

# JOE BERRY AWARD 2023

ENTRY – JBA-23-216

**Topic: 4A - Optimizing Retailer Pricing Strategy**

**Presentation #5**

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### **Inflation: A Beleaguered Pricing Manager's Guide**

Inflation crisis. Consumer despair. What strategies are available to a *beleaguered pricing manager* wishing to protect share sustainably?

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High inflation was almost a foreign concept – the current level has not been witnessed in a generation and is expected to persist for another 12-18 months. History indicates inflation is routinely followed by economic slowdown. Accordingly, consumers and retail decision-makers alike face new and complex trade-offs. Consumers are already actively seeking bargains and trading down to cheaper substitutes, reinforced by mortgage pressure, rising energy prices and cost of living concerns. Conventional thinking suggests discounters have a competitive advantage to grow share in a slowing economy. In response, traditional retailers need to invest in smarter pricing strategies. This does not simply mean mere price-down investment, which in isolation, in an environment of rising costs, is profitability dilutive and potentially commercially irresponsible. Rather, to sustainably optimise pricing to protect share, maintain margin, and better curate supplier partnerships, *our beleaguered pricing manager* should adopt five strategies:

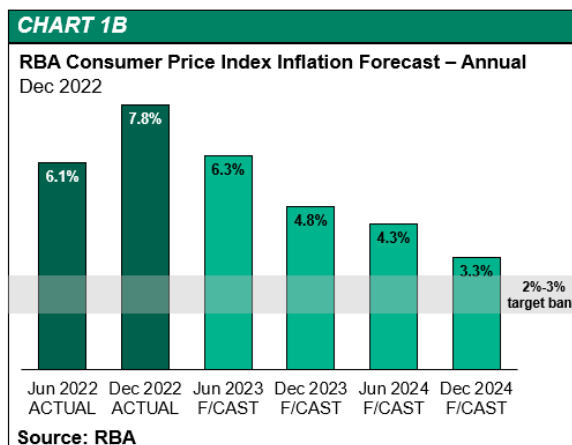
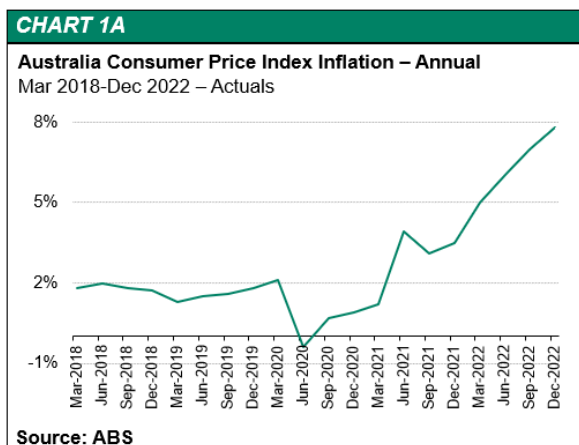
- i) Reassess and personalise price investment;
- ii) Selective pricing by geography;
- iii) Consumer data insights;
- iv) Communicate value and brand;
- v) Combat product costs and vendor management.

This approach can propel the traditional retailer from playing reactionary defence, to instead become an industry benchmark.

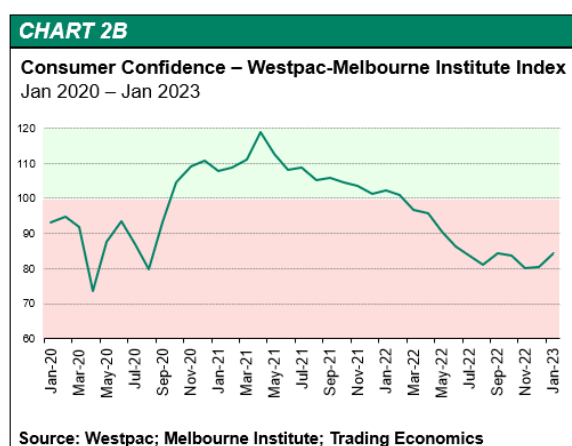
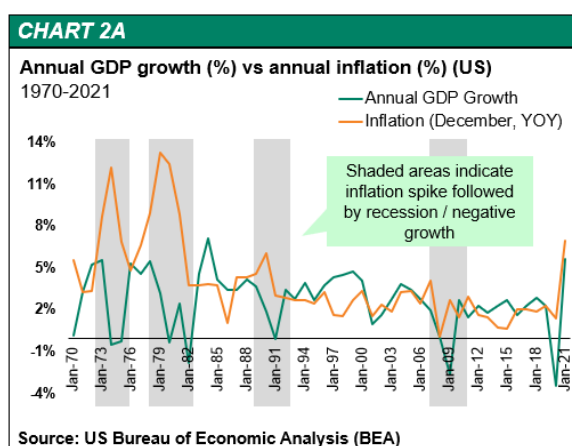
## Inflation, the economy and consumer reaction

### Inflation and the economy

European conflict and energy shortages sparked the global inflation tinderbox of loose fiscal policy, ultra-low interest rates and COVID-19 supply shocks. Australia is not immune. *Chart 1* depicts inflation's rise<sup>121</sup> and expected medium-term persistence.<sup>122</sup>



Historically, high inflation generally precedes economic slowdown. Australia has not experienced an inflation-recession cycle in more than a generation, so alternately, we look to the US example where every major recent inflation period has preceded recession (*Chart 2A*).<sup>123</sup> As of late 2022, in the US, there was already evidence of consumers behaving as if in recession.<sup>124</sup> Relatedly, Australian consumer confidence significantly declined during 2022-23 (*Chart 2B*).<sup>125</sup> Therefore, when 800,000 fixed rate mortgages switch to variable by mid-year<sup>126</sup>, household discretionary expenditure will further recede with up to four more cash-rate rises predicted by Deutsche Bank economist Phil O'Donoghoe (January 2023).<sup>127</sup>



<sup>121</sup> ABS, 'CPI', Dec 2022; <https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/consumer-price-index-australia/>

<sup>122</sup> Reserve Bank of Australia, 'Economic Outlook', Nov 2022; <https://www.rba.gov.au/publications/smp/2022/nov/overview.html>

<sup>123</sup> US Bureau of Economic Analysis (BEA), 'GDP, 2022'; <https://www.bea.gov/data/gdp/gross-domestic-product>

<sup>124</sup> A. Ruvio & F. Morgeson – Michigan University, 'Retailers may see more red after Black Friday as consumers say they plan to pull back on spending', Nov 2022;

<sup>125</sup> Westpac Confidence Index, Jan 2023; <https://tradingeconomics.com/australia/consumer-confidence>

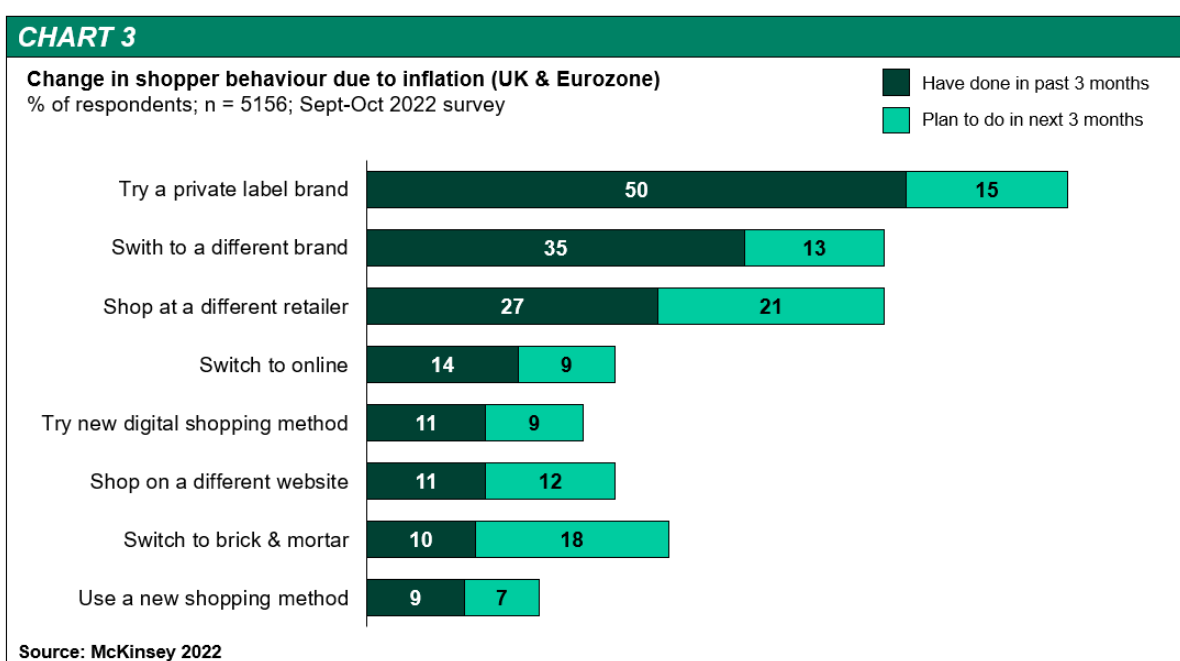
<sup>126</sup> M. Kohler – RBA, Senate Committee Cost of Living, Jan 2023;

<sup>127</sup> Forbes, 'Four More Hikes by August, Jan 2023, '<https://www.forbes.com/advisor/au/personal-finance/interest-rate-news/>

While a slowdown is probable, Australia is insulated from technical recession. There is close to full employment<sup>128</sup> and a moderate growth forecast from the RBA<sup>129</sup> (despite wages lagging inflation). Furthermore, economy-sensitive retail and consumer stocks have rebounded, indicating market positivity.<sup>130</sup>

### Consumer reaction

Media hyperbole and cost of living realities dramatically impact the consumer psyche. In the consumer choice hierarchy, price is likely to be a decisive factor at the expense of convenience and quality.<sup>131</sup> *Chart 3* shows consumers are likely to trade down to cheaper substitutes and private label, and switch channels and brands – with 80% of recently surveyed respondents indicating material behavioural changes in response to inflation.<sup>132</sup>



Prima facie, these conditions play to discounters' inherent strengths. How can traditional retailers respond?

### Five high inflation strategies

#### 1) Reassess and personalise price investment

Consumers are seeking bargains and becoming increasingly price-savvy. *Our beleaguered pricing manager* will need to convince their business to become

<sup>128</sup> ABS, 'Labour Force, Australia', Dec 2022; <https://www.abs.gov.au/statistics/labour/employment-and-unemployment/labour-force-australia/dec-2022>

<sup>129</sup> Reserve Bank of Australia, 'Economic Outlook', Nov 2022; <https://www.rba.gov.au/publications/smp/2022/nov/overview.html>

<sup>130</sup> J. Thomson - AFR, 'Myer, Block and the market's big punt on consumers', Jan 2022; <https://www.afr.com/chanticleer/two-key-lessons-for-investors-as-myer-shares-leap-20230124-p5cf4sv>

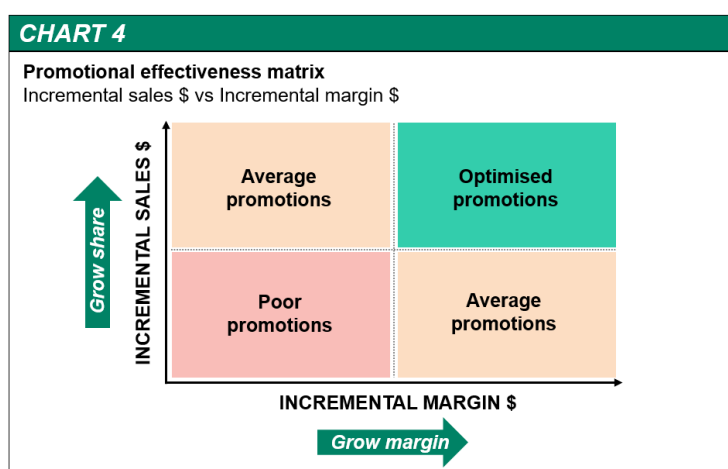
<sup>131</sup> Retail Economics, 'Top 5 strategies for retailers & brands to combat rising inflation & operating costs', 2022; <https://www.retail-economics.co.uk/retail-insights/thought-leadership-reports/top-5-strategies-for-retailers-and-brands-to-combat-rising-inflation-and-operating-costs>

<sup>132</sup> McKinsey & Co, 'How Retailers in Europe can Navigate Rising Inflation', Dec 2022; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation>

smarter with price investment to protect share.<sup>133</sup> For promotions, traditional retailers should:

- *Excite customers* with impactful but selective deep discount promotions on key value products,<sup>134</sup> to differentiate versus everyday low-price (EDLP) discounters (i.e. Aldi);
- *Pull back* on some promotions for products exposed to very high inflation to manage mix and margin as an alternative to blanket price increases<sup>135</sup>;
- Institute an advanced analytics *promotion optimisation engine*;
- *Go granular and personalise* promotions based on willingness-to-pay, utilising the insights and customer proximity of a loyalty program.<sup>136</sup>

Even retailers with pre-existing promotions engines will benefit from *personalising* the decision logic. Price-sensitive customers that regularly shop value products are targeted with the best offers, while the engine biases toward margin accretive products for premium shoppers.<sup>137</sup> Accompanying loyalty programs further reinforce this outcome. Sending specific customers tailored loyalty offers at the critical moments that matter, when they are most at risk of switching their spending behaviour, will greatly protect share. Woolworths has recently succeeded with this approach via Everyday Rewards points boosters. These offers bolster promotional effectiveness by growing the number of optimised promotions that drive price perception, share and margin (Chart 4).



Retailers may also consider strengthening customer trust in price via EDLP investments. Coles and Woolworths have introduced new 'price-locked' tickets to demonstrate value by holding a price steady.<sup>138</sup> Incentive tactics like this, or staggering inflation-driven price increases over time to soften their impact, are useful. Where financial constraints allow, selectively dropping shelf prices on some key price

<sup>133</sup> Bain, 'How Retailers Can Rediscover the Skill of Taming Inflation', May 2022; <https://www.bain.com/insights/how-retailers-can-rediscover-the-skill-of-taming-inflation/>

<sup>134</sup> McKinsey, 'How Retailers and Shoppers are Weathering Holiday Inflation', Nov 2022; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-and-shoppers-are-weathering-holiday-inflation/>

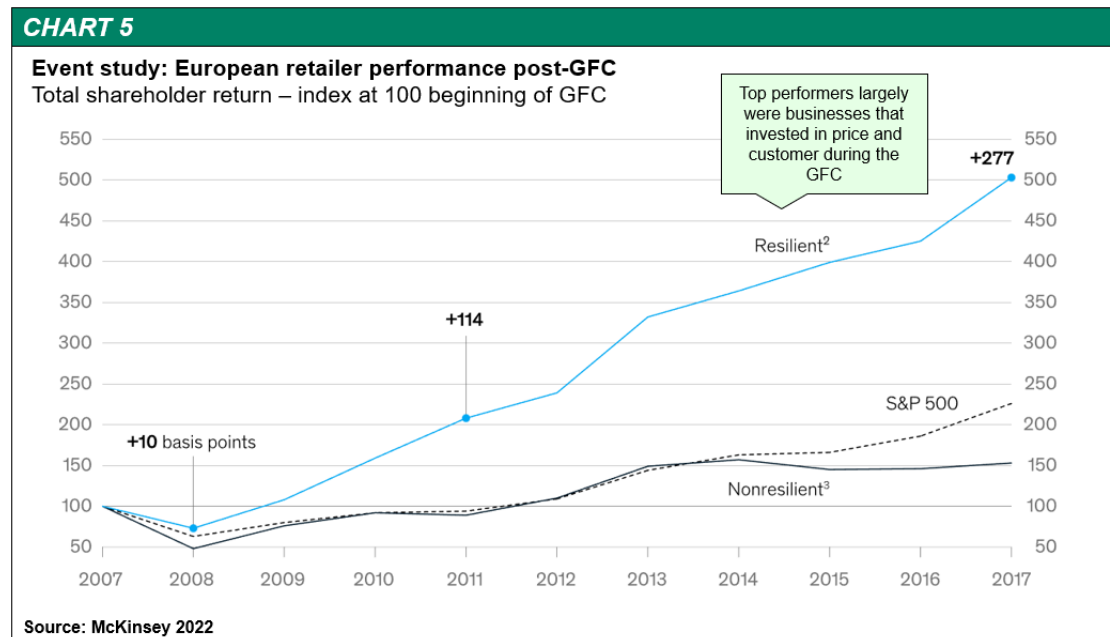
<sup>135</sup> Ibid, as above

<sup>136</sup> McKinsey, 'Navigating Inflation in Retail: Six Actions for Retailers', Jun 2022; <https://www.mckinsey.com/industries/retail/our-insights/navigating-inflation-in-retail-six-actions-for-retailers>

<sup>137</sup> Bain & Co, 'How Retailers Can Re-Discover the Skill of Taming Inflation', 2022, <https://www.bain.com/insights/how-retailers-can-rediscover-the-skill-of-taming-inflation/>

<sup>138</sup> E. Koehn – Sydney Morning Herald, 'Supermarkets Embrace Price Locks But How Long Will They Last', Oct 5 2022

perception forming products is central to defence against discounters. As per *Chart 5*, McKinsey analysed retailers post the GFC economic downturn, and those that invested in price, market share, and growth, outperformed competitors.<sup>139</sup>



Whether via high-low promotions, loyalty offers, and/or EDLP, a heightened value focus during economic downturn is crucial to defending share. However, investment must consider margin and retailers should seek supplier funding. Competitor responses should also be modelled to prevent price wars, particularly if exposed to competitor lowest price guarantees like Dan Murphy's or Bunnings.<sup>140</sup>

### II) Selective pricing by geography

Increasing prices is inevitable during high inflation periods. Doing so selectively, with surgical precision, optimises the price perception and margin trade-off.<sup>141</sup> To become selective retailers can either i) pause price increases on some key lines; or ii) localise price by geography.

Method one, holding back increases on key lines is straight-forward, and impactful to protecting price perception, but also vastly margin dilutive. Method two is a more surgical strategy, selectively adjusting prices by geography in line with customer willingness-to-pay. This is superior to simple, 'blunt' national price increases.

In December 2022, McKinsey described how despite an overall drop in spending in Australia, different consumers responded differently to inflation, especially amongst less price-sensitive consumers insulated from financial stress.<sup>142</sup> Retailers need to

<sup>139</sup> McKinsey & Co, 'How Retailers in Europe can Navigate Rising Inflation', Dec 2022; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation>

<sup>140</sup> BCG, 'Crisis Pricing for the Downturn and After', Sep 2009; <https://www.bcg.com/publications/2009/crisis-pricing-for-the-downturn-and-after>

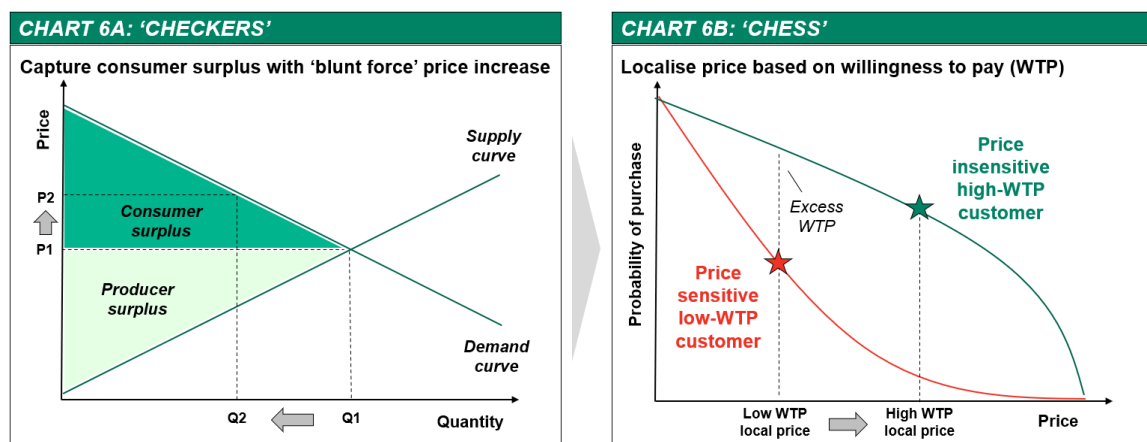
<sup>141</sup> McKinsey, 'How Retailers and Shoppers are Weathering Holiday Inflation', Nov 2022; <https://www.bain.com/insights/how-retailers-shoppers-weathering-holiday-inflation/>

<sup>142</sup> McKinsey, 'Uneven Impacts: Australian Consumers and Inflation', Dec 2022, <https://www.mckinsey.com/industries/consumer-packaged-goods/our-insights/uneven-impacts-australian-consumers-and-inflation>

nuance pricing for this non-homogenous consumer response. So, how does *our beleaguered pricing manager* nuance price by geography as a proxy for customer willingness-to-pay?

An effective approach involves lowering prices in lower affluence areas (informed by census household income data) and/or areas with a higher concentration of nearby competitors. Conversely, higher affluence geographies with lower densities of competitors are more likely to have higher prices. This works for retailers holding large store networks with local rather than broad catchment areas. Extending further, sophisticated, technology-enabled retailers could institute localised pricing with store-level elasticity informed regression modelling.

The localised approach is demonstrated below. *Chart 6A ('Checkers')*, is reminiscent of Economics-101 – price changes with one market price. *Chart 6B ('Chess')* depicts various price points according to different willingness-to-pay,<sup>143</sup> enabling investment or holding back increases for specific price-sensitive geographies.



Localised price does not suit all retailers. Supermarkets actively chose State-based and national prices to build customer trust. However, convenience and specialty retailers have greater permission to implement a localised strategy. McDonalds is one consumer business successfully adopting this approach in Australia. Nevertheless, these retailers should exempt breaking national prices on hero products with price points known well to customers.

### III) Consumer data insights

*“The retailers best placed to thrive during this period of surging prices are customer-obsessed, driven by data in their decisions” – Bain<sup>144</sup>*

Whether by enhancing and personalising promotions (*Section I*), or localising price changes (*Section II*), retailers need to boost pricing smarts in this environment. These ‘smarts’ are enabled by getting closer to the customer, specifically, deconstructing willingness-to-pay between segments.<sup>145</sup> Knowing which products impact price

<sup>143</sup> T. Stobierski – Harvard Business School, ‘Willingness to Pay: What it is and how to Calculate it’, Oct 2020; <https://online.hbs.edu/blog/post/willingness-to-pay>

<sup>144</sup> Bain & Co, ‘How Retailers Can Re-Discover the Skill of Taming Inflation’, May 2022, <https://www.bain.com/insights/how-retailers-can-rediscover-the-skill-of-taming-inflation/>

<sup>145</sup> Ibid, as above

perception is vital to knowing where to invest in defence against discounters. Maximising uplift from personalised and localised promotions requires intimate knowledge of shopper behaviour and mission.

Acquiring this knowledge generally requires some lead time and investment into loyalty programs, advanced analytics, and tracking customer transaction data along the ecosystem. Businesses experiencing high inflation that have not made these investments will be inhibited. Regardless, all retailers will benefit from refreshing their understanding of consumer decision-making, including the role of price, via choice-modelling insights research.<sup>146</sup> At the least, retailers should boost tracking customer price perception and price indexing versus competitors.

#### IV) Communicate value and brand

*Our beleaguered pricing manager's* best friend is the marketing manager. Value messaging is difficult in this climate, albeit essential, along with reminding customers why they love your brand.<sup>147</sup> Unilever CEO Alan Jope contends advertising spend must be maintained if inflation is threatening brand health.<sup>148</sup> For example, in this high inflation period, Lidl Switzerland launched its 'typical Lidl campaign' to educate customers on value versus competitors.<sup>149</sup> Communicating value can also extend beyond price, and can be informed by quality, service, and experience.

Category, marketing, and pricing teams should tailor the trade plan to underline value messaging. Bargain-seeking consumers are swayed by meaningful price offers even if on just a select few hero products – especially true when activated well, in-store and online, and when supplemented with strong advertising campaigns.<sup>150</sup> Collaborative, like-minded suppliers also choosing to invest in their brands despite inflation should be prioritised in these activations.

#### V) Combat product costs and vendor management

The strategies proposed above suggest investing in promotions and advertising while exercising caution with blanket price increases. So, how will this investment be funded? A business-wide cost campaign is advisable – and *our beleaguered pricing manager* should increase attention on combatting supplier product cost increases.

As customer agents, retailers should direct significant resources at a cost-of-goods-sold (COGS) program to deliver savings that can be reinvested into price. McKinsey

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<sup>146</sup> Ibid, as above

<sup>147</sup> Retail Leader, 'How are Consumers Responding to Inflation', Sep 2022; <https://retailleader.com/how-are-consumers-responding-inflation>

<sup>148</sup> Raconteur, 'Inflation Forces Brand to Rethink Advertising Spend', Mar 2022; <https://www.raconteur.net/marketing-sales/inflation-brands-rethink-ad-spending/>

<sup>149</sup> McKinsey & Co, 'How Retailers in Europe can Navigate Rising Inflation', Dec 2022; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation>

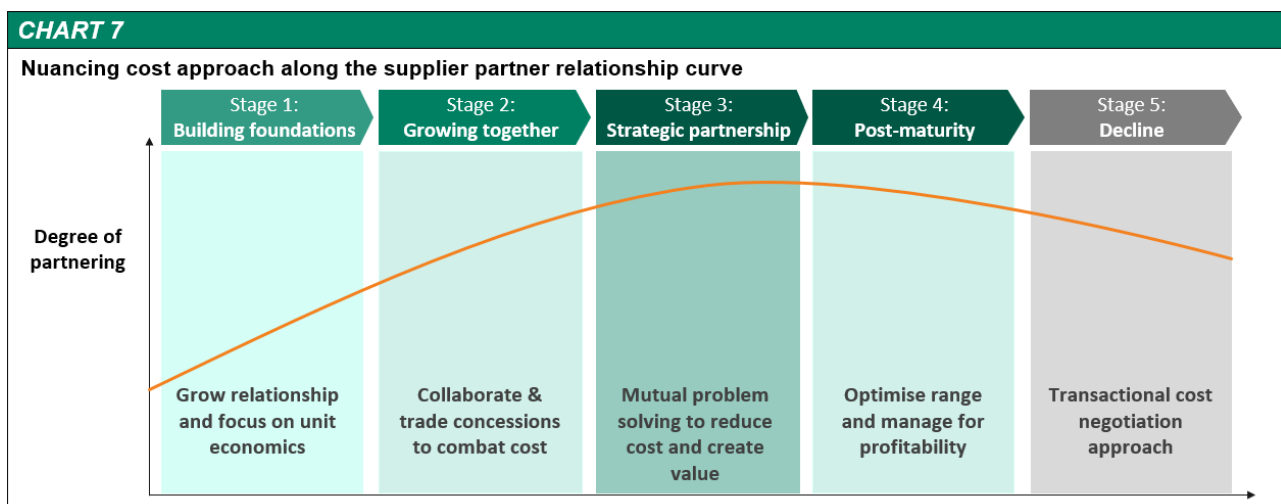
<sup>150</sup> McKinsey, 'How Retailers Can Improve Price Perception – Profitably', Nov 2016; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-can-improve-price-perception-profitably>



contends, “by understanding the impact of increases for raw materials on actual cost, companies can have fact-based discussions with suppliers,”<sup>151</sup> which in conjunction with negotiation strategies, can yield material COGS savings. Specific techniques to identify product cost opportunities for supplier discussions include:

- *Scrutinising new cost increases* and negotiating those not justified by commodity and supply chain cost movements;
- Identifying *historical* cost increases that *exceeded commodity cost* movements;
- Identifying *supplier portfolios* that are higher cost or *lower profit* than category peer benchmarks;
- *Trading growth and ranging* outcomes with suppliers for *better costs*;
- Identifying *mutual savings* with suppliers including collaboration on raw material strategic sourcing, supply chain optimisation and product re-formulation.<sup>152</sup>

Successful COGS programs adjust the approach according to supplier relationships<sup>153</sup> (see *Chart 7* next page). For strategic partners, the interaction becomes a joint problem resolution exercise, seeking savings for both businesses. Furthermore, agreeing range and distribution extension with partner suppliers can aid economies of scale, which in turn should be invested into lower retail prices. With more transactional suppliers, COGS discussions should involve firmer negotiation and potentially range rationalisation. Any range change should favour private label and entry price point value products.



Supplier cost discussions are challenging, and leaders should be intimately involved to provide direction. While some suppliers will share in the benefits, retailers need to ensure they act conscientiously and balance priorities with reputational risk, particularly with vulnerable suppliers, a balance Coles CEO Steven Cain recently explained:

<sup>151</sup> McKinsey & Co, 'How Retailers in Europe can Navigate Rising Inflation', Dec 2022; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation>

<sup>152</sup> McKinsey & Co, 'How Retailers in Europe can Navigate Rising Inflation', Dec 2022; <https://www.mckinsey.com/industries/retail/our-insights/how-retailers-in-europe-can-navigate-rising-inflation>

<sup>153</sup> S. Gates, 'The Negotiation Book: Your Definitive Guide to Successful Negotiating', 2016

*“We have to look after suppliers – some are doing it tough – and we have to look after our customer[s]... and there’s shareholders to consider.”<sup>154</sup>*

### **Conclusion – Sustainably maintaining a three-way-win.**

Successfully defending share against discounters, during peak inflation, without haemorrhaging profitability, is complex. The five key strategies discussed, strike a balance by: i) investing in price to win with customers; ii) acting selectively to protect margin; and iii) fighting cost and partnering with the right suppliers. This balance enables a three-way customer-retailer-supplier win, ensuring the approach is sustainable.

What is required in conjunction, is a committed and collaborative cross-functional effort. Senior leaders must invest time and establish a price and cost management office. As pivotal customer-retailer-supplier conduits, category managers need to believe in and co-create the pricing response. Furthermore, category, marketing, and operations teams must collaborate on customer value campaigns. Collaboration extends further to partnering with suppliers who share a growth and customer-focused cost optimisation mindset.

At this juncture, convincing business decision-makers to invest in the pricing program, as outlined, will transform our pricing manager from *beleaguered* to *triumphant*. A customer-first pricing mindset, that is cognisant of the financial and supplier trade-offs, is the most sustainable defence against discounters amidst high inflation.

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<sup>154</sup> S. Mitchell – AFR, ‘Food Retailers Need to Tread Carefully as Prices Soar’, Nov 2022; <https://www.afr.com/companies/retail/food-retailers-need-to-tread-carefully-as-prices-soar-20221109-p5bwrp>