INFLATION CRISIS & POTENTIAL RECESSION

HOW TO COPE WITH THIS CRISIS?

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EIGHT INTERNATIONAL

EIGHT ADVISORY

CONTENTS

INTRODUCTION

What is the purpose of this paper?

The following paper should respond to managers' concerns on how to deal with the current inflation crisis and potential recession. The first answer to this crisis is increasing selling prices. However, depending on the sector, types of clients and products, business will have to deal with four further situations to manage these challenges. In this paper, you will see we propose a decision tree with dedicated "tips" – this is based upon our own experience and is supported by recent interviews we have conducted with CEOs who have experienced high inflation in their regions for many years.

Context

The economic context is unprecedented: businesses are impacted by a runaway inflationary crisis which is affecting energy, raw materials, wage costs, and rising interest rates could result in a global recession. The last comparable situation in Europe was in the 1970s, though other regions have more recent experience of these challenges (e.g. Argentina's long term high inflation rate)

Action

So, this context is completely new for many top executives, resulting in fear and uncertainty. The following paper should respond to your current concerns, and offers a coherent method based the increase of selling prices, and a further four scenarios to manage the inflationary challenge. Dedicated advises and "tips" per situation are provided, helping managers and top executives to navigate the environment.

Decision tree

- Step I: Increase selling prices (as much as you can).
- Step II: Set up actions depending on 4 resulting situations

Situation 1: "Stay Focused"	Situation 2: "Grin and bear it"	Situation 3: "Restructure"	Situation 4: "Exit"

Way of working

Facing inflation and recession issues must be managed differently than the ordinary course of business. It requires speed, consistent communication and authority. As the inflation crisis impacts daily operations and strategic roadmaps, it is necessary to set up a dedicated and focused taskforce attached to ExCom to make prompt decisions.

Mid-term

It is important to not only focus on immediate issues, but also act within a medium-term perspective by reshaping the operating model and value chain to fit this new economic and geopolitical environment (i.e. client offer, supply chain, footprint, product components).

METHODOLOGY

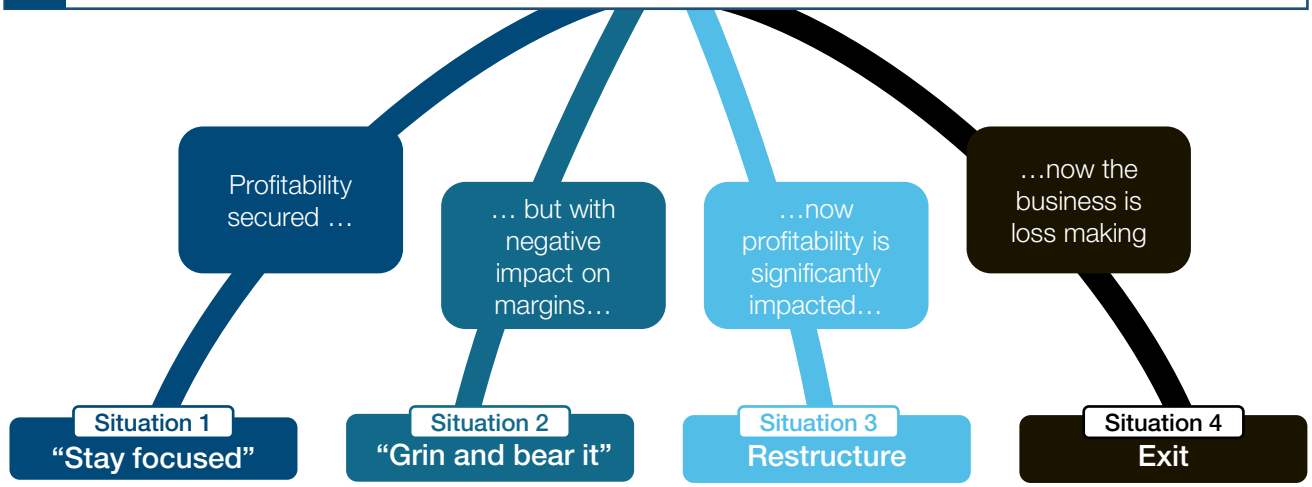
How to react facing this crisis?

1 **Step I:**
Increase selling prices (the most you can)

Increasing selling prices is mandatory to secure margin. As this is not straight forward to negotiate, pass-through of price increases may be declined by markets, clients, products, geographies…

- Quantify the current and future inflation impact on the cost base
- Drill down to identify the cost impact by clients x products x geographies
- Quantum of price increase which enables the return to past profitability
- Assess capability to pass through price increases again the impacts on demand (elasticity price/volume)
- Target achievable increase selling price objective by clients x products x geographies
- Consider impact on working capital as well as profit & loss
- Assess the global financial situation including inflation on interest rates

2 **Step II:**
Depending on the result of Step 1, set up actions for each situation



Situation 1 – "Stay focused"

- Keep monitoring inflation and prepare possible next prices increase
- Anticipate cost control and reduction

Situation 2 – "Grin and bear it"

- Refocus on profitable clients x products x geographies
- Implement cost controls and focus marketing efforts on core business

Situation 3 – Restructure

- Aggressive cost reduction on value chain (> 15% of cost base)
- Short-term shutdown on selected activities

Situation 4 – Exit

- Shutdown activity
- Divest activity

METHODOLOGY – FOCUS ON STEP 1

Step 1 – How to implement selling prices increases?

The increase of selling prices policy is mandatory within the inflation crisis and must be introduced by a pass-through analysis and then an impact assessment.

Timing is key: set up a dedicated and focused taskforce attached to ExCom to make prompt decisions and keep up the pace of analysis and transformations

Pass-through analysis & implementation

Quantify the current & future inflation impacts on the cost base

- Define a reference date before inflation period and not the current period or the last price increase date
- Conduct a detailed analysis of your costs to identify which categories face the highest inflation
- Take into consideration all costs subjected by inflation (including the increase of salaries), not only the ones included in the gross margin
- Consider cash flow as well as P&L impacts

Assess an overall review of your contracts

- Identify current clauses (price escalation, force majeure…) related to your supply and client contracts to assess future impacts on your cost and margin per activity/client
- Send a letter to your customers explaining the situation and using the "force majeure" clause
- Increase selling prices is also an opportunity to revisit wider contracts clauses, not just pricing elements

Consider the financial situation regarding the new environment

- Assess the forecasted financial situation (debt, hedging positions) to anticipate interest rate increases
- Anticipate several inflation scenarios over the next 18 months

Commercial & Operations excellence

Give to each business leader an objective and timing to implement the target

- Opt for objectives in value (price, margins…) as it is easier to decline and explain these internally
- **Besides prices increases, consider** elements the most exposed to inflation (packaging considerations, transportation, footprint)
- **Mobilize a meeting cadence which relies on analytics, fast decision making and strong governance**

Empower your sales team to maximize the pass-through

- Train your sales team for negotiations with the customers in this new high inflationary environment
- Document the reasons for inflation for your team and your customers (and if mandatory, work with an open book)

Leverage all your contracts potential

- Review price-revision clauses in your contracts as they are not intended for high inflation context (implement force majeure clause)
- Negotiate the incoterms of your contracts to have as many clients as possible in Ex-works (and limit your transportation costs)
- Secure future supply contracts with dedicated clauses

Impacts assessment

Assess the correlation between increase selling price and impacts on volume / demand …

- Set up a dedicated team and associated processes to gather and analyze real time data to make rapid informed decisions. Within some businesses, this assessment should be performed at a daily basis

… and translation on supply

- Assess the impact on supply to avoid being under the production break-even point

Understand in detail the impact on volumes and margin

- Assess results per distribution channel (retail, wholesale, e-commerce) and/or per territories

Identify cash flow impacts

- Assess suppliers in value vs. payment terms
- Implement a stock strategy based on hedging and covers

If several waves of price increase, always think in cumulative terms for better control and easier explanation to customers

- It is better to ask for one larger price increase which takes into account future price increase vs make several smaller waves

DEFINITIONS

How is inflation characterized?

Europe is now facing the highest inflation rates for 30 years, mainly due to higher costs and increasing demand.

Inflation is the loss of purchasing power of the currency and results in the increase of general and sustainable prices.

Monthly inflation rate in Europe by year, % (1997-2022)

5 main inductors for actual inflation in Europe

Cost

- Raw materials prices peaked last year (x8 for gas prices, x2 for wheat, x5 for electricity)
- Covid disorganized supply chains creating bottlenecks around the world

Demand

- Household demand shifted after covid (focused more on house equipment) while production supply can't match demand
- Government aid boosted this demand

Currency

- Euro depreciated against the US Dollar
- Sterling has depreciated against both the US Dollar and Euro

Monetary policy

- Since 2015, the ECB's quantitative easing program has injected huge amounts of money in the financial markets

Basis

- Calculation basis for the inflation rate was at the lowest level after the Covid crisis

Source: INSEE, Eurostat

DEFINITIONS

How is a recession characterized?

While all economic stakeholders are fighting inflation, they are already making changes which are negatively impacting GDP and may lead Europe to recession.

A recession is a period of temporary decline in a country's economic activity. A recession is most often defined as a decline in GDP for at least two consecutive quarters (GDP = Consumption + Investment + Exports – Imports).

A depression is a severe and prolonged downturn in economic activity. In economics, a depression is commonly defined as an extreme recession that lasts three or more years or which leads to a decline in real gross domestic product (GDP) of at least 10%.

Almost all inflation inductors may negatively impact the GDP

 **Cost**  **Demand**

- Consumption/Exportation: Inflation deteriorates margins of the companies and may force them to closes some business units if they are not able to pass or absorb costs increases
- Consumption: Inflation decreases household purchasing power if salaries do not track at the similar or higher rates
- Inflation: If salaries follow inflation, price/wages loop may appear and lead to an inflationary spiral that accelerates the prices increases

 **Currency**  **Monetary policy**

- Importation: Euro & Sterling depreciation against the US Dollar makes imports more expensive for Europe
- Investment: In a context where inflation is volatile, companies and consumers will be reluctant to invest because they can't anticipate the future
- Investment: Inflation decreases saving capacity of households
- GDP: Central Banks have announced that fighting inflation is their top priority at the expense of GDP growth, and have increased their policy rates to slow down the economy

Economic slowdown is already on its way
(GDP variation)

Q4 2021	+0.6%	+0.0%	+0.6%	+1.2%
Q1 2022	+0.6%	+0.8%	(0.2)%	+0.8%
Q2 2022	+0.6%	+0.0%	+0.5%	(0.1)%

Source: INSEE, Eurostat, Office for National Statistics

MANAGERS

Why are managers confused by this crisis?

For managers, the current crisis which combines high inflation and recessionary pressure is new and unique, resulting in fear and uncertainty.

Very few managers have experience in facing an inflation crisis in their professional lives, as the most recent crises was in the late 1970s. However, lessons can be learned from managers that experience in such crisis in other countries more recently

Inflation crisis is non-homogeneous; it depends on a variety of factors, including business activities, market volatility, territories etc.

Recession could impact demand and sales, bringing the production level closer to break-even and putting **at risk manufacturing organizations.**

The Macro & Micro economic context could result in **Fear, Uncertainty and Pressure on Management, in which unsuitable decisions are made too quickly.**

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