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# Five ways to ADAPT pricing to inflation

Price adjustments due to inflation call for nuanced approaches that, when done well, can strengthen customer relationships and overall margins.

*This article is a collaborative effort by Alex Abdelnour, Eric Bykowsky, Jesse Nading, Emily Reasor, and Ankit Sood, representing views from McKinsey's Marketing & Sales Practice.*



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**Key takeaways**

- Simply raising prices amid inflation has the potential to hurt customer relationships.
- Opportunity exists to forge a new partnership with customers, helping address their pain points while preserving margins.
- There are five key ways for companies to ADAPT to sales-led pricing while maintaining long-term value.

**As they eye the top of the Omicron peak,** most business leaders are hopeful that the worst impacts of COVID-19 may be subsiding. But as our returning-from-remote economy ramps up, inflation has taken off. The Consumer Price Index rose rose 7.5 percent through January 2022, faster than at any time in the prior 40 years.[1] Companies are grappling with rapidly rising costs that are passed on to their customers. Simply raising prices across the board is an option that, used as a blunt tool, can damage customer relationships, depress sales, and hurt margins. Businesses are caught between the proverbial rock and a hard place; re-pricing in an inflationary environment is necessary to sustain margins in a period of rising costs.

On a more positive note, this can be an opportunity to forge a new partnership with your customers by helping them address their own pain points and cost increases. We see many companies now moving beyond a pricing conversation into a broader discussion that addresses their customers' supply chain and inventory issues, credit challenges, labor shortages, and more. Done the right way, recovering your cost of inflation on a case-by-case basis can strengthen relationships and overall margins.

## How to ADAPT and protect your margins

Here are five ways to help you ADAPT (Adjust, Develop, Accelerate, Plan, and Track) to sales-led pricing for inflation while maintaining long-term value for your business and your customers (exhibit).

**1. Adjust discounting and promotions, and maximize non-price levers**

Price increases are a given in any inflationary environment. But companies that consistently address total customer and product profitability are likely to weather inflationary cycles better than those that focus solely on cost changes, which can limit the size and frequency of their price increases. These companies typically embed a pocket-price-waterfall approach in their pricing and revenue-management strategies. This can help them to accurately assess revenue retrieved from every transaction, limit unnecessary erosion, and maintain a disciplined, value-based margin level. So equipped, companies can maintain margins proactively through inflationary cycles rather than chase the market.

For example, a manufacturing company facing tight supply and productivity constraints had high manufacturing costs for certain low-volume products and experienced higher demand in a short period than they could supply. Instead of raising prices, they lengthened the lead time on all products to enable more efficient production scheduling. For custom products with higher gross but lower contribution margins than stock products, they increased lead times even further. Sales teams were trained to explain the new service levels and encourage customers to opt for more standardized alternatives. The result was an overall increase in productivity that maintained margins without price increases.

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[1] "Consumer Price Index Summary," U.S. Bureau of Labor Statistics, January 12, 2022.

Exhibit

**ADAPT, a sales-led pricing strategy for inflation, is based on five tools.**

**Five ways to ADAPT to sales-led pricing for inflation while maintaining long-term value**

A

**Adjust discounting and promotions, and maximize non-price levers**

Consider an overall reset to discounting and promotions, and revisit service-level agreements.

D

**Develop the art and science of price change**

Don't make across-the-board price changes, rather tailor pricing actions to account for inflation exposure, customer willingness to pay, and product attributes.

A

**Accelerate decision making tenfold**

Establish an inflation council of dedicated cross-functional, inflation-focused decision makers to act nimbly and quickly on customer feedback.

P

**Plan options beyond pricing to reduce costs**

Use value engineering to reimagine your portfolio and provide cost-reducing alternatives to price increases.

T

**Track execution relentlessly**

Create a central supporting team to address revenue leakage and to rigorously manage performance.

Some distribution companies, faced with unprecedented fuel and labor costs in combination with labor shortages, have abandoned a one-size-fits-all approach to servicing customers in favor of surcharges and fees for rushed delivery or less-than-minimum order quantities. Adding surcharges can allow distributors to maintain service levels and prices in the early periods of inflation and only charge for activities that put significant strains on their supply chain.

**2. Develop the art and science of price change**

Customers will react differently to price increases according to how price sensitive they are and how much inflation has affected the cost of the products they buy. Instead of making broad price increases that may erode customer trust and demonstrate insensitivity, companies can tailor their inflationary price increases thoughtfully for each customer and product segment.

Best-in-class companies typically ground their price-increase recommendations in analytics that examine their customers' end-to-end profitability, their willingness to pay relative to a comparable peer set, and the margin performance at a product and service level expected from the price change. For example, retailers may pass on most of their cost increases through secondary and tertiary items that are less price-sensitive for consumers while remaining competitive on key-value items. Retailers have long used personalization tools to tailor promotions to consumers whom they know from their behaviors to be more price-sensitive while passing cost increases to products bought by consumers who can absorb them. B2B companies today have dynamic segmentation tools that can allow them to do the same. Adjusting prices based on customers' willingness to pay and on product differentiation can help companies be thoughtful about their price increases now and beyond inflation.

**3. Accelerate decision making tenfold**

Raising prices as a response to inflation is seldom a one-and-done move. It is full of unintended and unexpected consequences and puts significant pressure on the selling organization. Companies that manage price increases well have a council of dedicated cross-functional decision makers who can act quickly to manage price increases thoughtfully and knowledgeably, approving exceptions and reacting to customer and market feedback. In a B2C setting, the council can test different pricing actions to build a view of consumer responses in real time, track the impact of price changes across the portfolio, and adjust future prices accordingly.

For example, a consumer durables company had not made any price adjustments with its largest customers for a few years for fear of losing volume. Going into 2021, relying only on price increases for small customers was no longer sustainable. Accordingly, the company created a cross-functional council to lead the price-increase effort and ensure customer acceptance. It also developed a pricing approach based on data and supported by market conditions, business reviews, and performance, to communicate the value the company provided to customers. It was able to pass on its largest price increase without damaging its relationships with its customers. More importantly, the company realized that this approach should be sustained to address future cost pressures.

Companies can use data and analytics to track key metrics, monitor prices and customer reactions, and respond efficiently to competitors' moves, increased stock levels, and other dynamic variables. By becoming more conversant with these critical data, companies can test and learn ways to optimize prices.

**4. Plan options beyond pricing to reduce costs**

We see best-in-class companies encourage their sourcing and engineering teams to reimagine products most affected by inflation. The aim is to adjust product design—materials, packaging, or even product features—in response to elevated production and servicing costs while maintaining the functionality customers require.

Companies without the capability to quickly redesign products often rely on category management to reduce costs by adjusting assortments, reducing SKU complexity, sourcing from preferred vendors, and minimizing inventory. From a commercial perspective, we see leading companies identifying product substitutes within their portfolios, often private-label equivalents that can be sold at a lower cost than branded products while maximizing margins and increasing the value delivered to the customer.

**5. Track execution relentlessly**

Value capture must be enabled through relentless execution and performance management. An important key to continuous performance management is providing the newly established inflation council the data and insights it needs to build conviction, enforce price increases, and react to customer feedback. Companies can create a foundational set of leading and lagging indicators linked to analytical models that can forecast margin impact and recommend and guide pricing actions. These can include cost indices, competitor actions on key traffic-generating items, and brief engagement surveys on customer responses to price changes.

Companies that track execution rigorously establish a data infrastructure that allows for a high degree of performance transparency. For companies early in this journey, arming the pricing council with the information it needs is the first step toward establishing a culture of performance that will last well beyond this or the next inflationary cycle.

## Making the changes endure

Embedding sales-led pricing in an organization calls for significant change management. If leadership provides the right role modeling, conviction building, reinforcement mechanisms, and skill building, the aspiration will bear fruit in the form of salesforce understanding, adoption, and support:

*Role modeling—"I see my leaders embrace the change and behaving differently."*

— Announce that pricing and the company's response to inflation will be the year's top priorities.

— Deprioritize conflicting initiatives, and consistently communicate the importance of the effort in town halls and small-group meetings.

— Take role modeling beyond one-way communication and include it in day-to-day interactions with sales leadership and frontline sales.

*Conviction building—"I understand why we're doing this and what's being asked of me, and I can talk about it in a credible way."*

— Give sellers clear pricing guidance for each customer and product category and over-communicate the whys—the cost of products, supply-chain disruptions, operational costs—and how they are impacting the company's bottom line.

— Show that competitors and peers face similar challenges and are likely driving similar efforts.

*Reinforcement mechanisms—"I see that our incentives, processes, and systems support the changes I'm being asked to make."*

— Align commercial team incentives with the new recommendations.

— Establish new processes to communicate pricing recommendations and support customer feedback.

— Upgrade existing systems to quickly reflect granular price changes and implementation at the customer and sales rep level.

*Skill building—"I have the skills, capabilities, and opportunities to make the changes."*

— Invest in the sales organization's capabilities, so that their conversations with customers move from pricing toward value and partnership.

— Create customer-facing sales and promotional material to support and explain the changes, and provide training to sales representatives while arming them with facts, talking points, and FAQs.

— Invest in role playing and "test-and-learns."

For example, a  global industrial company responded to higher supplier and operational costs, labor and freight rate increases, and supply-chain disruptions by raising prices. The increases were the highest in a decade, the sales force was not equipped to help customers substitute less expensive products or drive operational efficiencies to offset the higher costs, and the company had only two weeks to retrain hundreds of reps remotely for an entirely new level of negotiations.

The company's leadership, recognizing the problem, set up a central team to manage the sales team and train them to clearly and confidently articulate the reasons for the price increases, engage in discussions with customers, and partner with them to help in offsetting the cost pressure. As a result, most customers have accepted the price increase, and the value-added services have strengthened the partnership between the sales team and the company's customers. Indeed, sales volume has increased.

## What lies ahead

Inflation is a challenge for commercial leaders, but it also creates opportunities. The first is to maintain margins and rectify the pricing mistakes of the past. The second is to help frontline salespeople move beyond mere pricing discussions with customers to deeper communication about shared business concerns. It is a chance for an enterprise to build the internal infrastructure and processes to make disciplined pricing an engine for future growth and profit. Most important is the investment in building the sales organization's capabilities and pricing acumen.

Companies that do this well will improve their revenues, margins, and customer loyalty and will be equipped to respond more effectively to future shocks, inflationary or otherwise.

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