EXECUTIVE INSIGHTS

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Rethinking Pricing Strategies in Commoditized Markets: Network-based Best Alternative Pricing

As the construction industry starts its long climb up from the greatest collapse in recent history, companies are looking to repair the damage done by anxious suppliers who ceded margins to (unsuccessfully) maintain volumes. While this dynamic is perhaps most acute in the building materials markets, it is certainly not unique and can be seen across a wide range of commodity and manufacturing sectors.

Companies are now rethinking many of their core business processes including pricing, capacity, network footprint, product mix, channel priorities, capital investment and production levels. However, pricing is emerging at the forefront of many executives' minds as they look to regain pre-recession margin levels.

L.E.K. Consulting has found that many of the traditional models designed to optimize pricing have blind spots that prevent companies from maximizing their position in the market. This is often caused by the simplifications that companies make when calculating their bids. In particular, traditional pricing models do not account for sufficient knock-on effects across multiple markets, or the system-wide impact and likely reaction from competitors.

This is akin to playing chess without looking more than one move ahead. At the time a move may seem logical, but the subsequent countermoves can quickly leave you with the wrong mix of business at the wrong prices and with inferior profits.

The most common traditional pricing models with these limitations are those based on Next Best Alternative (NBA) techniques. These techniques simply set prices for each customer at or just below the cheapest competitor; and are typically based solely on their delivered costs. Many industries rely heavily on NBA pricing practices as the basis of their pricing decisions. But as each company reduces its prices, the inevitable "race to the bottom" occurs.

With growth on the horizon, companies continue to look to their competitors as price benchmarks; but no race up from the bottom will occur with this approach. The blind spot inherent in this approach is that the follow-on or network effects are missed.

L.E.K. has developed an approach to protect companies from making decisions that seem logical but in reality leave them vulnerable to their competition. This proprietary pricing approach builds on NBA but also considers cross-market, network impacts. Our Network-based Best Alternative (NBBA) pricing approach simulates multiple sequences of pricing decisions, both yours and your competitors, and analyzes the full system-wide impact of winning and losing each account at various pricing levels. To continue our chess analog, it enables our clients to look many moves ahead and put themselves in a powerful position to best their competitors who are simply taking a narrow look at a broader market issue.

Rethinking Pricing Strategies in Commoditized Markets: Network-based Best Alternative Pricing was written by **Aaron Smith**, **Chris Rule** and **Carol Wingard**, all Vice Presidents of L.E.K. Consulting. Please contact us at industrial@lek.com for additional information.

NBBA provides the potential for a company to create a "race to the top" dynamic; improve its competitive position and maximize its return on capital. NBBA merges network supply optimization techniques and game theory to accelerate returns as markets recover. NBBA is especially relevant if you are in an industry that is capital intensive, has high transportation costs, steep supply curves, and multiple plants that serve multiple markets. Examples include commodity chemicals, aggregates, cement, concrete, asphalt and steel.

Weak Link in the NBA Model

NBA follows the logical approach of setting your delivered price at (or near) your competitors' delivered price, or the delivered cost of the least expensive ton of idle capacity. For example, if Competitor A has idle capacity and their production cost is $200/ton and their delivery cost is $30/ton, you would price your product at $230/ton (assuming that you could economically supply at that level).

This approach is effective when all the competing plants are serving a single geographic market, you are the low-cost supplier, you have aggressive competitors who price at their marginal cost, and there is significant excess capacity. In most cases, however, this approach is limited because:

- It fails to consider cross-market supply impacts
- It often ignores capacity considerations beyond the least expensive capacity
- It fails to adequately address opportunity costs (yours and your competitors)

A slightly more advanced approach considers capacity that is "out of the market" and considers how a reduction in volume might enable higher pricing by "pulling" the supply curve to the left. This technique determines the volume where profit is maximized even though some share would be lost. However, this approach also fails to address cross-market impacts or opportunity costs.

Case Study: Global Chemical Company Finds Breakout Growth Through Hidden Pricing Opportunities

A leading commodity chemical manufacturer enlisted L.E.K. to examine how structural changes caused by the recession would impact the company's markets moving forward. Using this information, the company then wanted to recalibrate its market pricing practices ahead of competitive actions, and thus create a more favorable position for itself during the market recovery.

For its initial market analysis, L.E.K. looked at location-based supply/demand dynamics and the implied pricing levels using the NBA pricing model. However, the NBA pricing analysis was incomplete as it did not consider cross-market impacts. This factor is critical because many of our client's plants could serve several regional markets simultaneously. Using NBA alone would have resulted in significant underpricing in key markets and left the company saddled with long-term, low-value contracts – and increasingly vulnerable to competitive maneuvers.

To address this situation, L.E.K. applied its proprietary NBBA modeling techniques to the original NBA dataset to uncover specific system-level structural imbalances. We then worked with senior executives to develop a strategy to correct current pricing issues and implement an initiative to generate exceptionally high returns independent of competitive response.

We identified a 20% pricing increase opportunity under today's supply/demand conditions and more than a 40% increase under the industry's projected low-growth scenario. The manufacturer has already realized millions of dollars in annual incremental profits and is on track to more than double profits as it continues to implement the strategy.

The Six-Step NBBA Process

NBBA considers how volume and pricing changes in one market can impact adjacent markets; and how these changes impact a broader constellation of connected markets until the entire network "universe" is analyzed. L.E.K.'s techniques identify how a set of simultaneous, coordinated, price/supply moves throughout your network can have a synergistic effect – far outperforming what can be done in a market-by-market approach. The six-step NBBA process follows:

1. Research both the supply and demand dynamics at a very granular level, similar to what is needed for NBA. Often this information already resides within an organization
2. Gain a deep understanding of customer purchase behaviors, alternatives, requirements etc.
3. Construct the NBBA pricing model based on L.E.K.'s proprietary techniques
4. Run the model, interpret the findings and socialize the results with senior executives, the sales force and other key stakeholders
5. Develop detailed account plans to facilitate making the recommended (and potentially difficult) pricing actions
6. Monitor pricing levels against targets and update the model to ensure decision making is evolving with changes in the market

Conclusion

Market-centric pricing techniques that don't consider network-wide impacts leave significant money on the table and leave you vulnerable to competitor actions. L.E.K.'s NBBA's pricing approach can help accelerate margin recovery and position your company to realize the maximum benefits in a growing market.

NBBA Benefits

There are several benefits from L.E.K.'s NBBA analysis, including:

- Reducing the risk of being on the wrong side of competitive pricing maneuvers
- Identifying assets/capacity that most impact the pricing dynamic; and should therefore be prioritized for acquisition or strategic contracting
- Identifying the highest return on investments (ROI) in optimizing the supply network (both capacity and efficiency investments)
- War gaming the impact of expected changes to the competitive landscape
- Playing through "what if" scenarios to quantify the impact of rumors heard in the field (e.g., capacity expansions or reserve depletion) and developing contingency plans
- Optimizing supply volumes into specific markets – and quantifying the impact of over- or under-supplying each market
- Identifying optimal contract terms and targets, and improving contract negotiation outcomes with both suppliers and customers

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded nearly 30 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

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