

CHAPTER 1

What You Need To Know About Inflation

We now live in an environment of ugly inflation and a looming recession. Rising costs, persistent shortages, and pricing that is often behind the curve pose a whole new challenge to business leaders, most of whom have never managed through a period like this.

It is your job as a leader to steer the company through inflation, whether or not you have practice at it. That means fully understanding how inflation touches every part of the business and enlisting the help of others in the company to combat it. Hunkering down until the Federal Reserve fixes things is not a viable plan.

Think of the economic shift as a chance to reset the business, and learn from other leaders who are showing a realistic, actionable path to thrive in the new economic context. Some business leaders have moved swiftly, even

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preemptively, to stem potential damage to the business from shrinking margins, shaky volume, and cash shortages. Some saw inflation coming and raised prices early on, sometimes by as much as 20%. Chanel raised prices on some of its luxury goods three times in 2021.

The early movers are taking steps to weather the current economic conditions and, more than that, strengthening the business for what will unfold on the other side of inflation and recession some three or four years down the road. They are showing tremendous optimism in accepting the new realities and rethinking the basics of their business—from its compensation plan and pricing strategy to its mix of customers and business model.

This book lays out the hazards of inflation and how to avoid them so your company will survive this difficult time. It will help you build your confidence to act decisively despite the unknowns by showing how other leaders are stemming the damage and resetting their businesses for a brighter future. It will help you see inflation's impact through a wider lens and give you specific tools for dealing with it, including simple things like bringing people together from across the organization to address the challenges the new economic context presents. All of those tools and approaches will prepare you to contend with recession or stagflation if and when they come.

THE UNIVERSAL TRUTHS ABOUT INFLATION

You don't need charts and graphs to know that costs have been rising. But there's more to know about how inflation affects a business. You need to understand what inflation does to a company, an industry, and the economy as whole.

Here are some important facts about inflation that may not be obvious until it is too late:

1. **Inflation consumes cash.** Cash gets trapped in inventories and accounts receivable for the same unit volume. Growth gobbles up even more cash.
2. **Price increases roll through the value chain to the end consumer like a freight train, disrupting the economics and power balance of players along the way.** At some point, consumers will push back and demand drops.
3. **Aggregate measures like the Consumer Price Index don't tell you much about how inflation will affect your company.** Microsegmentation across your business and the supply chain is essential.
4. **The effects of inflation are cumulative.** A 7% inflation rate may be manageable for one year but a rate even close to that compounded over several years could ravage the business.

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5. **Inflation trends are partly psychological.** When people expect continual price increases, they hoard goods, creating even more demand and exacerbating the imbalance. This pattern can lead to hyper-inflation.
6. **Inflation can turn well-planned capital expenditures into bad investments.** Earlier decisions were likely based on assumptions that are no longer valid.
7. **Sacrificing customer trust to protect the business from higher costs has long-term consequences.** It is hard to restore a brand once it is tarnished.
8. **Inflation reorders competition.** It is an opportunity for businesses that can sustain in the near term and strengthen their position for future growth.

These truths show why many business leaders need a broader and more urgent response to inflation than they have undertaken thus far. They should help you appreciate that the kind of cost cutting many companies have been doing to struggle through the immediate hardships will not get them through a sustained period of inflation above, say, 7%, let alone a spurt of hyper-inflation, recession, or stagflation.

THE BRIGHT SIDE OF INFLATION

The current disruption to your company may make it hard to appreciate the eighth universal truth about inflation: it creates opportunities to improve your competitive position. But dealing with inflation's negative impact on the business will reveal a silver lining.

For one thing, some of the excesses that were tolerated in a zero-cost-of-capital environment will be squeezed out. The business will sharpen its focus and cultivate a stronger set of customers. You'll find ways to improve productivity and cut costs through more automation, or use technology to serve customers better with less cash usage. You may be a smaller company in the interim, but the cash you conserve or withdraw from projects that are no longer winners can be used to create new products, or even a new industry.

Look four years down the road and prepare to take advantage of the post-inflation world. The economy will have changed, and your industry and business model might well have changed too. New companies may have entered your space, because technological advancement doesn't stop. What will make you better prepared?

The company's response to inflation will be a differentiator, along the lines of ESG. Inflation will hurt those who can't manage their cash right, because the demand for cash—and

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therefore any shortage—is compounding. That creates an opportunity for you to lead an industry consolidation or to acquire critical talent, technology, or patents.

Your psychology will make a difference. Play offense. Take inflation seriously, adapt faster, and bring the rest of the organization with you.

WHY EVERYONE NEEDS TO KNOW ABOUT INFLATION

The most common effect of inflation is rising costs, something your company is probably already experiencing. In an effort to protect margins, it's tempting for a CEO to turn to the people who manage the supply chain. Ram's recent visit with a large consumer-goods company is a case in point. When the cost of raw materials started to increase sharply in early 2022, the CEO called a meeting to discuss the problem. He assumed his usual hands-off management style: he delegated the task of recouping those increased costs to the supply chain.

Left on their own, there was only so much those people could do. Other business functions didn't sense any urgency to consider their role in combatting inflation. For people in sales and marketing, for example, it was basically business as usual, with little adjustment in pricing or the number of SKUs (stock keeping units).

What that company and many others are missing is that inflation affects nearly every part of the business. That's why the entire organization must confront it. Why do sales and marketing have to be involved? Because inflation consumes cash. Every unit sold ties up more cash in inventory. If customers extend their payments, as they may have already started to do, accounts receivable will consume more cash too.

Meanwhile, if the sales force is reluctant to increase prices, or to increase them enough, margins and cash suffer. It may be uncomfortable for those on the front line, and even for the CEO, who wonders what will happen if they increase prices. Will competitors follow? Will customers be upset and market share crumble?

A study of 344 U.S. CEOs of industrial businesses by consulting firm Simon-Kucher & Partners found that as of March 2022, one-third of those businesses had not made any price increases for inflation. Price increases that lag behind cost increases cause margins to contract and, worse, can lead to insolvency.

Finance has to be involved to manage cash and, along with HR, to revise performance metrics. In this new economic environment, the usual performance metrics can become downright dangerous—that is, compensation incentives that push for revenue growth and market-share gains without consideration of cash consumption can bring the company to the brink. Growth projections and payback periods can be

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deeply distorted as well, particularly if the gap between your cost increases and pricing is not properly addressed.

Leaders have to change their priorities. Many have been in hot pursuit of revenue growth and market-share gains throughout their career. Now they may need an abrupt shift to become a smaller, financially sturdy business. They have to focus on the balance sheet, especially cash, and get the entire organization on the same page. Communication with employees is critical, as is keeping investors informed.

FROM CONFUSION TO CONTROL

We can all agree that the era of near-zero interest rates and ultra-low inflation is far behind us. Some saw the change coming sooner than others and took action accordingly. But spikes in energy and food costs from the Russo-Ukrainian War, along with prolonged shortages in supplies from COVID-19 and extended Chinese shutdowns, have created their own kind of chaos. Many leaders are feeling unprepared. Their confidence has been nicked.

This is a time to play offense, to lead with discipline, and move proactively. Every delayed price increase has an enduring impact on the business. Every day that cash is not collected from delinquent customers is a step closer to financial distress. In high inflation, timing clearly matters.

The shift from low to high inflation calls on you to learn some new management tools to deal with it. This book is organized to provide them. It describes best practices of companies that have been adapting quickly to the new environment with the specificity that makes those practices replicable. You will learn to read the **early warning signs** of economic shifts, so you can be preemptive versus reactive; manage for **cash**, avoiding cash traps and ensuring liquidity; be smart on **pricing**, knowing what approach to use where and its timing; evaluate the **value chain** for opportunities to protect cash and margins; and use inflation as a chance to reset the **business model**. The final chapter walks you through specific issues **each business function** should address.

Along the way, it will show how leaders have converted from a “grow grow grow!” mentality to one focused on a smaller, higher quality company; reined in costly programs without sacrificing the future; managed talent in a rising-wage environment; and kept ecosystem and customer relationships intact.

The economy is nowhere near settled, and no one can see into the future, but decisions must be made and resources committed on a daily basis. This is a call for leaders to step up to the new game.