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**MANAGING INFLATION**

Complimentary research

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# Understanding and Managing the Impact of Inflation

## Four scenarios for success

By Anthony Snowball and Jim O'Connor

# With risk comes opportunity

In recent decades, low and stable inflation has allowed companies to plan by assuming a high degree of price and wage stability. This environment has come to an end.[1] In The Hackett Group's annual Key Issues Study, conducted during the fourth quarter of 2021, 31% of respondents cited inflation as a major concern, and 53% said it is a moderate concern.[2] Nearly a quarter expected inflation risk to increase. Tellingly, concerns about inflation drivers, such as supply chain disruption risk and availability and cost of labor capacity, were even greater.

This environment presents a major challenge for 2022 and possibly beyond – and companies must navigate it in conjunction with significant continuing uncertainty such as that surrounding the conflict in Ukraine. As is often the case, though, disruption presents opportunities, as well as challenges. Agile, well-prepared organizations can turn their advantage into real economic gain. The Hackett Group's latest research found that a combination of managing inflation, reducing costs and advancing digital transformation can yield a 54% pretax margin improvement – adding $408 million of pretax profit for a typical $10 billion company. Capturing this will require careful analysis and strong organizational coordination.

[1] While inflation in the EU zone was lower – at close to 5% by the end of 2021 – this rate also marks a significant increase and is well above historical levels.

[2] Most likely, the level of concern about inflation and inflation drivers has increased since the study was completed.

# Modeling the opportunity

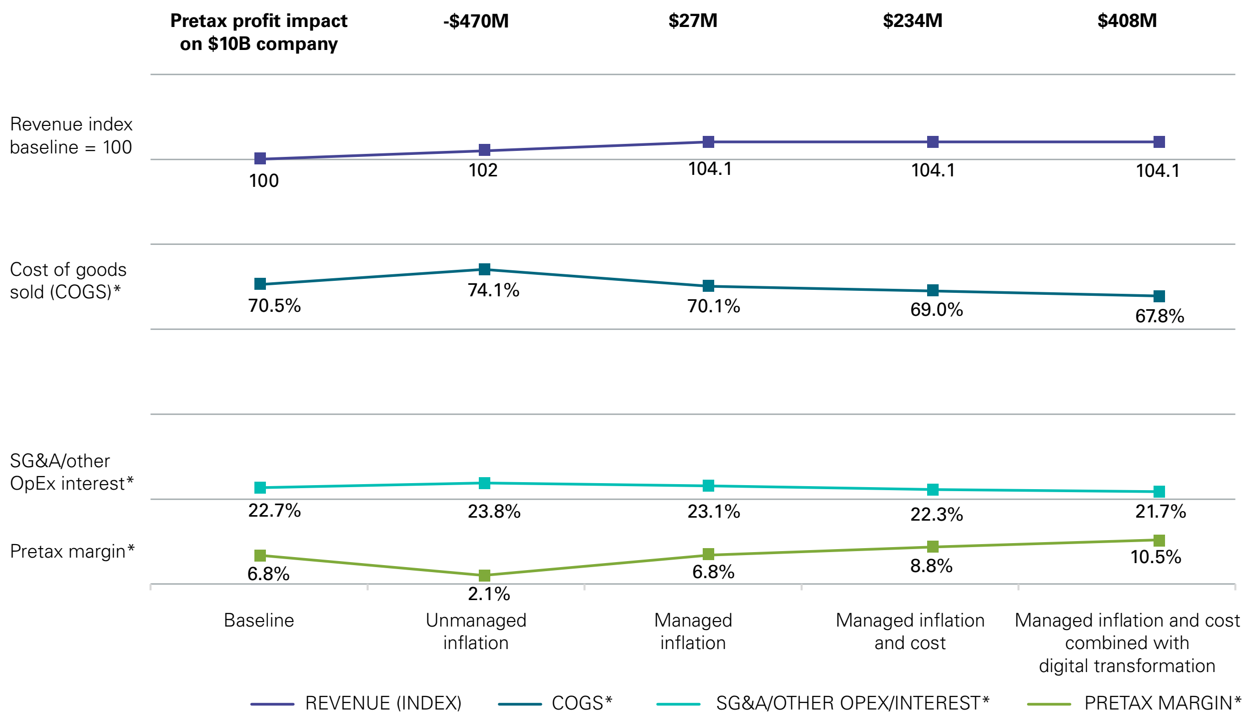
Modeling inflation scenarios and the impacts of certain strategies is critical to determining appropriate responses. But this can be very challenging due to an array of factors:

- Input cost components with different supply and demand conditions
- Product lines with unique cost structures
- Regional differences
- Price elasticity that varies widely by product
- Competitors' varying responses to similar input cost increases
- Complexity of planning wage increases in the context of the Great Resignation and structural labor shortages
- Rising costs of borrowing, working capital, and long-term debt that affect capital investment and other decisions

The Hackett Group analyzed the impact of four inflation response scenarios on the financial performance of a typical $10 billion company (**Fig. 1** on page 4). This analysis is based on financial information of publicly listed companies, in combination with spend breakdown metrics from our procurement benchmark, which yields a baseline profitability profile.[3] We conducted company profit and loss analysis for illustrative purposes and to arrive at high-level estimates of macro-level inflation exposures. The baseline profitability profile serves as the basis for calculating inflation exposure by projecting unmanaged inflation on spend categories.

[3] The analysis is based on financial information of publicly traded North American and Western European companies with revenues of over $1 billion. The cost profile used in our analysis is based on 2019 financial data because the COVID-19 disruption materially distorted 2020 cost structures and profitability.

**FIG. 1 Profitability impact of four inflation management scenarios**




* As a percentage of revenue

Sources: 2019 public financial information, analysis of The Hackett Group's procurement benchmark data, and The Hackett Group's inflation poll

# Modeling the opportunity (continued)

**Scenario 1: Unmanaged inflation** – This scenario assumes a price increase at the historical rate of inflation of approximately 2%, while input prices inflate at the projected higher rate of the current inflationary business environment. This analysis projected a 70% decrease in pretax margin.[4]

**Scenario 2: Managed inflation** – This scenario assumes some mitigation of price increases through active management. To account for increased costs, companies raise their own prices to maintain the baseline pretax profit margin of 6.8%. In the analysis, they increase prices by 6.4%, causing demand volume to fall by 2.3% – thus, revenue increases by 4.1%. In this analysis, pretax profitability is maintained.[5]

**Scenario 3: Managed inflation and cost** – Three inflation drivers – indirect materials and services spend, direct and indirect labor cost, and interest expenses – can be mitigated with traditional cost-takeout initiatives. Techniques for reducing labor cost include downsizing, offshoring and outsourcing and, given current turnover levels, not replacing people who leave voluntarily. Budget tightening and strict spend controls can contain indirect materials and services costs. And working capital usage reductions achieved through inventory, days sales outstanding (DSO) and days payables outstanding (DPO) optimization

[4] A decline of 6.8% baseline margin to 2.1% represents a 70% change.

[5] While the pretax margin is the same as the baseline at 6.8%, nominal pretax profits are $27 million higher than baseline because the revenue base has increased by 4.1%.

# Modeling the opportunity (continued)

can reduce interest spend. This scenario assumes a 3% labor cost takeout,[6] a 3% reduction in indirect spend volume, and a 10% reduction in debt resulting from inventory, DSO, and DPO rationalization.[7] Accordingly, it projects a pretax margin improvement from 6.8% to 8.8% – a 29% improvement. This would add $234 million of pretax profit for a typical $10 billion company.

**Scenario 4: Managed inflation and cost combined with digital transformation** – Without structural transformation, cost-takeout initiatives are often difficult to sustain. Therefore, companies must continue to accelerate the digital transformation that occurred in response to the pandemic. Digital capabilities – specifically, advanced analytics – are also key to planning and executing short-term cost-takeout responses.

The fourth scenario combines managed inflation and cost takeout with a digital transformation agenda that sustains and delivers incremental operational efficiency and agility improvements. This scenario assumes a sustained 5% productivity improvement, a 5% reduction in indirect spend volume and a 20% reduction in debt resulting from working capital rationalization.[8] The analysis projects a pretax margin improvement from 6.8% to 10.8% – a 54% improvement. This would add $408 million of pretax profit for a typical $10 billion company.

[6] The 3% productivity improvement is reflected in a direct labor volume decline of 5.2%, which is 3% more than if direct labor volume declines at the rate of projected output volume decline of 2.2%, resulting from the price increase.

[7] All improvements are assumed to be annual recurring and net of initial investment.

[8] While based on conservative assumptions well within the range of digital transformation improvements observed by The Hackett Group, the scenario serves an illustrative purpose. Companies must model their own unique cost structures, improvement initiatives and revenue increases.

# Shaping your response

Managing the response to inflation requires input, expertise and action from multiple organizational disciplines. Therefore, executive leadership must provide sponsorship, establish governance and ownership of inflation response planning in the C-suite, and commit sufficient resources. Leaders should also be prepared to resolve escalated issues – for example, decisions regarding price increases, strategic supply switches, and major price negotiations. Under the guidance of this coordinated enterprise response, business services functions play unique roles and must take specific actions themselves.

**Finance** plays a leading role in developing inflation scenarios relevant to the company and is primarily responsible for analysis and modeling of the impact of inflation on input prices, price increases on sales, and profitability. Finance also provides critical data and analytical support to other functions.

**Human resources** must mitigate the wage and benefit components of inflationary pressures through compensation planning, while minimizing voluntary turnover risk against the backdrop of the Great Resignation and structural skills shortages.

# Shaping your response (continued)

**Procurement** has the best visibility of category-level price increases and controls critical supplier relationships. It must strengthen commercial acumen to minimize price inflation and mitigate contract exposure – while also managing key supplier partnerships proactively to find solutions for curtailing price surges and mitigating supply disruption risks.

The **technology** function represents a significant component of spend that is subject to inflationary pressure. Mitigation efforts should include strategic project timing adjustments, negotiated commodity price caps in exchange for longer-term contracts, commitments for future purchases at today's rates and limits on contractor hourly rates built into master service agreements.

**Supply chain** functions play a key role in addressing inflationary pressures, while balancing efforts to improve resilience and customer service levels. It will be critical to enhance planning capabilities; drive scenario planning to optimize capacity, network utilization and inventory levels; and increase visibility across the supply chain.

**Global business services** organizations play a key role in working capital improvement and revenue and spend leakage reduction initiatives. They may also own critical transactional and master data needed for the planning, executing and monitoring of inflation mitigation initiatives, in addition to managing outsourcing contracts impacted by inflation.

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# Can you navigate inflation challenges and seize the opportunity?

To optimize your response to inflation, you will need driver-based models and a cross-functional effort sponsored by and led from the top and supported by multiple business functions. The Hackett Group can help you shape your response and seize the opportunity. For more information, contact us.

To learn more, please contact us at 1 888 842 2538 (US) or +44 20 7398 9100 (UK), or visit us online at **www.thehackettgroup.com**.

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