Fluctuating Raw Material Prices

How to Manage Higher Costs, Inflation and Collapsing Margins

Before the economic crisis, raw material prices knew only one direction: upwards. The sky seemed to be the limit. Now the situation has changed. No one seems to know in which direction raw material prices will go. They go up and down with irregularity and without any discernible pattern.

Companies have a hard time correctly judging the risk of strongly fluctuating raw material costs. If they pass on increasing costs only minimally, delayed or too conservatively, or if increasing raw material costs coincide with decreasing sales prices, a margin squeeze is inevitable. Highly fluctuating raw material costs and ineffective price management can greatly endanger a company's success.

Bayer, as an example, expects a loss of approximately €500 million in 2010 due to higher raw material costs. The steel industry is in a similar predicament. A price difference of €30 per ton for the remaining capacity of the year is enough to cause either a small profit gain or a huge loss for one major German steel manufacturer.

How do market players assess the current situation? Do volatile raw material costs pose a danger to the economic recovery? What determines the highs and trends of raw material prices? We asked over 250 European managers from the chemical, construction and base material industries these questions.

Assessment of the Current Market Situation

The price trend of raw materials with its current ups and downs is primarily driven by supply and demand, according to approximately 60% of the surveyed managers. They claim that traditional factors are influencing the situation: the crisis, the reserve level, the free capacities and the current inventory.
But there are other influencing factors at play here: speculations. In an effort to spread out their risk and take advantage of opportunities, investment funds, retirement funds and insurances are investing in the raw material market. Yet, only 40% of the responding managers believe that speculation is the cause of higher raw material costs. This emphasizes that speculators are "only" strengthening the up and down trend. They do not set a specific trend, they simply go where ever looks best.

Facing increasing volatility, companies must move away from rigid and fixed systems.

Annual contracts, e.g., are no longer appropriate or up-to-date with the currently volatile raw material cost developments. 70% of the managers confirm this. Moreover, 80% of the respondents are sure that the elimination of annual contracts will further exacerbate the price dynamics.

In a dynamic market and cost environment, shorter terms (quarterly and monthly prices instead of annual contracts) allow companies to quickly and accurately assess the price opportunities and adapt prices accordingly. The gap between contract and spot prices should then start to decrease. 50% of the respondents feel that shortening the negotiation cycles and moving away from annual contracts will not necessarily lead to higher prices.

**Measures and Approaches**

It would be correct, but also trivial, to suggest that increasing costs should be passed on to customers. There is hardly a customer out there, who would be willing to bear the raw material cost risk (alone), if he didn't also have the chance to pass on the costs to his buyers. Since mass product buyers are usually at the end of the value chain, the acceptance of such cost increases is low. And the high competitive intensity is another reason, why the costs cannot be converted into price increases. In such cases, price formulas, like "costs up, price up," cease to work as intended. Yet, 62% of the managers are of the opposite opinion. They feel that the price formulas do work as an effective means of overcoming cost and price dynamics. This percentage is particularly alarming: formula pricing in fact turns active price management into passive "pricing-by-the-rules".
A recent case from the steel industry reveals how price formulas are not necessarily the cure-all: to increase long-term customer loyalty, major steel producers wanted to continue negotiating annual contracts - but with formulas. Most buyers fought this, as the retention of fixed prices in their contracts was what they wanted.

**There Must be Other Solutions**

But what are they? Inventory management, according to 78% of the respondents, is seen as the most important means of dealing with raw material cost fluctuations. 70% of the managers, the basis material producers especially, feel that active price leadership on part of the market leader is another important solution. Contract optionalities (regarding dates, volume, standards, fees, etc.) are seen by 60% of the managers as important. Only every second respondent considers surcharges as a means of managing cost and price dynamics.

**Conclusions and Recommendations**

Assessing the current raw material situation, including potential measures and approaches, leads us to the following conclusions and recommendations:

1. **The (increasing) dynamics and fluctuation of raw material costs, along with the tendency to shorten contract terms, require more efficient dynamic price management from a company.**

Pricing processes must become faster, more transparent and more effective in reacting to changing market environments. Simple and clear pricing guidelines help to overcome the complexity of pricing. After all, not only do the monthly or quarterly contract negotiations and the cost dynamics determine the price, so do other factors: the customer size and negotiating power, the order behavior of customers and the customer value.
2. The higher requirements also demand that companies are able to forecast supply and demand developments and that market-leading companies practice active price leadership.

Price forecasts are difficult and not always 100%, but they are not impossible. An educated guess based on an expert system is always preferable over a subjective decision based on gut feeling. This is especially relevant for market leaders who set the market tone and have to possess strong pricing competence and expertise.

3. Price formulas are not cure-alls. Initiating and setting price changes should not be based solely on escalation clauses. This is the responsibility of management, which should review the options of time-restricted surcharges as price-relevant factors.

Price formulas are only recommended, if raw material costs are the main or sole price driver. If all cost factors cannot be objectively assessed and indexed, then the terms of buying and selling cannot be properly matched. If other factors like inventory, demand or customer behavior are the primary price drivers, then price forecasts or decision support models would improve the price setting process.

Initiating and setting price changes is a key component of price leadership strategies.

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