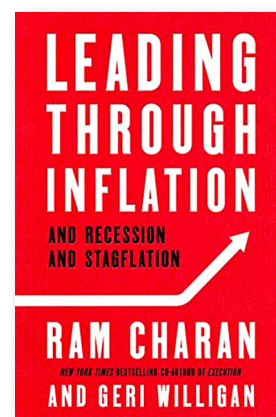


# Leading Through Inflation

And Recession and Stagflation

by **Ram Charan and Geri Willigan**



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## THE SUMMARY IN BRIEF

In the first half of 2022, people were grappling with high inflation and starting to talk about the possibility of recession and stagflation. Things were getting tough. But when the going gets tough, the tough get going. Business leaders need to learn about inflation's insidious effects and take those lessons back to the businesses they run to get through this period in great shape.

In *Leading Through Inflation: And Recession and Stagflation* co-authors Ram Charan and Geri Willigan lay 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.

Economic damage comes fast. Through the overarching message that leaders must move quickly, this book is designed to speed learning and shorten the time to act.

## IN THIS SUMMARY, YOU WILL LEARN:

- What you need to know about inflation.
- Why you must pay attention to cash.
- How to find cost cuts that build business.
- How to renew your business model.

### What You Need to Know About Inflation

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.

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 a 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 push back and demand drops.
- 3. Aggregate measures like the Consumer Price Index don't tell 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.
- 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 leaders need a broader and more urgent response to inflation than they have undertaken thus far. They should help you appreciate that cost cutting to struggle through the immediate hardships will not get you through a sustained period of inflation, let alone a spurt of hyper-inflation, recession, or stagflation.

The bright side? **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.** Dealing with inflation's negative impact on the business will reveal a silver lining. The business will sharpen its focus and cultivate a stronger set of customers. You'll find ways to improve productivity, cut costs through more automation, or use technology to serve customers better with less cash usage. Your company's response to inflation will be a differentiator.

### A War Room to Pick Up Early Signals

Inflation intensified in late 2021. Some cost increases may have been predictable, but the sudden constriction of Russian oil and Ukrainian agricultural products was a shock. Companies that have a mechanism to detect such changes and coordinate a response sooner are better positioned than others.

This is what war rooms are for. Whether or not you use the term, every company needs a mechanism to get people's attention focused on the urgent threat from high inflation and to enlist their help in executing a solution. Some companies have simply changed the content of existing meeting formats. Others have created something new.

Best practice is not just to examine the immediate threats to the business but to look ahead and make judgments about what might be coming next, an exercise of gathering data and reasoning out the possibilities. An ideal war room is not just for firefighting; it's also strategic. Early warning signals will tell you not just where the problems are emerging but also their pace. They allow you to be predictive, prescriptive, and preemptive.

Every company needs a war room. A war room is a frequent gathering of people who will aggregate information, strategize, and drive the plan. It has an important social purpose in aligning and intensifying people's focus. Much

## Inflation brings the risk of insolvency. Bankruptcy can happen to the unwary.

like in a military situation, it is an excellent way to convert anxiety and fear into energy and action. Energizing people to spring to action based on information others share is valuable, but there's another benefit: it sensitizes everyone to early warning signals they may be exposed to in the normal course of their workday.

Early warning signals from your customers, supply chain, or industry statistics should be tracked on a dashboard. Along with some macroeconomic measures you find useful, choose some metrics that are specific and critical to your business. Data can help you detect shifts in buying patterns, from which you can draw other inferences. Be sure you are monitoring internal early warning signals as well.

The only way to be preemptive is to be predictive. Use your war room to brainstorm what the data are pointing to, what trends are emerging, and take some leaps to consider how things could combine to create what's next. The thought process will set you apart.

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### Pay Attention to Cash

Cash management is the number-one risk to your business and the key to managing it safely through inflationary times. You need to have a clear picture at all times of where cash is coming from and where it is going to, with a view of how those flows will change in the coming quarters. You should be seeking ways to reduce costs and lower the break-even point, but the important shift is to focus on the balance sheet, not just the P&L. Orient yourself to think in terms of cash profits, not paper profits or percentages.

If you're not watching cash and taking steps to ensure you have enough of it, you are putting your business on shaky ground. As inflation persists, many items you consider done deals could come to haunt you. For example, if you have contracts to sell at fixed prices with no such assurances on the cost side, you are headed for trouble. If you have variable-rate loans or need to borrow money going forward but don't have a plan to cover higher cash payments, you could likewise be in trouble. If you are in an industry that relies heavily on energy, directly or indirectly, you could also be in trouble.

And don't forget that customers consume cash in the form of receivables, inventory, and production, some more than others. A customer that pays receivables in 275 days might not be worth having, even if you get a hefty margin. Things look very different when you analyze profitability on the basis of a margin measured in percentage points versus profitability measured on the basis of net cash.

You have to know how cash is flowing and learn where it typically gets trapped, especially as rising interest rates slow economic growth. You will want to scrutinize how you use cash to build the business and keep it running, whether as operating expenses or capital expenditures. All of your business planning and forecasts should include an analysis of cash, and you should revisit the investments you already planned with an eye toward cash.

The sooner you fix the balance sheet to protect cash, the better. In a period of rising inflation, debt is a killer. You might think it's fine to keep the debt you have because it is low-priced. But you have to consider whether you can actually service that debt. Will inflation shrink your cash margins? If you can't generate as much cash as you did before, then even low-priced debt will be a problem.

Inflation brings the risk of insolvency. Bankruptcy can happen to the unwary. Watch your balance sheet and safeguard your liquidity.

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### Change Your Pricing Approach—Fast

Pricing may have been a relatively low priority over the past decade, but under inflation it is central to survival. Whether you're expecting more inflation, recession, stagnation, or a return to growth, you should fully understand how pricing affects your money making and relationships with customers. It's not just that you have to raise prices, which you almost certainly do, you may have to revise your whole approach to pricing.

This economic era demands a break from past practices, even those that have worked fine so far. Maybe your sales are largely transactional, but now a subscription-based

approach works better. Maybe you've ruled out surcharges, but now they make sense. The range of options on pricing is likely wider than you think, and the options you choose matter more than you think. Revisit your choices.

Regardless of where you sit today, inflation gives you the opportunity to evolve the pricing function and build a new capability for your company. Accelerate your pace of price changes, but be thoughtful about how you implement them so you don't wear down your sales force or alienate customers.

Improve your approach to pricing broadly, including the following:

1. **Your pricing mode**—are sales transactional, subscription based, or contractual?
2. **Your pricing method**—Do you use dynamic pricing, peer pricing, index pricing, or custom negotiations?
3. **Your pricing model**—Are prices derived by a desire to fill a factory, maintain a target margin, hit a list price, or extract an estimated value?
4. **Your pricing strategy**—Do you set prices with the intent to penetrate a market, retain a customer base, or maximize value extraction?

However you combined these elements in the past, you should consider whether a shift might work better in current times. Unless you pick up the pace of price changes, you could seriously miss cash and earnings that you can never recover. Across an industry, someone will be first to make a move. If you leave it to sales and marketing alone, you may never get the price increase you need, let alone be first in line. They may stall because they don't want to lose the customer or dread getting serious push-back from them.

The dominant psychology of sales and marketing for the past decade has been to capture as many customers as possible and make every sale one can, without thinking too hard about whether the sale is profitable or the customer is sound. There's been a psychological aversion to raising prices. Senior leaders have to address this issue head on. It's one thing to know that price increases are in order and another to see that those changes are made promptly.

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### Find Cost Cuts that Build the Business

As you cope with inflation you'll need to cut costs. You will run up against some costs that are impossible to control, whether it's because the material is rare, the trading floor

sets the price of a commodity, or front-line workers have a multitude of options. Go beyond the obvious targets and consider all the direct and indirect costs strung across the company. How could they be reduced?

Then go further. Those incremental savings will add up and help you weather rising costs, but you should also step back and ask a different question: Can you make a more radical change to reduce costs and/or cash consumption? A step or jump in reducing costs might come from looking beyond the boundaries of your business and working with others in the value chain. When one link in the chain is affected, others are too. Or you might have to completely revise your geographic footprint, for people as well as sourcing.

The point is to get through an inflationary period with customers intact and with a stronger business than before. That comes from keeping customers top of mind and searching for things you can do to help them get through. At the same time, you should work with the other side of the value chain to help suppliers cut whatever costs they can control.

Apparel, footwear, and other consumer staples are among the industries that have been severely challenged by both the pandemic and inflation. Many players in the supply chains for those industries are based in Southeast Asian countries. As consumer demand dropped precipitously, cash froze up, and exports dwindled. Companies and their domestic economies were badly hurt. One company, a medium-sized player in the middle of the footwear supply chain, recognized the opportunity to demonstrate their differentiation.

Knowing that its customers—the companies next in the value chain—were still recovering, raising prices to pass along cost increases was not a realistic option. Instead they looked to cut costs that would not weaken the business, either their own or those of the customers or the subcontractors that manufactured their products. That declaration took many typical cost cuts off the table and spurred more creative thinking.

For example, making internal changes can save money and make the company operate more efficiently, which can translate into faster approvals and decisions. The company can thus become more responsive to customer's requests. Helping to improve operations at the manufacturing level helps those customers become better able to handle the cost increases that are externally driven. Your customers and your customer's customers all stand to benefit.

If you think bigger and more broadly and don't back

If you think bigger and more broadly and don't back away from a bold change, you'll see how inflation creates a chance for your company to leap ahead.

away from a bold change, you'll see how inflation creates a chance for your company to leap ahead. In a high-inflation environment, you've got to help your customers deal with rising costs, even as you fight to contain them. You also have to work with suppliers because cost incurred on that side of the value chain will affect players at every step that follows. Along the way, you should search for ways to add value, not just cut costs, on both sides of the value chain. It's all connected.

## Renew Your Business Model

The cumulative effects of inflation are leading to a world of lower consumption overall, one in which some consumer behavior will have changed permanently. There will not be a return to what we've known. Some segments—even some industries—will have shrunk, and some new ones may have appeared. As you adjust your pricing, product offerings, costs, and cash flow along the way, at some point your business model might reach a breaking point. To thrive in the emerging world of lower consumption and slower growth, you will almost certainly need a new business model.

You should focus on it now. Don't wait for mountains of evidence that the current business model isn't working. Be honest: Is your most lucrative market evaporating? Are the new market segments you've targeted still there, and at the same price points? You may be convinced demand for your services will return to what it was, but when? Can you really wait it out? Will something more appealing have sprung up in the meantime? Pool your observations, look at data and trends, and start to think about how you will reinvent the business model.

Creating a new business model may be as new to you as inflation. But don't ignore the necessity. Remember that even if you are slow to recognize that the business model is breaking, investors won't be. Declining or persistently stagnant earnings with no sign of future building will begin to affect your market valuation. With that comes another insidious impact: you'll have to use more cash for things like pension funding. When resources start to dwindle, you have

fewer options to make a change.

The elements of your business model include sources of revenue, customer mix, product mix, geographic footprint, cost structure, and the money making model. The mental challenge is to conceptualize how the key elements could work together differently. To win in profitable customer segments, you need innovation. Digitalization will help you reduce waste and therefore cost. It will help you customize products and services and therefore boost revenue and cash. It also makes innovation cheaper and more efficient.

Keep iterating your conception of the business model until your products, customers, and business portfolios work with your money making formula—your need for positive cash flow, gross margin, and profitable growth that can fund critical investments.

- **Customer segments.** The need for cash might force you to drop customers that cannot keep up with payments to you, and price increases might drive some customers away.
- **Product mix.** Look at your customer mix with fresh eyes. A prolific number of products can create all kinds of complexity that works against efficient management of production and cash.
- **Ecosystem.** Your ecosystem extends beyond your linear value chain to include networks and partnerships. This is a time to question whether you have the right partners.
- **Geographic footprint.** As you look at where you sell, produce, source, and hire, geopolitics and exchange rates should play a role. You will probably want to put more emphasis on where there will be more stability and more sustainability of cash growth.
- **Portfolio Mix:** If you have a portfolio of businesses and are considering merging, acquiring, or divesting, think about how they will fare in inflation.

No business model lasts forever. Be ready by rethinking all the places and ways you currently play. Be ready to change the mix.

## Inflation is Everybody's Business: Your Role

Armed with a general understanding of how inflation affects a business, you are better prepared to help your company succeed despite it. But that is not enough. Every business function has a role to play in coping with inflation and preparing for what will follow. Actions you take now will not only mitigate the damage from inflation but also strengthen the company so it will be well positioned when the economy takes a turn for the better.

What is your role?

### CEO

1. **Cash coming in, going out, and its timing.** Every major financial decision must be viewed through the lens of cash.
2. **Pricing, and making it happen.** The CEO must understand the basic choices in philosophy and tactics, be hands-on with sales and marketing to be sure they are moving fast and smart on pricing, and reassign some leaders if they are unable to implement price changes.
3. **The business model and strategy.** The focus of the business may change to conserve cash or to pounce on opportunities. Continue to build the future even as you focus intensely on the day-to-day immediacies.
4. **Operations.** Link with the COO to stay grounded in how costs are changing, supply and demand are matching up, and problems are being addressed. The COO's perspective will inform communications with the investment community.

These four items alone will not sustain the business. In this time of pronounced economic volatility, the CEO must also be the chief integrator of people and information. This role involves psychological leadership, helping others to face reality and adapt their behavior. But it also has a mechanical component, which includes establishing a war-room type mechanism and a cadence of frequent communication.

The CEO does not combat inflation alone. Here are a few checklists for other key roles.

### CFO and Finance Department

- Watch for cash traps

- Take charge of working capital
- Check the assumptions in planning and capital expenditures
- Communicate with investors

### Sales and Marketing

- Work on segmentation and customer profitability
- Update the pricing approach
- Ask IT to help with competitive data
- Train for the new customer dynamic

### Operations

- Revisit and recommend capital expenditures versus operating expenditures
- Use digital applications to keep improving
- Be a conduit between front-line employees and management
- Help investor relations build credibility

### Procurement

- Secure supply
- Gather intelligence
- Keep management informed
- Be decisive

### CIO and IT Department

- Learn the new business priorities
- Do small projects with a short-term payoff
- Find ways to help business leaders
- Use outside help for low cost and speed

### Public Relations and Investor Relations

- Know how your company fits in the macro environment
- Be clear about the company's plans and actions
- Be ready to explain big pricing moves
- Learn what investors are thinking and doing

### Human Resources

- Help identify those who can't adapt
- Defend fair treatment in times of stress

- Keep KPIs up to date
- Use training to build skills and reduce anxiety

### The Board

- Spur management to action
- Help break bottlenecks
- Use a framework for capital allocation
- Revise the compensation plan

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## Ram's Closing Message

It is leaders who let companies decline or take them to new heights. This could be your time to shine. The things that will help you lead through inflation will also help you lead when the next change comes. Use the external change to your advantage, and get everyone aboard to navigate through the rough patch. Take the hand you are dealt. Use it to create new value for the customer, shareholders, and the constituencies you serve. That's how you and your company will come out ahead and be ready to ride high when stability and growth return—as we know they will.



Ram Charan is a bestselling author, teacher, and world renowned advisor to CEOs and other business leaders of some of the world's best-known companies, including Toyota, Bank of America, Aditya Birla Group, Novartis, Fast Retailing (Uniqlo), and Humana. The author of close to forty books, four of which were bestsellers, he is known for providing real-world solutions—the kind of advice you can use Monday morning. His book *Execution*, lauded for its practicality, spent more than 150 weeks on the New York Times best-seller list.

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