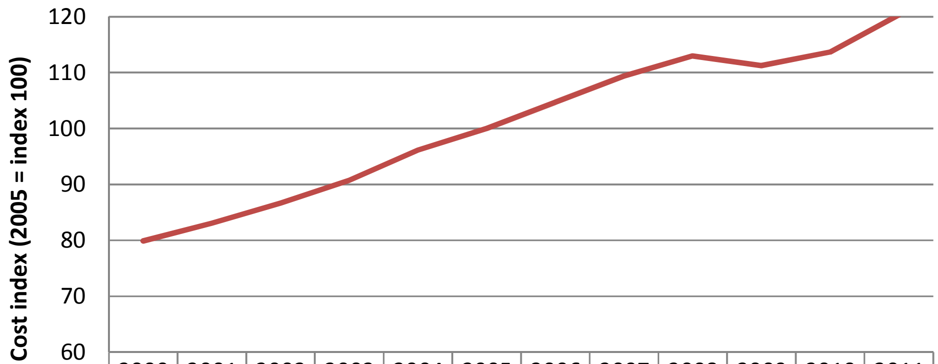
One simple calculation demonstrates the importance of price as a profit lever. If you were able to improve your cost, volume or price by 1%, what would be the resulting effect on your earnings (all else being equal)? This calculation applied to the balance sheet of a major raw materials company shows that a cost improvement of 1% results in 1.6% extra earnings, while volume results in 3.7% and price in 5.3%. Typically, price leverage has between two to three times the impact of cost reduction in this industry.

Margin defence is key – and price increase is king

While construction volume is still in a perilous state, construction costs have continue to rise, albeit a small slump in 2009 (see Figure 3). In the New Normal, price increases for construction materials are not driven by demand rather by increasing cost and margin pressure.

Manufacturers cannot afford to omit a price increase in view of increasing input costs. This is especially true for the New Normal in which price increase implementation is more challenging than ever. Successful price increases in the New Normal are characterised by more determined management and preparation – internally as well as externally. An organisation requires clear price change targets and a focus on consistent implementation across products and customers; and for the sales force, clear argumentation and price escalation guidelines to strengthen its confidence. Market expectations are managed by establishing price increase patterns through transparent communication, followed by "walking the talk".

Figure 3: Construction Cost in Europe



	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
EU-27	79.89	83.08	86.67	90.76	96.14	100	104.7	109.4	113	111.3	113.7	120.4

Source: Eurostat

Price management needs to be more differentiated

Keeping price increases in step with cost increases is indispensable; however, to grow profit, more is required. Apart from across-the-board price increases, the differentiation of margins and prices - defined in a 'price logic' - becomes critical for success. Differentiating prices by price attention (slow vs. fast moving products) and product qualities (commodities vs. specialties) becomes more important to profit growth in the New Normal. It allows adaptive pricing for non-differentiated volume products while still capturing the value of the broader product range.

Commodity products General availability, fierce pricing	**Key products** High volume sales with high price awareness
Specialty products High value, niche products with low price sensitivity	**Slow Moving products** Low sensitivity but requires competitive price to clear stock

Figure 4: Differentiation by price attention

Price differentiation strategies even apply to commodity products where the common belief that "a brick is a brick is a brick" can be disproved. Applying a consistent "value" price logic of a price list of bricks based on properties such as compressive strength, colour consistency, efflorescence, etc. created additional price potential of 1-2%.

Product price alternatives counter the "more for less" attitude

Customer expectations and price sensitivity are rising while products are becoming more sophisticated in terms of performance, functionality, efficiency and sustainability/ecological standards. Discounting premium products to drive volume accelerates commoditisation and should be the last resort. The needs of price sensitive customers can be met instead by matching lower price with lower performance through a 'less expensive alternative'. Forcing customers to adopt trade-offs helps sales teams to repel price pressure and commoditisation risks in the New Normal.

A leading brand manufacturer of sanitary systems for example introduced a 'less expensive alternative' for project–led business and price sensitive customer segments. Their product provided basic functionality but was lacking alternative design options and links to system solutions, which was reserved for the premium offer.

Unbundling services is another way to provide 'less for less'. Value-add services (technical services, product training, engineering drawings, etc.) and non-standards (samples, mixed pallets, crane unloading, express delivery, etc.) should be excluded from 'less expensive alternatives' and should instead require an extra charge to customers.

Customers can help to grow profits with the right price incentives

In the New Normal, with volumes still down and a lack of market direction, insecurity and margin pressure affect the entire value chain.

Distributors purchase smaller volumes more often to reduce inventories and manage their own insecurity. Or, they may suddenly place larger volumes after running down their stocks, making the planning process more difficult for suppliers. Manufacturers may also be requested to deliver smaller volumes directly to third parties. These changes in ordering behaviour adversely affect the cost-to-serve for suppliers.

Moreover some distributors start consolidating their supplier base and bundle volumes in order to gain efficiency and negotiation power. At the same time, however, others also start considering smaller, local suppliers that offer core ranges of volume products at cheaper prices and lower freight costs. 'Cherry picking' is becoming more prevalent in the New Normal and the loss of turnover in volume products puts further cost pressure on full-range suppliers.

Proven practices can however help building material manufacturers to defend their supplier position and optimise profits. Incentivising and rewarding customer behaviour through performance oriented discounts and rebates are a practical option.

Gross Price				
1. Product discount				
Discount by product type	Type 1= 30%	Type 2 = 34%	Type 3 = 40%	...
2. Wholeseller discount				
Customer size	<300k EUR=0%	>300k EUR=1%	>600k EUR=2%	>1000k EUR=3%
Order size	< 42 m3 = 0%	> 42 m3 = 2.5%	85 m3 = 5%	
Payment delay	0%	2%		
3. Wholeseller Rebates				
Customer size	>200k EUR=2%	>300k EUR=4%	>600k EUR=5%	>1000k EUR=6%
Growth	<0% =0%	>=0% = 1%	>5% = 2%	>15% = 3%
Product mix: share of type A	<40% =0%	>40% =2%		
Product mix: share of type B	<40% =0%	>40% =1%	>55% =2%	>70% =3%
Stock size	<10% =0%	>10% =1%	>20% =2%	
Commercial participation	<200k EUR =0%	>200k EUR =1%		

: Exemple of changed behaviour noticed in customers

Figure 5: Discount incentive system (example)

A case in point was an insulation material supplier who achieved a significant increase in the share of full truckloads (up from half loads) and a rise in the deliveries to merchants' stock (as opposed to third parties), as well as optimisation of product mix at merchants. Functional price elements such as rebates for stock-keeping and product mix and an additional order-related logistics discount were drivers of this successful accomplishment.

Improve price discipline and targets to secure price quality

If your sales force doesn't know the difference between 'good' and 'bad' prices, then any price will be implemented as the 'right' price. If you can't measure price quality, you will never achieve it. Price guidelines with target and limit prices help to guide price setting and drive price consistency and profit. Clear price targets are of greater importance in the New Normal when 'bad' prices can't be balanced by volume growth.

Establishing price escalation schemes and following up deviations from target and minimum prices will support the implementation of price increases. Controlling the consistent application of charges for minimum order volumes, order changes, excessive sampling, or late payments helps to halt profit leakages.

A "Gross minus logic" brings structure to the price setting process. Using such methodology, companies are able to better account for price erosion through discretionary discounts and rebates. While your sales force may retain some amount of flexibility, the "Gross minus logic" provides it with clear rules and guidelines. A transition discount may even be implemented in the short term to ease customers into the new pricing system. Here, 'bad' prices stand out with large transition discount, while 'good' prices are implemented effortlessly.

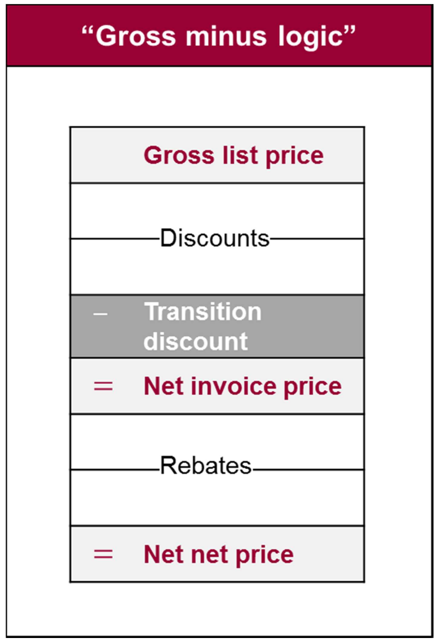


Figure 6: Gross minus logic

Price strategy should give guidance to the market and balance margin and volume targets

Insecurity and disorientation are high in the New Normal. Every other week, news headlines swing from "Construction growth bolsters economic recovery hopes" to "Construction data raise recession fears", depending on indicators, sector hopes and interpretation. Pricing management in such an economic environment requires courage and direction. The European Pricing Study by Simon-Kucher revealed that nearly half of managers say that boosting their market share is core to their strategy. Such a volume strategy - especially if based on price cuts - can harm profitability for the entire construction material sector. Managers must learn to reduce price aggression and not over-react to competitors' price moves. Balancing volume and margin targets is of critical importance in the current economic context. The New Normal requires focus on margin optimisation, not volume.

Six pricing guidelines to grow profit in the New Normal

The New Normal in the construction sector:

- Has no direction. Economic indicators are confusing and the construction market has a volatile lateral movement.
- Has fewer and smaller projects while volume is flat and below pre-crisis levels. Input costs are increasing, but driven by inflation. Margins are squeezed and price is the only driver of profit growth.
- Has professional and end-user customers who are more price sensitive while, at the same time, environmental & building standards and quality expectations are up. 'More for less' is the new attitude.

A 'New Pricing' by construction material manufacturers is required for the New Normal, that needs to be more structured, differentiated, performance-based and disciplined:

1. Defend margin levels and implement price increase standards not in spite of, but because of lack of growth. Be transparent, regular and determined in your price increases and prepare the market and your organisation.
2. Be more differentiated in your product pricing. Ensure value, niche and side products are appropriately positioned. Give product prices a price logic framework.
3. Offer 'less expensive alternatives' and unbundle services for price sensitive accounts to force trade-offs and counter the 'more for less' attitude. Charge for the 'extra'.
4. Provide price incentives for those accounts that help to grow profits. Functional price elements support efficient behaviour and counter 'cherry picking' by customers.
5. Define and communicate price targets and enforce pricing discipline in your sales teams. Follow up price achievements and results.

6. Focus on margin and demonstrate price leadership.

These pricing strategy elements for construction material suppliers are crucial for successful competition in the New Normal. Companies will need to demonstrate price leadership to navigate the current market environment and to achieve desired profit growth.

1) Credit Suisse Equity Research, 18 Oct. 2010

2) Simon-Kucher: Pricing Power: An online survey report on pricing power and the seven ways it can improve your business, April 2012

Data source: Eurostat

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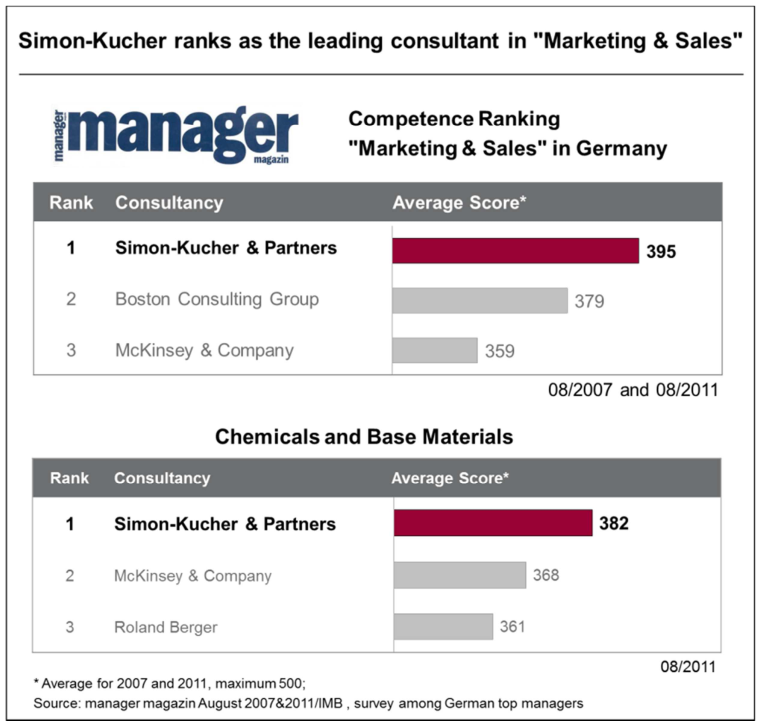

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