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Striking the right balance

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The imminent threat of inflation and the opportunities it presents

Why it is imperative to act now and strike the right balance

Businesses need to act fast to respond to rising inflation

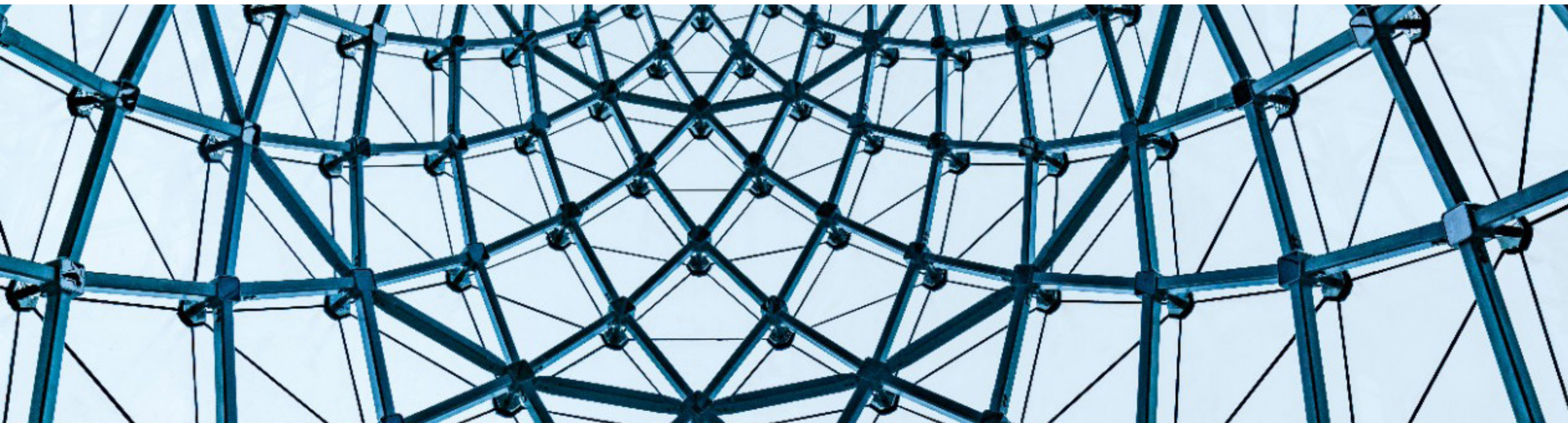
The rising cost of doing business, a cost of living crisis fuelling increasingly price-conscious customers and a new discount rate on the return of capital are all ways in which the impact of inflation is beginning to be felt by businesses. And with a peak expected later this year, businesses can't afford to ignore it.

Although the full extent is still unknown, inflation will disproportionately affect some businesses more than others. 'Economic escalation' could exacerbate the problem; for example, Russia restricting gas supply to Europe.

But even in these conditions, new opportunities exist for some. Those with large cash balances on their books have a new impetus to invest or pay back shareholders – and may even build competitive advantage compared to those borrowing at higher interest rates.

Waiting too long to address the potential impact of inflation on revenue, costs, investments and capital allocation will leave businesses at risk of being outdistanced by savvier competitors. Instead, regardless of industry or circumstances, businesses must quickly reassess direction, potentially reposition and be prepared to act to mitigate the impact of the immediate pain.

With a relatively higher spend on food and energy, customers in lower income households – as well as businesses in energy intensive industries – will be particularly impacted.



Thinking strategically is about striking the right balance

Moving quickly isn't as simple as reviewing your pricing and slashing costs.

The effect of cost challenges from rising energy costs through to inflation will be felt differently across sectors; we recognise for some businesses that they are grappling with the immediate effect of a substantial increase in their energy bills. For others there has been a sustained effect from COVID-19, challenges with the supply chain compounded by employment and productivity issues.

Few companies will be able to pass on the full cost of inflation to customers. Instead, their responses will need to look beyond pricing – to taking out non-core costs or where you could improve your operating model by driving operational agility and looking at strategic product improvements and technology innovations.

Looking across these areas – or levers – with a strategic growth mindset will help you alleviate immediate cost pressures without compromising mid to long term ambitions. And it will provide companies with competitive and commercial advantages compared to those who focus exclusively on cutting costs.

Managing costs for sustainable success is easier said than done. Instead, organisations find themselves cutting the wrong things for the wrong reasons, or investing in the wrong areas. As a result, they become weaker and unfit to compete.

Costs need to be thought of strategically – as investments that will fuel growth. This will allow organisations to continuously cut bad costs while redirecting resources to the areas that build or strengthen differentiating capabilities.

We developed the Fit for Growth framework based on research into hundreds of companies across various sectors. We found that those who best follow these principles achieve higher total shareholder returns than those that do not. Their secret? They tightly link their growth and cost agendas to fuel growth.

Three actions to strike the right balance

What businesses should do about inflation in the immediate future

Following COVID-19, we recommended three actions to optimise your cost base in the right way. Given a new set of market dynamics and in particular, rising inflation, businesses perform the same exercise again – 1) revisit strategic priorities; 2) look for what's different across the value chain to reset your cost structure; and 3) bring your people with you and drive operational agility.

1. Revisit strategic priorities

The first step in achieving the balance between cost and growth priorities is to answer some simple questions about strategy.

How has your market changed? What has happened to your customers, suppliers and competitors? What market trends or disruptors have accelerated?

For example:

- Do your customers have heightened price sensitivity and to what extent can you pass on increased costs? Is this a potential catalyst for disrupting long standing relationships?
- Have any of your suppliers been impacted by the war in Ukraine or the lockdown in China, which will cause delays?
- Which competitors have raised prices (and by how much) and are any shifting their commercial models (e.g. Buy-Now-Pay-Later is suddenly less attractive to competitors given accelerated inflation)?

What value propositions look promising? Can you articulate the few things your organisation needs to do better in order to meet those value propositions? What will your competitive advantage be?

For example:

- What elements of your offering should be reviewed to meet shifting customer priorities (e.g. an insurer may consider providing faster claims processing for vulnerable SMEs)?
- Are you investing enough in those few things? Where do you need to spend less so you have the funds to redirect costs to value-creating differentiation?

How has a new return on capital ratio affected your capital allocation and capital requirements (both for investments and solvency)?

For example:

- Do you have excess capital which is an increased competitive advantage and could be invested in the near term to improve strategic positioning and mitigate the impact of inflation?

Consider how your competitors are already prepared to respond in areas such as:

- **Long-term shifts in consumer preferences:** What digital experiences or hybrid models are competitors providing that provide customers with flexibility, convenience and fulfil unmet needs?
- **Impact of inflation varies by industry and geography:** What suppliers are your competitors using? Are they subject to the same inflationary pressures as yours?
- **A shift in the nature of work:** Employers are moving from fixed and predictable workforce models to more flexible, virtual and diversified models that support autonomy, flexibility and adaptability – which ones are most preferred?
- **A more volatile and ambiguous business environment amidst a cost of living crisis:** Your industry's structural change should point to what's no longer working as a differentiator. What are the few capabilities that you must have, and how can you reprioritise their activities to support those differentiating capabilities?

2. Look for what's different across the value chain to reset your cost structure

Corporate vision is often not expansive enough in times of significant cost pressure. Too often leaders deploy a playbook based on belt-tightening and across-the-board cuts: cutting from a project or functional budget; reducing vendor spend; and shuttering underperforming locations. Each of these cuts may be necessary, but they should support more than just a cost objective. Combining steps to get lean will make it possible to reinvest and grow.

Where to take action? How fast to push? Leaders should assign these decisions to teams that can look across the value chain. Work together to identify what's changed for good and how the business should respond. You'll need to solve the immediate problems while keeping the everchanging future in mind.

Actions in both the short and medium term will be a combination of 'no-regrets' moves (low risk moves that help in any scenario) and 'strategic bets' that are high-reward moves in the scenario on which you're placing your bets.

In After the crisis, we explored a number of 'no regrets' and 'strategic bets' following the pandemic across commercial, operations, enabling and compliance, and workforce. In light of rising inflation, businesses should explore a few additional actions:

- **Create spend visibility:** Improve visibility across all main cost categories to enable the baseline for a targeted response e.g. hedging strategies, extending contracts or alternative delivery models. Consider how the line items of your cost base are affected differently by inflation.
- **Review cost and investment strategy:** Ensure alignment of cost optimisation initiatives with corporate strategy as it reacts to market volatility / shifts (e.g. changes in asset class demand, insurance product line profitability movements, geographic focus). Reconsider capital allocation and investment strategy given the new interest rate, inflation and therefore rates of return by investment opportunity.
- **Build supply chain resilience and efficiency:** Building supply chain resilience is now a table stake, but many still have more to do. For example, investing in automated supply chains, end-to-end AI enabled workflows and distributed operations.
- **Review third-party spend:** Given the likely variability in contracting discipline, a short term action to review protections / controls in place to limit inflation is recommended. This could act as a catalyst to review strategic relationships and value in the longer term.
- **Accelerate productivity in the human workforce:** Focus on key initiatives to take a step change in productivity, e.g. high performance routines for ways of working in scale functions and improved data insights on people engagement and performance. Take much more aggressive action in digitisation to decouple volume from human activity.
- **Leverage managed services:** Look anew at functions / processes that can be provided by others to provide more flexibility, e.g. change as a service.
- **Accelerate shift to cloud:** The mid to long term costs of owning and running infrastructure should now act as an impetus to consider a more accelerated shift to cloud for those businesses with retained data centres.

Consider the impact by cost category and location in the operating cost base.

Many costs are lagging inflation (e.g. payroll). Businesses are not feeling the full effects yet, but this will change by January 2023. We see the highest near-term impacts to be from payroll, contractors and IT (e.g. hosted data centres). Third-party contract costs will increase at point of renewal, but lead times are less immediate.

Inflation impact by selected cost categories

Selected spend categories	Inflation impact	Commentary
Payroll & staff benefits	8-10%	• The OBR expects pay to rise ~5% in the twelve months to Jan-2023 across industry. FS workers have experienced double the rate of pay inflation in the last three years. • Wage inflation is currently lagging. Semi-annual pay/reward reviews expected. • Expected differential approach between lower paid and top of the organisation within insurers • Staff benefits costs are expected to rise broadly in-line with payroll, given their indexation against pay.
Temporary staff	10-15%	• Demand for temp staff will remain high given continued high attrition and pressure on lower earners. • Significant spread in cost of contractors expected. Scarce skills (e.g. Cyber/AI) will see continued high inflation. Costs of general skill contractors expected to be muted.
Contractors	5-10%	
Travel & Entertaining	8-10%	• Entertainment prices are forecast to have increased ~15% and Transport prices ~5-10% to the end of 2022. • The effects are being delayed in some cases (e.g. pre-booked tickets/fixed pricing for rail fares).
Property	5-15%	• Office property running costs are now starting to rise across the board, due to inflated energy / maintenance costs.
Marketing	5-10%	• Marketing cost increases are highly dependent on the advertising channel mix. • For example digital advertising has increased but we expect this to stablise/deflate entering a high interest rate/low growth environment as advertising spend overall retrenches.
IT in-house	10-20%	• Hosting and data centre costs will see a significant rise in line with energy costs. This will impact insurers with retained data centres.
Third-party IT Technology - SaaS	5-10%	• Expectation that SaaS / cloud hosted ERP costs will increase moderately. • Cloud costs will remain flat (or continue negative) due to hyperscalers established green energy strategies and scale.
Third-party IT Technology - Cloud	0%	
Third-party - Non IT	5-10%	• Operating expenses are protected to a degree by contractual commitments with outsourcers i.e. short term caps, or fixes, meaning costs don't increase immediately for insurer, but there will be pressure when contracts are renegotiated. • Facilities management and utilities bills are particularly likely to increase due to exposure to energy and commodities prices.

Source: PwC Strategy& analysis

Outsourcing to South and Southeast Asian economies may mitigate against UK-based inflation, with price increases lower in economies distancing themselves from Russian sanctions. Inflation is expected to be higher in European economies, with Poland particularly exposed. Economies that are more distant from Ukraine, e.g. India and the Philippines, will see lower inflation due to less impact to food supply, energy or trade / supply chains.

3. Bring your people with you and drive operational agility

How are your people being affected by inflation? There is a substantive challenge for employers with UK-based workforces to meet salary expectations. This is particularly acute for lower grades (e.g. contact centre staff) and those exposed to energy or food cost inflation. Companies may also suffer from continued high employee turnover (and disruption to service) as individuals seek higher salaries from competitors.

As with any disruptive period in the past, businesses have adopted a number of new behaviours coming out of COVID-19. Leaders must continue to isolate these few behaviours – the ones that have allowed teams to solve problems quickly – to promote, sustain and build them into the new way of operating, including, for example:

- Give teams autonomy to solve problems quickly.
- Take accountability for decisions and raise the tolerance for imperfection.
- Drive operational agility through technology and supply chains.
- Collaborate across the normal boundaries of hierarchies and functions.
- Show empathy, express gratitude and place value on learning.

Conclusion: The importance of considering your specific factors

Look out for industry-specific insights and upcoming content to reflect your circumstances and guide your response.

Businesses need to re-optimise their cost bases. But while cost cutting is necessary, approaching it in the wrong way can harm chances of survival. Furthermore, it will not be enough by itself. Leaders also have to pivot value propositions, figure out ways to grow and find new sources of revenue to find their place in the future. In other words, striking the right balance between cutting costs in a way that doesn't harm the business and redirecting costs to the drivers of growth – capabilities that differentiate a company.

To be able to cut costs in the right way, it's important to consider the industry-specific nuances which will affect how inflation will impact customers, competitors, suppliers and costs. Others may also need to consider their amount of available cash or how to tackle already identified priority areas such as their supply chain. Over the coming months, we will explore the details of what this means by industry and by selected topics – stay tuned.

As you assess your next moves – both in terms of immediate actions as well as mid to long-term strategic priorities – rest assured that while inflation is a threat that needs to be thought through, every threat presents its own opportunities. As long as you are informed and empowered to make the right decisions, your business will come out stronger and more resilient.

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