INFLATION INCREASES COSTS – DECREASES PURCHASING POWER

Ideas that can help businesses compete in this environment

Inflation (consumer price index) was 5.7% in February 2022, a 30 year high, impacting both consumers and businesses. The key components are shelter, up 6.6%, and gasoline, up 6.9%. US inflation, 7.5%, is higher, but US calculations include used cars, which are not included in Canada's calculations. A recent survey by McKinsey shows that the two key risks to economic growth are supply chain disruption and inflation, with Covid 19 third. Many countries are suffering from high inflation, for example, Germany at 4.9% and the UK at 5.4%. The average labour cost increase, running about 3%, has not caught up. Small and medium businesses are especially hard hit by price increases and the lack of supply, and many have not built up reserves in the last few years.

How did we get into this mess? The answer isn't simple and there is a combination of issues; high demand is one contributing factor, lack of supply of products is another. Around the world, production of many products slowed, resulting in shortages. To support consumers and businesses, all governments pumped up the money supply to a high level, and there were certain geographic-specific events, including shipping shortages, back-ups at ports, blocking of the Suez Canal, a fire on a container ship which destroyed one retail chain's entire order of Christmas décor, and a winter freeze in Europe which spiked energy prices.

Who has the power and authority to influence inflation? One of the mandates of the Bank of Canada is to keep the rate of inflation within a range of 1 – 3%, approximately. The BoC thought that inflation would be "transitory," but that was the wrong call, meaning that they didn't act soon enough to slow inflation, despite many calls for action. In March 2022, they acted with a .25 interest rate hike and signaled more to come. As one economist said, "They lost control of inflation." Another economist told the Financial Post that "demand destruction" was the only way to lower inflation.

What can small and medium companies do to mitigate inflation? Pricing is the first strategy that comes to mind. Depending on the product/customer need structure, it may difficult, since your customers are also in a price/cost squeeze. Some customer testing might be in order, as well as some research on what price increase will be required to cover all costs. For example, one company raised prices by 8%, but total cost inputs were up by 10%, resulting in a decision to absorb some cost and have a lower margin. The company came to the conclusion that their customers could not bear a 10% increase, and it would be better to keep their customers at a lower margin. Another company decided to raise prices every 6 months, rather than their usual annual price increase, and they no longer guaranteed a quotation price for longer than 30 days. Make some assumptions on the elasticity of your product and forecast revenue with the new prices. Not raising prices will result in lower margins which may or may not be tolerable. Increasing prices may lower sales, but to what extent is the issue. Each product could have a different price elasticity (elastic demand is when the change in quantity demanded due to a change in price is large, and inelastic demand is when the change in quantity demanded due to a change in price is small). Some products may be able to accommodate price increases, while other products may not. For example, one company increased prices on their premium line only, since such products are usually more inelastic.

A review of current and potential suppliers, including their prices and product quality, and the creation of a back-up list, is another strategy to help mitigate the impact of inflation. For example, a company that ran afoul of its prime supplier spent 2 – 3 weeks finding a replacement. Keep in mind that a good supplier is not just one who can provide a suitable substitute, but also one who is sufficiently flexible to sell a smaller order to match the size of the company (the trend is not to accommodate smaller orders). I know of a small manufacturing company that now has to purchase an 18 month supply of a necessary input, instead of their previous purchase of a 6 month supply. The payment process for many companies has also tightened up.

Other strategies could include a longer term on a contractual agreement in return for a lower price, however, this is becoming more difficult because of the underlying volatility of raw materials. In times of supply shortages, there is no reason to sell with lower margins. In the current environment, many times the security of supply becomes more important than marginal savings. Restructuring the value chain is a more dramatic and difficult process for a small/medium company. It involves by-passing the distributor and going directly to the source company. With smaller volumes, this is not always attractive to the source company, but it can be done in some industries. The restructuring of the manufacturing process is perhaps even more difficult and long-term, but it may be worthwhile to review the processes with a view to suppliers.

To illustrate, wineries are facing significant cost increases, from bottles and packaging to transportation and energy. Labour costs have not yet risen with inflation, but are likely to do so in the future. The cost of capital has increased and will increase further. Some wineries are starting to raise prices, others are investing in systems such as ERP (Enterprise Resource Planning) to become more efficient, and others are investing in production efficiencies. Prices in Ontario are less volatile because of the controlled distribution system (LCBO), but prices in the US are forecast to increase by 10% - 20%.

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