The price is right!
The quick guide to profitability

By Ralf Möbus & Joachim Klein

Paper can mostly be considered a commodity where prices are largely determined by market supply and demand. Still there is ample opportunity for paper companies to manage pricing actively in order to improve margins.

In commodities industries prices are determined by supply and demand – very close to the microeconomic theories on price determination.

A commodity is defined as a good for which there is demand but which is supplied without qualitative differentiation across a market. The price is determined as a function of its market as a whole and is transparent to the market participants. Managing cost is key to survival in commodity industries. Assets have to be on the lower end of the cost curve in order to remain competitive. In commodities industries non-competitive capacities are bound to disappear. On the price and margin side it seems as if not much can be done. One might ask if a sales force is needed at all.

Although prices in the paper industry are transparent and "set" they are not as transparent as commodity metal prices that are traded on stock exchanges. While they give an indication, there are many factors that can be influenced and actually managed by sales (and other functions) in order to maximize margins. Success of pricing activities for the paper industry largely dependent on:

- Competitive landscape
- Demand & supply situation
- Pricing control and governance
- Determination and discipline to defend prices or push price increases
- Negotiation and communication skills of sales force
- Sales force incentive systems

The following article outlines these factors and what pulp and paper companies can do to proactively manage their profitability through pricing measures.

Capacity Management

One reason for the constant pressure on sales prices certainly results from the demand and supply situation. In many segments overcapacities exist so that prices are determined by the cost curve of cumulated capacity. In theory the price will be determined on the basis of the cost of the marginal capacity. Capacity (mills) above this price will neither be competitive nor is the capacity required. The result will be closure of this capacity (see figure 1). In practice many capacities are not shut in an attempt to increase their competitiveness and move them further to the left. This will however only shift the problem to the next marginal capacity and will lead to an overall reduced price level as overall capacity is still in excess of demand.

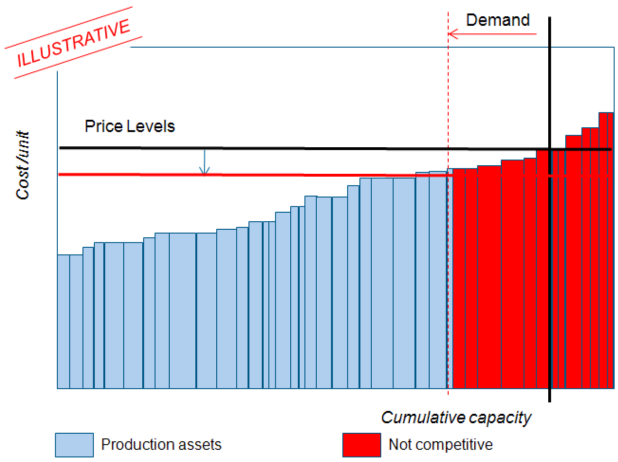

Figure 1: decreasing demand meets excess capacities

On the one side this system to balance supply & demand is the macro-driver for overall industry profitability and needs to be considered in a company's capacity strategy. On the other side, there are many factors within the control of each company which can help to manage profitability.

Lack of best practices

In order to understand what needs to be done to increase profitability sustainably requires a look at current shortfalls. Methodology, tools and processes to manage margins and prices have been available for a long time and have been successfully applied in many other industries. Why does the paper industry have such a hard time implementing it? After all, it doesn't appear to be rocket science but there are explanations why these systems have not been implemented.

One important aspect is missing transparency of profitability on different operational levels. "Is this customer profitable? Does this business unit, sales channel or service model create returns?" – Often these questions are answered on the level of gross margins, which does not provide a view accurate enough to understand margins based on production, distribution and selling costs.

Profitability is also impacted through the practice of price increases. As the increases are widely announced across the industry, differentiation in implementing the hikes at the single customer is mainly based on current price and volume – not necessarily customer profitability. This practice of pricing on the basis of announced prices may lead to a wrong focus and in the worst case might overburden a profitable customer or may not be sufficient for the complexity of services offered to a customer.

Cash flow per customer

However, even if profitability is known, the right reporting structures and incentives are rarely in place. Sales people are often still measured purely on the basis of tons sold. A total profitability view per customer including payment terms, prices, margins, and supply chain costs is not commonly found. The ultimate KPI could be cash flow per customer even allowing for a calculation of a total customer lifetime value.

As sales in the paper industry are still very much volume driven, implementing a price increase on the cost of losing quantity is rather the exception than the norm. The killer-argument used in most cases in favor of volumes is the high fixed costs. Even the automotive industry is learning the hard way. In an interview with the Financial Times on March 8th, 2010 Dieter Zetsche CEO of Daimler said “We certainly have to try to become more flexible as far as volumes are concerned. This means reducing fixed costs.”

Understanding price sensitivity and elasticity

An exemplary calculation of the effect of a 1% price increase on the P&L of a paper maker, versus a 1% decline in volume, shows where the priorities have to be.

Original P&L			**Scenarios**		
			1% price increase	1% volume decrease	1% price increase; 3.25% volume decrease
Sales volume	to	100.000	100.000	99.000	96.750
Price	€/to	600	606	600	606
Revenue	'000 €	60.000	60.600	59.400	58.631
Variable costs	'000 €	40.000	40.000	39.600	38.700
Fixed costs	'000 €	17.000	17.000	17.000	17.000
Result	'000 €	3.000	3.600	2.800	2.931
Margin	**%**	**5,0%**	**5,9%**	**4,7%**	**5,0%**
Margin change	**%**	100%	18,8%	-5,7%	0,0%

Figure 2: margin impact of 1% price increase vs. 1% volume decrease

In the example, the company sells 100.000 tons for a price of 600 € per ton. Variable costs are 400 € per ton while fixed costs add up to 17 million €. The margin in the original P&L is 5,0%.

In the first scenario prices climb up 1% which increases the margin by 18,8% to 5,9%. The second scenario shows the margin sensitivity at a volume decrease of 1%: the margin decreases only to 4,7%, i.e. a decline by -5,7% versus 18,8% increase at the first scenario.

The third scenario combines the sensitivities of a price increase versus a volume decrease. While prices rise, some quantities are lost with customers that are not willing to accept the increase. The break-even point at a 1% price increase is at 3,25% volume loss. This means that the company can roughly lose up to 3% of its volume to push the 1% price increase into the market and still realize a positive impact on its margin.

The price sensitivity and elasticity can be calculated for each market, customer and product. The trade-off and break even between volumes and prices can then be incorporated as an additional corner stone into the pricing strategy and communicated to the sales force accordingly.

Challenging the traditional approach

Often comments like “if we increase the price here, we lose the customer” remain unchallenged. Of course one might ask provocatively “How do you know if you never tried?”. In some cases price increases are even necessary to turn a customer into a profitable one. Losing such a customer due to a targeted price increase to the competition may actually not be a bad choice and will strengthen the P&L.

The example shows, that even if profitability of a customer is known, the appropriate reporting, follow-up and incentive systems have to be in place for the sales force to adapt decision making when it comes to the question volume versus price.

It would be a shortfall to blame unprofitable customers on the sales force alone. Few sales forces today are equipped with the right tools to support them in their daily negotiations. Starting with customer profitability, they are often reduced to “price messengers” who transport the price request of a customer below a certain threshold to their supervisor in order to get a better one. What is often missing is a good understanding and supporting information of the services that the customer requires and values. Having this information on hand, a sales person is able to argue with the customer, be more confident and might capture additional margin points.

Finally, there are organizational and structural topics which turn to obstacles in a company’s quest for profitability.

Structural obstacles

Examples for these structural topics can often be observed as being established in the business culture and organizational structure of a company. Many companies in the sector still have functional responsibilities (Sales, Production, Finance …) with vast powers given to the Sales organization to set prices and define the customer portfolio – often without cross-management review of the customer profitability.

Existing structures are not questioned on a regular basis, even if these structures were introduced decades ago. The decision for a proprietary truck fleet for example might have been an advantage years ago, but may not have been questioned ever since, even if the transportation and service landscape has completely changed – and companies are strongly measured against ROCE.

Another example for structural hindrances might be the power of the sales department which is often able to "protect" or "shield" the customer against internal influences and often tries to avoid transparency. Working capital initiatives, where finance departments struggle to push sales to harmonize (not standardize) payment terms are a good example for this. Sometimes excessive supply chain costs are accepted for complex customer requirements in order to please customers at all cost.

No doubt, the customer has to remain king but only as long as he is profitable in the long term. This key learning is often misunderstood and used to increase prices. However, this may lead to out-pricing in case cost-competitiveness of a company is not given.

It should rather be used to question existing structures for improvement potentials. Identifying such an opportunity, the first question should be: "how can we achieve that in a cost competitive way?" or "how can we get better?"

The Pricing Manager

Of course sales departments know the markets best and have a good sentiment for who the good customers really are. Over-engineering is certainly not required or suggesting that sales people are not doing their job. However, even the best sales people cannot control or know the profitability of each sales transaction and really understand if a customer is profitable if the information basis is not provided. Therefore a concerted approach is required between the different departments in order to obtain the right view on profitability. Same as "Credit Managers" were installed in order to independently manage credit limits and risks of the customer portfolio in the last years it may be the time to install the "Pricing Manager" to monitor and control pricing.

Applying the margin wheel

As stated above, if a company is one of those with competitive cash costs (the cost of production at a site per unit of output), time and efforts spent in further pricing and margin management projects will increase profitability even further.

The approach outlined below comprises two major areas that need to be tackled:

- Processes to manage margins
- Adjustments of the existing organization to support and govern the implemented processes

Especially the second topic represents the classical shortfall of paper companies.

Process improvements are mainly implemented in the respective silo and not established across functional boundaries, i.e. Finance implements for example a new profitability calculation scheme, Logistics increases its service levels and sales is incented on volume achievement.

The StepChange Margin Wheel below demonstrates the elements that need to be covered in order to arrive at a successful pricing and margin management. It does not show the organizational adjustments necessary to sustainably implement the elements.

Figure 3: StepChange Margin Wheel

Both, elements and organizational adjustments are briefly outlined below:

1) Accurate cost visibility

Costing initiatives may fail because they tend to become too complex very quickly. The critical point is to identify the relevant cost blocks, i.e. those that are big enough to make a difference and which are not evenly consumed by the cost units.

In order to do so, there needs to be a thorough understanding on the finance side about how the company serves their customers - in different business units and in different countries.

It is also essential that costs are not taken for granted. They constantly have to be questioned in order to remain competitive. Cost transparency is not a big advantage if costs are generally too high. Organizations have to struggle constantly to "stay in shape" and remain cost competitive.

2) Transparent profitability

The profitability calculation needs to be suited to provide answers to operational and strategic questions, e.g.:

- How profitable is a customer?
- Do we generate a profit with a certain product or with a bundle of products?
- Is a certain sales channel profitable?
- Is our service model for big customer groups in region X still profitable?

It is recommended to take some time to think about the questions a profitability model needs to answer in order to get the scope of the model right. This also provides focus, ensures results and prevents the initiative from getting too complex.

It is already at the design stage of the methodology that Finance, Sales and Supply Chain departments need to work hand in hand to properly identify and allocate cost blocks and ask the right questions.

Once the approach is defined the questionable customers have to be identified and consensus decisions have to be taken about what to do.

3) Segmentation

Segmenting the customer base usually comprises two components:

- What does the customer value?
- What is the customer value to the company (today and tomorrow)?

The profitability model feeds into the second bullet.

The matrix generated by the two categories "customer needs" and "customer profitability" has to be assessed whether customer value can be provided to an acceptable level of profitability.

This exercise should not be limited to single departments. The aim is to set up a broader forum (Sales, Supply Chain, & Production) to discuss customer profitability and to take decision which customers to serve.

4+5) Service offerings and pricing

The service offerings have to be revised based on what the customer segment values. If current service models are not generating sufficient returns, there are three alternatives to pursue:

- Increase efficiency of service delivery or alter service package
- Adjust pricing for service provided
- Drop service offering

One may find out that the current sales force is actually overdesigned and too costly in order to compete with the existing service offerings from other suppliers. A solution could be to restructure the sales channels and differentiate the customer approach according to segment profitability. The ultimate goal is to find an attractive service offering that generates satisfying returns for all segments. If this is not possible, services need to be priced in or segments should not be served.

Definitions of service offerings do not need to be complex but should also not be too simple [traditionally an "A" customer is a BIG one]. A good way to differentiate service offerings is to define service catalogues and levels with potential pricing impacts, e.g. "Standard" service offering, "Silver" & "Gold" services. Here one can borrow from the services industry with "Menu-based" pricing models.

Important at this point is that pricing leakages are identified and that the practice of over-serving or undercharging the client is avoided.

6) Monitoring and incenting

The right governance structure has to be set-up and maintained in order to make each initiative sustainable. The same applies for a margin management initiative. A good governance structure revolves around two tasks:

- Supporting performance
- Monitoring target achievement

Supporting performance starts with providing Sales with useful information that they are able to make informed decisions based on customer profitability.

Sales teams also need to be equipped with the right incentives to trade-off volumes against margin.

This seamlessly links into monitoring target achievement as performance indicators have to be defined in order to assess performance.

In an asset intense industry, it is good practice to monitor volumes, but it needs to be differentiated between volumes and profitability, i.e. volume ≠ profitability.

Conclusion

Few initiatives have succeeded in transforming players of the paper industry into profitable and healthy companies. Certainly the economic environment combined with high net debts for many companies is causing financial distress. Although capacities were curtailed in the North Americas and Western Europe, there are still overcapacities in quite a few markets as new production sites have been launched. All this is negatively impacting margins.

Still, there are opportunities which companies can pursue in order to improve their returns. Implementing the elements of the margin wheel is a mandatory exercise in order to pursue a stringent approach in serving the customer base and improving profitability.

To make this effort sustainable, companies in the sector need to put more emphasis on installing a good governing body across departmental boundaries with respect to pricing. Improving transparency and visibility about customer profitability needs to be a concerted action. Why not install the "Pricing Manager" as a central and independent function to support and monitor pricing?

In addition to potential structural changes the incentive and governance systems should be adapted to support profitability based decision making. The traditional volume focus can thus be overcome.

Sales as "owner" of the customer has to be more transparent to other company functions – in return sales needs to be supported by better information and management tools to be able to navigate company resources towards the common goal of serving the client while maximizing return.

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About StepChange Consulting
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