BUSINESS GUIDE

8 Actions to Manage Inflation

Expert-Backed Strategies for Proactive CFOs

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As consumer prices and global energy costs edge ever higher, it's become clear that this bout of inflation isn't transitory. Economists and business leaders alike agree that supply-chain-driven hikes will persist through the majority of this year at least, with stickier increases around labor possibly becoming permanent.

Still, businesses can take action to bolster their financial health. We've assembled eight steps for leaders looking to not only weather this inflation surge, but set themselves up for success in the new normal of costs.

Our Sources
For this business guide, we spoke with:

Chelsie Kugler, VP of business development at CFOshare, a management consulting firm. Based in Denver, CFOshare provides accounting, financial planning and analysis services to small businesses.

Jesse Morris, executive VP, CFO and COO at Main Street Capital, a principal investment firm. Based in Houston, Main Street Capital provides long-term debt and equity capital to lower middle market companies and debt capital to middle market companies.

Tuan Nguyen, Ph.D., who serves as the United States economist for RSM US LLP, the US member of RSM International, a global network of independent audit, tax and consulting firms. In his role, Nguyen focuses on the US and global economies and the growth of the American middle market.

1. Update Your FP&A Process and Cash Flow Projections With a Focus on Nimbleness.

Inflation tends to be volatile by nature. Your business needs to be just as agile.

"Both short-term and long-term business plans should be able to adapt quickly to significant changes in inflation and at the same time, the Federal Reserve's course of action," said Tuan Nguyen, Ph.D., US economist for RSM. "In a time of great uncertainty, planning flexibility will help companies react quickly to any possible economic outcomes while staying ahead of the competition."

To react both quickly and appropriately to new conditions, Chelsie Kugler, vice president of business development at CFOshare, recommends using your financial forecast to run "what-if" scenarios to test various potential impacts of inflation, such as:

- Wages increase for key positions by 15%.
- The price doubles for certain raw materials.
- Supply chain disruptions cause 25% or greater revenue delays and inventory build-ups.

To reap the benefits of forecasting each what-if scenario, Kugler advises answering the following tactical questions:

- How will cash flow be affected in each scenario?
- What evasive maneuvers can we take in each scenario?
- Can we lower risk now with preventative measures?
- What leading indicators can we watch that predict these scenarios?

By planning for a range of potential impacts, businesses can proactively drive toward desired outcomes. Identify the current trends that impact your sector, just as you did when your business was doing FP&A as a startup. Disruptive forces are not equally impactful for all businesses. For example, in the pandemic, many sectors saw increased sales.

It's also time to revisit longer-term scenario planning exercises, especially if the last time you updated was during the pandemic's peak.

Learn More

Creating a financial plan in isolation from other parts of the business is no way to operate in periods of disruption. Smart companies now use **extended planning and analysis (xP&A)** methods to extend FP&A practices and tools beyond finance to the larger organization. Learn more about xP&A.

The pandemic magnified the value of **scenario planning**. Inflation and a possible recession further highlight the need to assert control over an uncertain world by identifying assumptions about the future and determining how your organization will respond. Learn more about scenario planning.

2. Diversify Supply Chains to the Extent Possible, Even If It Raises Costs in the Short Term.

Given the current climate, inflation-proofing a supply chain is impossible, but mitigation steps are still wise. That's true even if you introduced some supply chain sustainability measures over the past two years.

"Supply chain issues are not only widespread in the US but also across the world due to pandemic-related disruptions," said Nguyen, who admits there is no easy solution to deal with a shock of that magnitude followed by global inflation and uncertainty.

Still, he reiterates what many companies learned the hard way: A lean and cost-effective supply chain is more vulnerable to economic shocks.

"Despite trade-offs, sustainability often wins in the long run," he said.

Investments in supply chain sustainability and resilience can take multiple forms. Vendor diversification, domestic alternatives and keeping more critical materials on hand can all help businesses sustain production. Some steps, like stockpiling items that are hypersensitive to inflation, will help ease the effects of rising prices.

Other moves are more about being able to get customers what they want, when they want it, even if that's at a higher cost. Moving to domestic vendors or splitting orders among multiple sellers rather than choosing the lowest cost source will contribute to margin erosion just like inflation does, so experts advise also testing the price increase waters. Getting this right is a balancing act, so consider supply chain stress tests to better prepare for supply-induced inflation, and refer back to strengthening measures you may have considered a year ago.

Strengthening the Supply Chain: 6 Keys

Here are top areas to address for supply chain resilience:

Sourcing materials: Strengthen relationships with current suppliers so you get preference if there is a disruption. Audit important suppliers to make sure they have adequate scale, geographic redundancy and downstream relationships. Add alternates where needed.

Demand planning: Understand how not receiving materials from a given supplier will affect production, especially of top-performing SKUs.

Manufacturing downtime: How could you meet demand when production teams and/or facilities are not operating at full capacity or face an unforeseen increase in orders? If the answer is "subcontractors or temp workers," make sure agencies are lined up and preapproved.

Warehousing: Consider also having a third-party logistics (3PL) provider on call in case a warehouse becomes unusable or you need to increase production to meet surging demand.

Inventory management: Complete visibility into current inventory, including both finished and unfinished goods, is critical to making informed decisions.

Customer service: When orders are delayed or can't be fulfilled due to a supply chain disruption, you need a clear line of communication with customers. Use crisis management best practices to explain what's causing the disruption and what you're doing to resolve the situation.

Those facing significant supply chain disruptions and cost pressure can take resilience a step further through vertical integration.

“A good solution is to take the matter into the companies’ own hands by looking for opportunities to expand control vertically through investments, partnerships or even M&A,” said Nguyen, adding that vertical partnerships are particularly useful for small and midsize companies, which lack the clout of larger competitors.

Whatever the method, establishing stronger relationships with key suppliers is the goal right now. Longer contracts, careful investments and a willingness to be flexible can all help smooth over inflationary spikes.

Learn More

Supply chain leaders are constantly seeking an edge — they know that even a modest technical or process improvement can pay huge competitive and cost-saving dividends. Learn more about 22 top supply chain metrics and KPIs to track.

Managing the supply chain only becomes more complicated as you surpass $10 million in annual revenue. There are certain areas leaders need to pay closer attention to as their operations grow. Learn more in our Project $50M series.

3. Spend in the Right Areas — That Is, Those That Feed Your Success.

Bain & Company analyzed the performance of 5,700 global companies in previous inflationary periods. In that research, the firm found that those that worked hard to make smart, judicious cost cuts — defined as ones that didn't impact the company's profitability — achieved higher total shareholder returns than companies that didn't do that analysis.

But what are the "right" cuts? Interestingly, they're ones that also often work in recessionary times.

In their book, "Cut Costs and Grow Stronger: A Strategic Approach to What to Cut and What to Keep," authors Shumeet Banerji, Paul Leinwand and Cesare Mainardi tackled the issue of reducing costs without risking performance through a concept called "capabilities-driven cost reduction."

10 Dos and Don'ts of Cost Cutting

Do	Don't
Address operational inefficiency. There may be redundant positions or processes that can be eliminated or restructured for significant cost savings.	Cut strong talent. Good, committed staff are hard to find, and even harder to train.
Consider cutting initiatives that are not a core function of your business or are underperforming. Profitability comes to the front of the queue.	Cut marketing completely. Consider guerilla social marketing and other inexpensive brand-awareness drivers popular with startups.
Consider taking payments off autopay to better control payment timing. Cancel underutilized subscriptions.	Cut technology that helps your team work remotely. Again, there are very affordable collaboration tool options.
Think about the future. Will you need as much real estate? Will some systems be rendered unnecessary?	Overlook the small stuff: office supplies, snacks, furniture and that fancy coffee machine stack up in cost.
Be transparent with employees if pay or benefits need to be temporarily cut.	Cut areas generating positive cash flow, like sales, SEO or digital ad spend.

In this framework, companies first identify their key capabilities. As defined by the authors, these are "the interconnected people, knowledge, systems, tools, and processes that establish a company's right to win in a given industry or business." Capabilities are a select few strengths, usually around two to five, that give you a clear advantage in reaching and serving the customers you care about most.

Broad, untargeted cuts could impede growth and usually prove to be unsustainable.

Companies then need to sort through activities to ensure their spending is aligned to nurture these capabilities. This process is typically based on three questions:

- What do I need to keep the lights on? For example, sales, general and administrative expenses.
- Where am I spending that will make a difference over time in terms of winning in the market?
- How do I keep the rest as lean as possible?

As an example, Frito-Lay in the early 1990s faced decreasing sales due to an encroaching competitor. Business leaders identified a key capability: an innovative approach to direct-store delivery that would allow the company to consistently deliver the right products to the right stores at the right time by equipping their delivery truck drivers with hand-held computers, a novel concept at the time.

The CEO went big, cutting $100 million — 40% — of general and administrative costs, simplifying Frito-Lay's management and practices. That freed up money to invest in its chosen capabilities around direct-store delivery as well as product and manufacturing innovation and consumer marketing.

4 Quick Wins in Cutting Costs

1. Renegotiate outdated contracts.
2. Eliminate free shipping, and up the cost of expedited delivery.
3. Maximize spend on existing contracts whose prices aren't indexed for inflation.
4. Remove or reduce discounts and promotions.

Plus: 5 Unexpected (and Painless) Ways to Cut Expenses

To effectively triage, consider adopting a version of zero-based budgeting, where expenses are justified one by one and budget owners must show how spending is aligned to strategy. This approach carries the risk of getting bogged down in the sheer amount of financial data, which makes it critical for businesses to move on from manually maintained spreadsheets.

Learn More

Following expense management best practices — the process and technologies involved in reimbursing workers for travel, hotels, meals, entertainment and other out-of-pocket expenses — is a big deal when looking to cut spending. Learn six expense management best practices.

Deciding whether to make a new investment to feed growth? **A break-even analysis** will provide fodder for considerations such as price and cost adjustments. Learn how to run a break-even analysis.

4. Get Strategic About Pricing.

Inflation directly adds to the operational costs of a business, so it should be easy to justify raising prices, right?

Maybe. Price hikes can forestall some of those cost cuts, but you run the risk of losing customers who don't see enough value in your product or service to justify paying more.

Ultimately, companies need to consider their larger market and what competitors are doing, not just inflation.

"Small and midsize companies — often without dominant market shares — do not always have the leverage to influence overall market prices," said Nguyen. "That is when data on demand and market structure, as well as upstream and downstream costs, becomes crucial to the pricing decisions that a company should consider."

Pricing strategy should look at the four "Cs": customers, costs, competitors and cash.

Customers: How important is price in customers' purchasing decisions? Do your customers love the quality of your products and services, or are they mostly buying on price? High price sensitivity means companies should stay near market norms.

Costs: How is inflation affecting your costs? Are supplies or labor significantly more expensive?

Competitors: If the competition has increased prices, it's worth considering a price increase to match. The exception would be if your company has the ability to keep prices steady to gain market share.

Cash: The ability to hold prices steady will depend on what's happening with your cash flow. Here are 24 cash flow metrics and KPIs to watch.

For businesses that must raise prices to cover costs, the most common approach is a blanket increase. However, particularly for those with price-sensitive customers or stiff competition, there are creative pricing strategies that companies can incorporate to lessen the perceived impact of an increase. Examples include product bundling and unbundling, installments, adding or removing features, or different pricing models for different product varieties.

"Any pricing decision should not be based only upon the short-term fluctuation of inflation, which has been difficult to predict on its own," said Nguyen. Instead, he advises basing decisions on each company's long-term strategy so that any gains via price increases won't be outweighed by long-term losses in market share.

Learn More

Communicating price hikes is all about alleviating the sting for customers. Success tactics for services firms include introducing value tiers and premium features. Learn more about how to increase profits without losing business.

For product companies, there are price-hike strategies to follow as well. Check out our interview with a Harvard lecturer on how to raise prices without losing customers.

5. Clean Up Your Product and Service Portfolio With an Eye Toward What You Can Make, and Sell, Now.

Walk around a grocery store, and you'll notice some empty shelves and missing products. While these shortages are often blamed on supply chain issues, some are the result of a calculated strategy.

To meet demand, contain costs and simplify the supply chain, companies like Mondelez, General Mills, PepsiCo, J.M. Smucker, Campbell and Coca-Cola all cut back on their breadth of product offerings. Instead of more niche items (*cough* Swedish Fish Oreos *cough*), companies are focusing on high-margin core products with the most consumer demand.

"Companies have had to take a hard look at SKUs which may have had short runs or other factors which reduced operating efficiencies, as well as SKUs with lower margins," said Jesse Morris, executive vice president, CFO and COO at Main Street Capital. "These are sometimes the same products, but not always."

While trimming down the roster of offerings may feel antithetical to growth, it has benefits in inflationary periods.

In a class at MIT's Sloan School of Management, former Sam's Club CEO John Furner explained how reducing variety pays off.

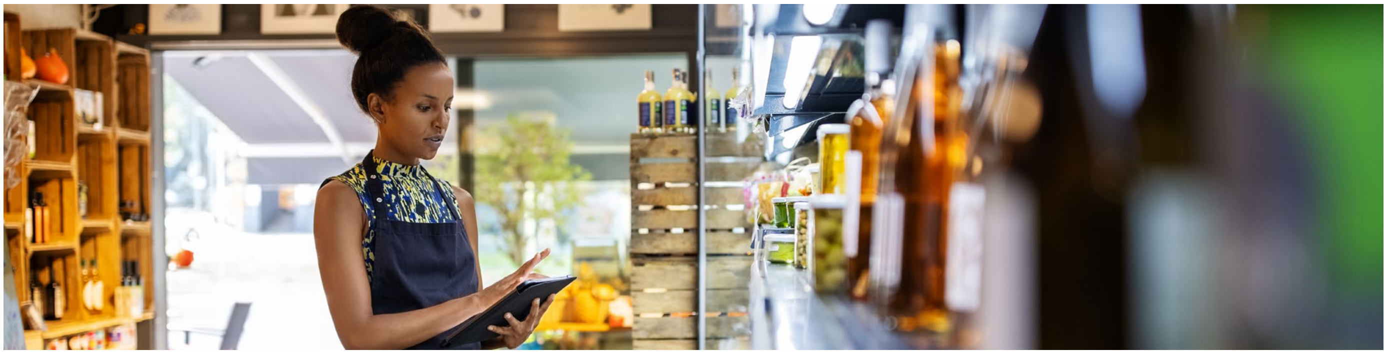
"As the [SKU] count came down, the club became easier to manage," said Furner. "Our in-stock positions were better. The most unusual thing was the member response. We took a 20% SKU reduction, and our members were thanking us for all the new items."

That is, all those items that had been hard to find on overcrowded shelves.

To streamline your offerings, examine data around products and services to determine which have the strongest demand and healthiest margins. Challenge the relevance and profitability of your portfolio, and retire or press pause on those products and services that are not contributing to profitability.

Learn More

Product lifecycle management is the discipline of developing, planning, manufacturing, distributing, marketing, selling and servicing products at every stage — starting with conception and following through until they're removed from the marketplace. Learn more about PLM.



6. Use Your Inventory as a Physical Hedge.

In a poll conducted by JP Morgan, 65% of midsize companies cited strategic stockpiling as their tactic of choice in dealing with the increased costs, and time, associated with sourcing and stocking goods. With little relief in sight for inflationary pressure, collecting materials that are important to the sales or movement of key products is a smart use of cash.

"Because prices for goods are likely to increase, you should plan to leverage your working capital for inventory spend," said Kugler. "Do you have a line of credit you can execute based upon your accounts receivable balance? If so, use it to order the inventory now and try to keep your finished goods prices stable in comparison to your competition."

To measure how well strategic stockpiling is working, track metrics such as your average days in inventory as well as your inventory turnover ratio; that is, the amount of time that passes from the day an item is purchased by a company until it is sold.

In addition to lowering costs and providing a competitive edge, having enough inventory on hand to fulfill customer orders can enable you to be strategic about pricing.

"In many cases, companies have had to make meaningful working capital investments in raw material inventory to ensure availability and capture supply costs in tandem or ahead of customer orders," said Morris of Main Street Capital.

However, this step comes with a caveat: The difficulty and costs involved in obtaining warehouse space have increased substantially. Companies looking to stockpile inventory will need to have the required capacity, or brick-and-mortar retail locations with room to spare, otherwise storage will be difficult and expensive.

Learn More

Inventory management methods help companies identify which and how much stock to order at what time and then track inventory from purchase to the sale of goods. Learn more about inventory management.

A solid **inventory analysis strategy** helps you determine the right amount of stock to keep on hand to fill demand while avoiding spending too much on storage. Learn more about inventory analysis.

7. Implement Future Contracts Now, But Mind the Accounting Rules.

In addition to the physical hedge of inventory, companies can work to reduce risk by hedging. Future contracts on a commodities exchange are especially popular during inflationary periods. This hedging tactic is an agreement to buy and sell a particular asset at a predetermined price at a specified time in the future.

For example, if a chain of cafes is worried about the price of coffee rising, the purchasing team can enter into a futures contract to buy a designated quantity of coffee at an agreed upon price, with the ability to exercise the option on or before the expiration date. So they might agree to buy 1,000 pounds of coffee in 6 months at $2.00 per pound. Even if the price of coffee jumps to $2.40 a pound, the cafe chain will still only pay $2.00.

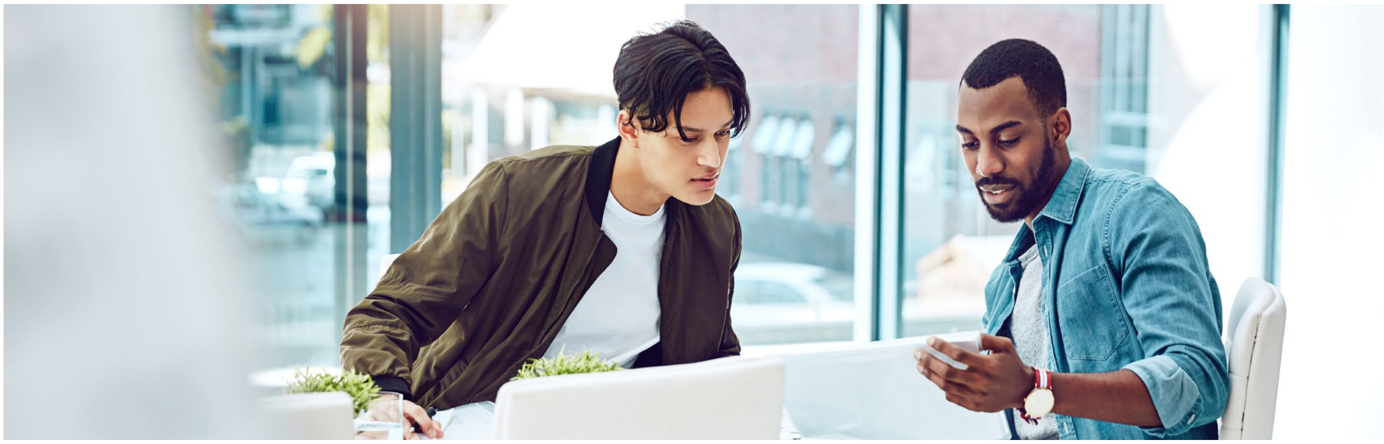
However, futures in this sense aren't going to get coffee delivered from a supplier at the agreed upon price. Rather, you'll be going to an exchange or an over-the-counter desk and buying futures there. If you make money on your futures, it'll cover the extra cost you incur with your suppliers. If you lose money on the futures contract, you'll get it back by buying at a lower price from your supplier.

In either case, the goal is cost predictability. In addition to helping companies protect themselves against future price spikes, future contracts provide stability needed for planning the budget.

In the past, complex rules around accounting for hedging have given finance teams pause. ASC-815 changed the rules for accounting in 2017, and a subsequent clarification from FASB sought to simplify accounting. Nonetheless, while futures and derivatives are complicated to use and complicated to account for, they are an effective means of bringing predictability to commodities when prices are unstable.

Learn More

Hedge accounting was designed to let companies match their input purchases with an offsetting position to minimize the bottom-line impact. But hedge accounting has been notoriously complicated. Learn more about hedge accounting from Deloitte.



8. Automate to Reduce Labor Costs.

With both skills shortages and higher salary and benefit costs affecting businesses now, it's a good time to look at ways to reduce labor expenses. While cleaning up the company's product portfolio can decrease demand, executives will also need to scrutinize the labor costs associated with the remaining products given upward pressure on salaries.

Maybe now is the time for that automation project that's been discussed and shelved in past years.

"A popular solution [to combat inflation] is to invest in technology and automation," said Nguyen.

He cites US firms' capital investment spending since 2021, which has significantly exceeded pre-pandemic levels, and suggests that any company that does not follow the trend will be left behind the curve.

Reducing work through automation means that less labor will be needed to run operations. And, it will free up workers to focus on strategic value-add activities, benefitting the business and increasing retention.

"Whatever the case, increased productivity is always the best and most sustainable tool to counter inflation," said Nguyen.

Learn More

With **business automation**, companies can simplify and optimize workflows. The ultimate goal is less to replace human labor and more to augment employees with technology in a way that helps improve the entire, end-to-end process. Learn more about 13 business areas to automate.

Warehouse automation is the process of automating the movement of inventory into, within, and out of warehouses to customers with minimal human assistance. Learn how to automate your warehouse.