Pricing Is the Biggest Tool for Earning Improvement

A Company With Different Competitors in Each Region That Measures Itself the Same Way Across All Regions Will Be Hard Pressed to Understand the True Opportunities in Pricing.

By Ryan Brown

"Economics," quipped Nobel laureate economist Paul Samuelson decades years ago, "has never been a science – and it is even less now than a few years ago."

Impossible as it is to forecast the duration or depth of this downturn, the aggregates industry that was just enjoying an upbeat earnings report months ago must now prepare for the virus-inspired recession that will inevitably follow.

Although recessions usually strike different sectors in different ways and at different times, aggregates and building materials in general may see an extended grace period given its "essential" status in April. Massive unemployment and low confidence will eventually work their ways into purchasing decisions for 2020. Entering the downturn of 2008, operators first looked to control operating costs and deleverage their balance sheets, both of which has a lower perceived risk than addressing price. Should the same playbook be followed?

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In such an environment, managers might think it lunacy to talk about holding or even raising prices. But the opposite is true. Pricing right is the fastest and most effective way for managers to maintain profits.

Consider the income statement of a large materials producer: a price rise of 1%, if volumes remained stable, would generate a 4% increase in operating profits (Exhibit 1) – an impact nearly 2.5 times greater than that of a 1% fall

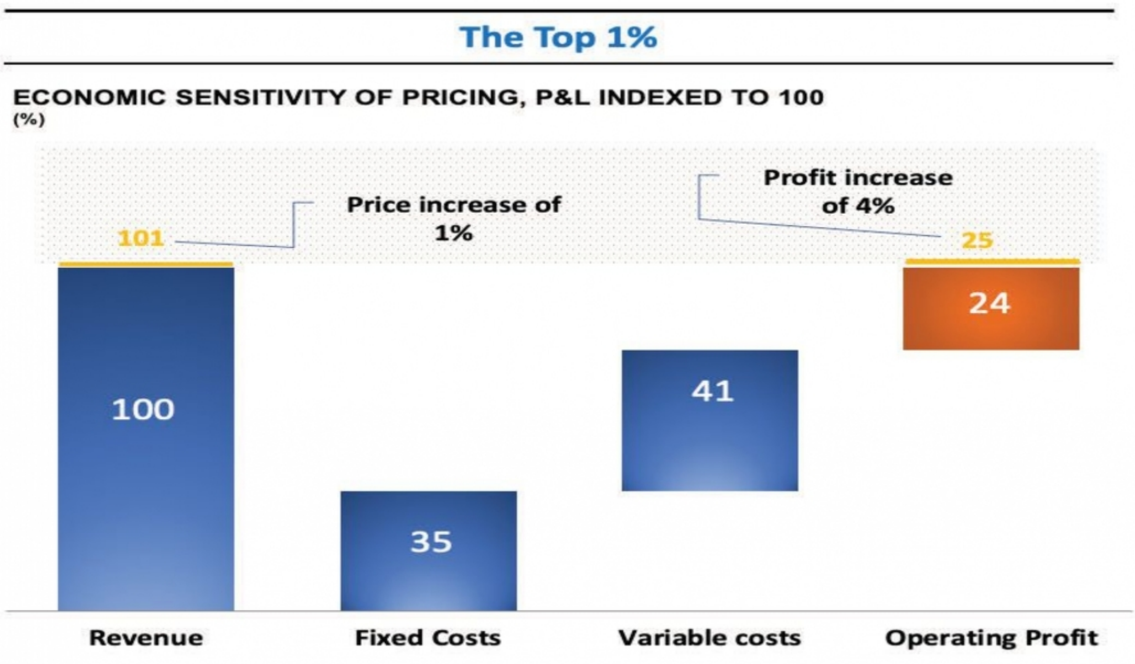

Exhibit 1

Source: Next Level Essentials, LLC industry analysis in variable costs and more than three times greater than the impact of a 1% increase in volume. The numbers are even more pronounced when all mid-size U.S. public companies are taken into account (Exhibit 2).

Consider again this same company, competing in many markets and within different customer segments. In this case pricing is analyzed by its managers but the comparisons they use are not very meaningful. For instance, classification by location can be misleading, as the physical location by itself doesn't indicate the level of market competitiveness.

And benchmarking pricing by customer type or size ignores the level of demand. In order to really assess whether average selling price is too soft or too hard, it is useful to know two things: the competitive intensity (supply) and the scope of opportunity (demand.)

How do you currently do this? Usual intelligence gathering like customer surveys or sales rep anecdotes to gauge the pricing landscape is useful to some. However, the population size is small and subjective, and it can take just one customer story who balked at price to influence the judgement of senior management. A better way forward involves collecting raw and objective data from each region, location or branch. This can be done annually and should include these three things:

1. The number of true competitors each location battles against for sales.
2. Revenue growth the past few years.
3. Percent of orders that customers rejected initial bid price.

Based on what the numbers tell us, we can plot supply vs. demand in simple groupings (Exhibit 3).

Notably, the top concerns from executives are competitive responses – competitors would change their pricing behavior to capture market share – and customer defections. From experience, we know that when pricing improvements are implemented in the right pockets of opportunity, the risk of customer loss is widely overestimated and competitors that do drop price best have deep pockets.

In the booming economy we have enjoyed the past eight years, robust demand and cost-cutting programs have driven up earnings. But an imminent economic downturn will slow growth. Thus, assuming the cost controls have been implemented along the way, the shortfall in pricing capabilities will be exposed. Knowing where to hold and where to fold in the turbulence ahead will be the single most important decision a producer will make.

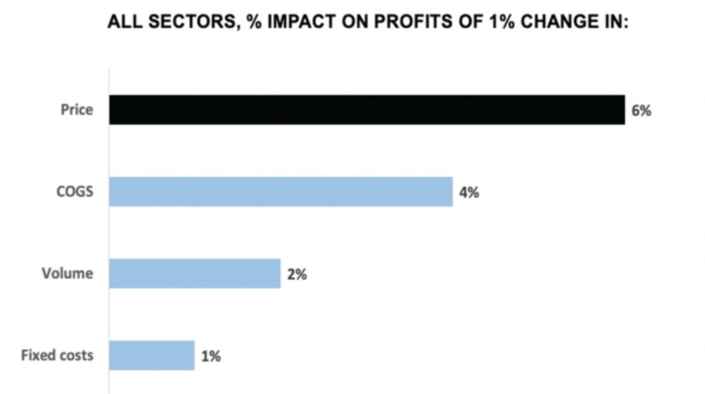

Exhibit 2

Source: Dunn & Bradstret Hoovers, $100M-$1B revenue U.S. public companies 2019

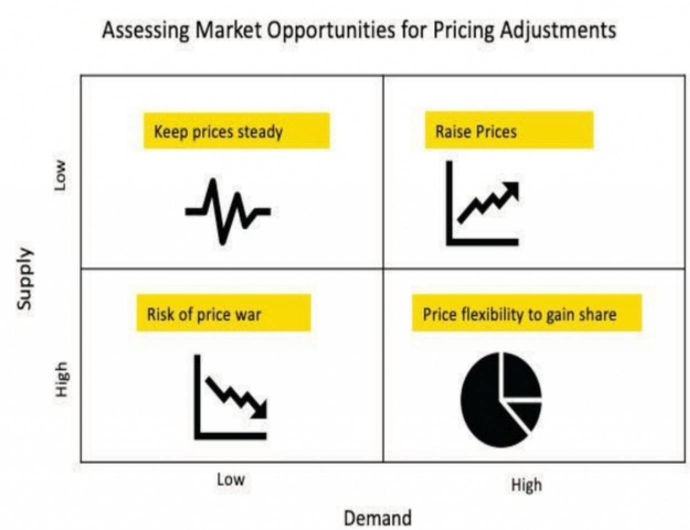

Exhibit 3