Grant Thornton

Stay ahead in an inflationary economy

Risk and opportunity in a volatile market

The inflationary pressures of the post-pandemic landscape have created tremendous economic challenges, squeezing businesses across the board and creating unprecedented levels of uncertainty.

Soaring prices and a range of related challenges have taken a significant toll on the economy, with annual inflation accelerating to a 39-year high in 2022, before slightly easing in July. And while it's unclear if the Consumer Price Index (CPI) will climb or abate in the months going forward, broad-based inflation doesn't appear to be going away any time soon. In fact, the Bank of Canada doesn't foresee a return to its 2% inflationary target until the end of 2024[1].

While the central bank has raised interest rates in its efforts to tame prices, there are many related challenges that aren't easy to solve. Labour shortages, fluctuations in demand and supply chain disruptions due to geopolitical events like the Russia-Ukraine conflict and tensions between China and Taiwan, wreaking havoc on the even the best-laid plans.

Given the level of volatility, businesses need to be proactive in managing the impacts; however, data from the 2022 Grant Thornton International Business Report (IBR) suggests that Canadian businesses have been slower to act than their global counterparts.

According to the report, which provides a comprehensive overview of the challenges mid-market businesses are facing, common actions to combat inflation are only being pursued by about a quarter of Canadian businesses. When taking a closer look at the 12 specific actions cited in the survey, Canadians ranked lower than the global average in every category except for one.

1 Bank of Canada, July 13, 2022. "Monetary Policy Report Press Conference Opening Statement." Tiff Macklem.

Actions taken or planned to deal with inflation

Which, if any, of the following actions have you taken or are you planning to take to meaningfully deal with higher costs and concerns about inflation?

ACTIONS	CANADA	GLOBAL
Taking steps to improve internal efficiency and costs, and/or reduce waste	33%	37%
Changing our pricing strategy so it's more in line with cost increases	28%	31%
Taking action to limit external cost increases	26%	31%
Drawing up plans to mitigate the risks of inflation	26%	28%
Taking action to reduce levels of debt or interest	26%	26%
Focusing on product or service differentiation	24%	29%
Working with competitors, industry bodies or government to help alleviate costs	23%	24%
Improving our understanding of the true cost to serve clients	22%	31%
Making more use of long-term staff incentives like equity and profit shares to help control costs	22%	25%
Reducing exposure to loss profitable products/services or customers	19%	23%
Altering the quality or scale of products or services to save on costs	17%	25%
Outsourcing more activities to lower costs	15%	22%
None of the above	3%	4%

Source: 2022 Grant Thornton International Business Report (IBR)

These survey findings may be related to the fact that our resource-based economy benefited heavily from the commodity boom that emerged from the pandemic; this potentially gave many businesses a false sense of confidence as inflation's grip took hold. Whatever the reasons, keeping calm and carrying on—without taking decisive action–could give Canadian businesses a global disadvantage as other economies strive to overcome inflationary challenges.

"It's definitely a warning sign," says Troy MacDonald, National Advisory Leader at Grant Thornton. "It's indicative that the Canadian market isn't taking inflation as seriously as some other markets."

If Canadian businesses are moving sluggishly, it doesn't appear to be because of lack of impact. In fact, the report highlights that Canadian businesses are feeling the squeeze when it comes to cost increases. According to the IBR research, respondents identified labour costs and energy costs as the greatest issues when asked about specific constraints to expansion and growth. And those costs, along with others, are up considerably.

According to the survey results, raw materials, energy/utilities and transportation have all spiked 18% for Canadian businesses over a period of one year. Rising equipment costs, wages and interest payments are not far behind, suggesting that many businesses are feeling cost increases across a wide spectrum.

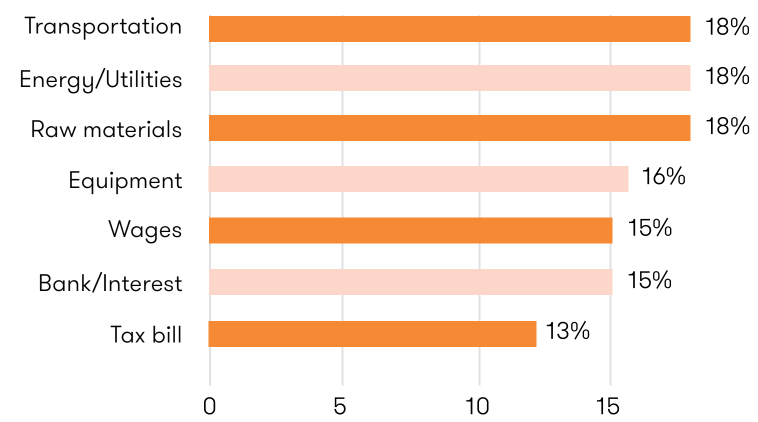
While Canadian businesses need to step up their game to remain competitive and keep themselves in a strong financial position, knowing how to do this in such a complex economic environment can be difficult. The last inflationary period occurred in the 1980s and, while there are some parallels between then and now, there are also significant differences. Most notably, we aren't experiencing the hallmark of stagflation, which is high unemployment[2]. Further complicating matters is the fact there are many opposing factors at play.

When combined, a hot labour market, rising interest rates, slumping real estate market, and skyrocketing prices add up to a complex landscape. "I think we're in a very strange economy because we have these contradictory things going on. It makes it a very difficult time for a lot of businesses," says Troy MacDonald.

The other factor to consider is that inflation can mean different things to different industries—and while some could be struggling in a turbulent economy, others may be thriving. Interestingly, there are also sectors that may be experiencing a mixed bag of impacts. Take, for example, the global hospitality industry. After being hit hard by the pandemic due to travel-related and other restrictions, hotel chains are experiencing a revival as demand soars. Room rates are surging but the industry, like other labour-reliant sectors, is facing a tight employment market[3]. Hotels are seeing this growth in revenue as their cost structure—based on previously constructed buildings—remains heavily fixed.

Average increase in costs over the past 12 months (%)

By how much would you estimate the following costs have changed in your business over the last twelve months?



Source: 2022 Grant Thornton International Business Report (IBR)

2 Bank of Canada, May 12, 2022. "The Perfect Storm." Toni Gravelle.

3 CNBC, June 11, 2022. "Why Marriott, Hilton and Hyatt say Hotel Prices are only Going Up," by Ian Thomas.

To understand how inflation may be swaying where Canadians are opening their wallets, look no further than the CPI.

The CPI provides a startling picture of how high the cost of many essential items has spiked for households. When looking at the year-over-year increases, the cost of energy, transportation and food immediately stand out[4]. Gas prices, in particular, skyrocketed by more than 50% at one point in the year before finally easing[5].

While oil and gas prices have fallen sharply recently, other key items like groceries have not. Even with a decrease in grain prices, it will likely take months for any difference to make its way to grocery stores shelves. The bottom line is that more money being spent on essential items means less money available for discretionary ones, so rising prices—along with the increased cost of borrowing—may be biting into the revenue of businesses that provide non-essential goods and services.

4 Statistics Canada, August 16, 2022. "Consumer Price Index, July 2022."
5 Statistics Canada, July 20, 2022. "Consumer Price Index by Product Group."

Despite inflation's reputation as an economic bogeyman, it's not all bad news. In fact, an inflationary period can pose significant opportunities—much like the pandemic did following the initial shock.

"You have a lot of disruption happening in the economy," says Troy MacDonald. "So for businesses that are thinking creatively and prepared to be a bit more aggressive, this might be a time to get really innovative and try to change the rules in terms of how things are done."

Retrench, invest or hold? One size does not fit all

Taking all of this into consideration, what steps should you take to deal with inflation?

The question of whether to retrench, invest or take another type of action is not an easy one to answer. According to Tara Benham, National Tax Leader at Grant Thornton, times of disruption have historically encouraged many businesses to re-examine their operations and come up with new and exciting ways of doing things. “There are so many examples of business that have sat back and said, ‘The world is burning, what does that do to us?’ And then they come up with all of these great ideas.”

While an inflationary economy carries a lot of uncertainty, one thing is for sure: there’s not a one-size-fits-all approach. In fact, strong variation in strategies is a good sign that businesses are making informed decisions based on their individual circumstances and goals. While some leaders may decide to pull back amid uncertainty, others may ultimately determine to take a more aggressive approach. With that in mind, Grant Thornton advisors have identified a series of actions that businesses should be considering.

Whether you’re looking to alleviate inflationary pressures or explore options to accelerate your growth track, there are many ways to achieve your goals. Not only can these actions help you deal with an inflationary period, but they can also position your business to take advantage of immediate opportunities and build resiliency to manage future changes.

Inflation action plan

Identify and mitigate the risks of inflation for your business

Given the complexity of an inflationary economy, understanding the impacts can be half the battle. Building an initial understanding of the forces at play and the recommended actions for addressing them should be the starting place for any business. Financial modelling and analysis, data analytics and tax planning, in particular, can help you better understand your business and uncover opportunities that aren't always obvious. Taking this first step can pay off by powering your business with the information it needs to limit your cost increases.

26% of Canadian businesses have or plan to draw up plans to mitigate the risks of inflation

"In our client conversations, we're spending more time thinking about what inflation will do to the profitability," says Troy MacDonald. "So even if it's at a certain level of profitability today, we're stress-testing it to say, 'Okay, how contracted is the revenue and what inflationary protection is in the revenue versus the cost structure? And if you flow through inflation over the next 12 to 24 months, is there a risk the profitability of the business is going to get squeezed because the costs are going to go up?' We're trying to spend more time understanding those dynamics."

Take action to limit external cost increases

When it comes to managing external cost increases, a proactive approach is the best approach to protect your bottom line. There are multiple ways to blunt inflationary impacts, including locking in prices, bulk buying, negotiating terms with suppliers, and also changing suppliers. These basic countermoves can go a long way in keeping cost increases to a minimum. For businesses with cash in hand, this may be a good time to consider buying now if a particular cost is expected to continue rising.

26% of Canadian businesses have taken or plan to take action to limit external cost increases

Tara Benham recalls how several clients—in anticipation of inflationary pressures and related supply chain hurdles—had the foresight to stockpile the inventory they needed. So while inflation has creeped up and creeped in, they've enjoyed the benefits of having up to a year's worth of inventory. This has kept their goods flowing and their margins protected at a time when others have been forced to scramble.

Inflation action plan

Gain insight into your sensitivity to growing inflationary pressures

As inflationary pressures continue to put the squeeze on businesses, it's vital to have an understanding of any areas of sensitivity. Particularly as interest rates rise, advisory services such as financial modelling and analysis, restructuring, and data analytics can help you gain much-needed insight. For example, a cash flow forecast can identify potential liquidity issues, leading to a number of immediate actions to help you get ahead of a crisis. This includes proactively discussing options with your financial partners, accelerating cash collections, and filing timely GST/HST returns to help you potentially access cash sooner. Having solid insights into potential pressure points can better guide strategic decision-making in the short term and minimize exposure to risk.

Improve your understanding of the true cost to serve customers

You may know your business, but do you know your customers? More specifically, do you know which customers are driving your margins and which ones may need more attention? Customer segmentation is an underutilized tool, but it's an extremely valuable one. Having this level of detail is not about being in the weeds–it's about arming yourself with a comprehensive picture so that you can make informed and strategic decisions. Calculating the costs and profits of individual customers can help you better manage your client base so that you can prioritize profitable areas and tackle unprofitable ones.

of Canadian businesses have or plan to improve their understanding of the true cost to serve their customers

Change your pricing strategy to better align with cost increases

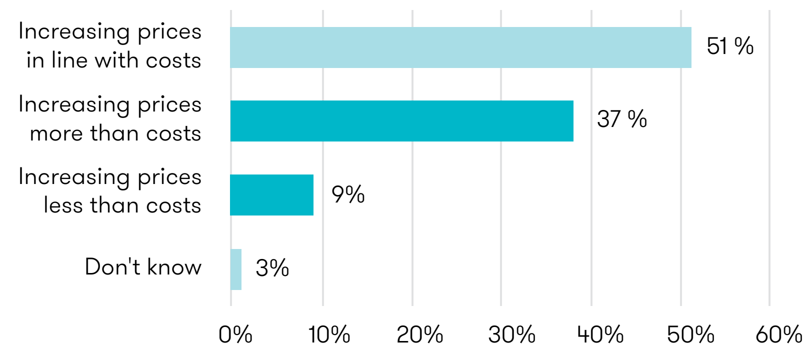
To offset your business' cost increases, changing your pricing strategy should be your go-to move. While many businesses may have previously reviewed their price lists annually, monthly reviews may now be wise. Given how rapid the ascent of inflation has been, this is the one area where many businesses have started to take action. In fact, a majority of businesses are already increasing their prices in line with–or above–other costs. Troy MacDonald has even seen price changes implemented on committed orders—after the contract's been signed.

> **"We've been talking to our clients about being aggressive with the price increases because a) it's the only way to protect your margins and b) everyone is becoming aware of inflation issues so there's more market acceptance. Price increases are just a reality now."**

Cost increases are not only about keeping up with the rising costs of other goods–they're also about providing employees with a living wage. Particularly as businesses face pressure to attract talent amid a labour shortage, they should not be shy about understanding their true cost of service and flowing that through. Much depends on your pricing power in the market, however, so keep that in mind when making adjustments.

Current pricing strategy (%)

How would you describe your pricing strategy at the present time?



Source: 2022 Grant Thornton International Business Report (IBR)

Inflation action plan

Outsource more functions to lower costs and alleviate labour shortages

Traditionally, the main benefit of outsourcing has been to lower costs. While that is still a worthy objective in an inflationary environment, outsourcing can also improve access to skills in a time of labour shortages. This also includes looking beyond your borders and being open to remote work models. While this option includes tax and other jurisdictional considerations, it may be a viable way of leveraging a new pool of talent. For immediate relief, automated solutions are also an option.

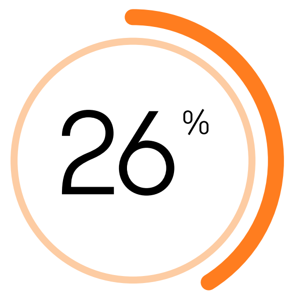
of Canadian businesses have or plan to outsource more activities to lower costs

Cloud accounting, for example, can perform many business administration and accounting tasks that traditionally fall under the purview of a controller or accounts payable manager. Not only can this help cut down on time-consuming processes, but it can also provide businesses with better insights and data to make real-time decisions. Staffing crunches have added to an already complex post-pandemic economy while high turnover imperils both productivity and work culture. To mitigate these risks during this time, consider ways to outsource more functions so that you can stay competitive.

Take action to improve your capital structure

Decades ago, a mid-market business learned through lived experience that banks can become more cautious during periods of volatility. Since then, the business has built up a solid reserve of cash to ensure it has the financial freedom it needs no matter the economic situation.

Today, that same company is looking to acquire additional equipment—and it's doing so without the fear of lender scrutiny or rising interest rates. While their story demonstrates the advantages of saving for a rainy day, it also reinforces the key benefits of having a healthy capital structure in an inflationary period: it provides businesses with greater flexibility and far more options.



of Canadian businesses have or plan to take action to reduce levels of debt or interest

Not only can a strong position help control the rising costs of capital, but it can also provide your business with the working capital it needs for actions in other areas. Especially in times of inflation, it pays to be proactive. Doing a cash flow forecast or conducting a stress test to map out 'what if' scenarios can give you a clear line of sight so that you can get in front of challenges. Too much debt, for example, should be an immediate area of focus, particularly for those looking to take a big step, such as growing their business. Another consideration is the timing of major capital expenditures. In an inflationary market, delaying major capital expenditures may be wise until there's more stable footing in terms of costing. That decision, however, must be weighed against efficiency gains as well as other factors.

Inflation action plan

Take steps to improve internal efficiency and costs, and/or reduce waste

Businesses can do all the right things to manage inflationary pressures, but it won't be easy to move the needle unless your own house is in tip-top shape. Greater internal efficiencies can help by allowing your business to do more with less. Integrating forward-thinking technologies, in particular, can significantly improve productivity by lowering output costs and making better use of human capital. This, in turn, can reduce the strain on your team and create a better culture. Tara Benham recalls how one client introduced a cloud accounting solution and experienced dramatic benefits when its data input tasks were halved. "That was a really interesting exploration into how automation can help," she says.

33% of Canadian businesses have or plan to take steps to improve internal efficiency and costs, and/or reduce waste

The IBR research shows a positive trend in this direction, finding that 53% of Canadian respondents plan on increasing their investments in technology over the next year. Incorporating technology alone, however, may not create the efficiencies you need. New investments should also be married with tactics to improve your internal processes. Once your processes are optimized, technology can be woven in to get you to the next level. The good news is that taking steps to become more efficient can also lead to reduced waste. This is not only good for profits – but it's also good for the planet.

Carve-out and divest underperforming parts of the business

If you need liquidity for your business, shedding a redundant asset may be the right move. Taking action to divest underperforming areas can allow you to focus on the more profitable ones. While an inflationary economy may be the right time to be bold, the process can be complex. From initial planning to final execution, there are many steps in ensuring a successful close. The same can be said for selling a business outright.

A positive outcome starts with planning for success—among those are establishing your goals, understanding the value of your business and making your go-to market package as attractive as possible. Providing you with the right guidance throughout all stages can give you peace of mind and also demonstrate confidence in the future of your enterprise to help ensure a successful outcome.

Next stop: forward

So where do we go from here? Until inflation returns to pre-pandemic levels, all eyes remain on the global landscape, including geopolitical tensions, the state of the pandemic, supply issues and labour constraints. Monetary policy will continue to do its part to reduce inflationary pressures. In the meantime, business leaders will need to actively deal with their individual impacts, consider the levers at their disposal and be strategic about the actions they take. Decisive action in the short term, however, should always be made with your long-term goals in mind. So consider a holistic health check that takes your business' life goals into account before moving ahead in the here and now.

While it's clear that progress needs to accelerate to better manage inflationary pressures, questions may remain about how best to move forward. At Grant Thornton, we're here to help. With our wide range of services and deep experience in helping clients navigate through uncertainty, our teams understand how inflationary pressures have had a profound impact on businesses. Taking action to weather the inflationary storm and even thrive during this time isn't easy, but we can work with you to find the best way forward. Whatever your goals are, we are here to guide you every step of the way.

About the international business report

Grant Thornton's International Business Report (IBR) is the world's leading survey of mid-market companies. Launched in 1992, the IBR now provides insight into the views and expectations of around 10,000 businesses across 28 economies. The research takes place twice a year and involves interviews with chief executive officers, managing directors, chairpersons or other senior executives from all industry sectors. This survey was held in May and June of 2022 and includes the responses of more than 250 Canadian business leaders

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