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Riding the Stagflation Wave

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Executive Summary

We are facing a period of uncertainty without much comparison to past inflationary eras. Left unmanaged, we anticipate 400-700 basis points in margin risk by 2024 against the record profit in 2021. Navigating the uncertainty ahead requires taking proactive measures to position for strategic growth opportunities. Major corporations provide useful case studies to inform potential strategies to: defend EBITDA by examining every aspect of the business model and balance sheet, make judicious counter-intuitive bets to win the long game and engage in strategic investments and opportunistic acquisitions.

Choppy Waters Ahead

Inflation running hot. Slowing growth. And the prospect of a recession. In a major report on the economy issued on July 13, the U.S. government said that the Consumer Price Index rose 9.1% from one year ago – even faster

than had been expected.[1] The Federal Reserve is determined to slam on the brakes with a series of sharp interest rate hikes. Combined with an anticipated interest rate hike of 75 basis points to as much as one percentage point when the central bank meets in late July, the economy is facing a one-two punch.

These factors reflect a combination of economic forces that haven't been seen in 40 years. And with it comes the risk of stagflation, an economic phenomenon that many experts thought had been relegated to the past but is now emerging as a principal threat to Fortune 500 earnings and profit margins in the coming quarters. Inflation is usually associated with faster economic growth, but with stagflation, rising prices become entrenched even as growth slows. Consumer spending power, a major driver of economic expansion, slows down, while margins erode.

This confluence of events makes it urgent that executives and boards start acting now. Margins are already coming under pressure, forcing Wall Street to revise earnings estimates lower in some cases. And although there is pricing power available across some sectors, and specific industries such as energy are well-positioned, stagflation needs to be front-of-mind as businesses prepare for the second half of 2022 and full-year 2023.

Indeed, decisions must be made soon. If the situation goes unmanaged, we project that Fortune 500 companies are facing a 400 to 700 basis point risk to margins by 2024, threatening the record $3.6 trillion in profits earned by these companies in 2021. Under the worst-case scenario, revenues would fall from $15.5 trillion in 2021 to $13.6 trillion in 2024.[2] The headwinds in this case would be falling consumer confidence and expenditures. Meanwhile, businesses would be limited in their ability to pass through the impact of rising costs. Geopolitical uncertainty, the war in Ukraine and higher energy prices only compound the uncertainty, with little clarity on how long these threats will persist.

Riding the Stagflation Wave

Coming out on top of this stagflation wave will require companies avoid the survival mode instinct, and instead plan strategically by taking both defensive and offensive measures. Four strategies have proven effective in past downturns:

1. **Strategically defend EBITDA by examining all aspects of the corporate model and business economics.** Rather than simply taking a scalpel for across-the-board cost cuts, this is an opportunity to take targeted pricing actions and simplify the business across products/SKUs, supply chain network and organization, while accelerating AI/automation across the enterprise.

   For example, in 2021, a food manufacturer drove a holistic margin enhancement through product/retailer pricing increases, ingredient and packaging harmonization, SKU rationalization, labor optimization, and organization and supply chain consolidation. They are on track to deliver a 10-15 percentage point EBITDA headroom for margins.[3]

   At the same time, recession doesn't necessarily mean retrenchment. During the recession in 2009, Domino's Pizza successfully improved its operations by focusing on quality, changing the recipes for cheese, sauce and dough while reworking the entire supply chain based on consumer input. It also launched a $75 million ad/marketing blitz, catapulting growth.[4]

2. **Shore up the balance sheet.** Whatever you do, don't run out of money. Take action to improve visibility into inventory, actively manage the trade-off between

supply availability and obsolescence risk. Additionally, scrutinize compliance of payment and receivable terms.

Flexibility counts, too. Just prior to the dot.com bust in 2000 and the ensuing recession, Amazon raised $670 million in convertible bonds, thus avoiding a cash crunch and giving it the capital cushion to launch what is now the thriving Amazon Marketplace.[5]

3. **Invest in future bets.** Avoid using the knife indiscriminately on all items in the cost structure. Instead, judiciously increase investment in opportunities that drive long-term equity value such as product innovation, customer experience and marketing.

   Looking back to the 2009 recession, Samsung heightened focus on R&D, securing 4,500+ patents in the U.S. in 2010 (12% more than the previous year), constructing new research facilities and maintaining its marketing investment. It also launched the first Galaxy smartphone, effectively setting the stage to compete with the market leader, Apple.[6]

4. **Conserve "dry powder" to scoop up bargains.** As companies are forced to make more challenging portfolio choices and hive off brands/divisions to focus the business, buying opportunities will emerge for those who are well capitalized. Opportunistically timed acquisitions can be a smart pivot, even when other indicators are less positive. Valuations are becoming more appealing, and the effective closure of the IPO market means private equity firms and other owners are looking for exit strategies from their investments that can open up new entry points for buyers.

   For example, despite the lackluster economic environment in 2009, Pfizer spent $68 billion to acquire Wyeth, building out its pharmaceutical portfolio to make up for the loss of its blockbuster Lipitor patent. This presented a unique opportunity to diversify its portfolio to include vaccines, a major growth engine.[7]

The Way Ahead

How should a company prepare for this rising risk of stagflation?

- Start with a hard-nosed evaluation of the stagflation margin risk, analyzing the current cost structure and the impact of headwind changes – especially rising input costs and potential fluctuations in demand.
- Apply scenario planning to inform the range of potential outcomes over the next 12-18 months.
- Define the strategic initiatives (based on the levers described above) and targets to allow you to get ahead of the anticipated financial risk and transform your business.
- Adjust rapidly to changes in the outlook or as new opportunities arise by continuously assessing progress and results.

Conclusion

Business leaders have a choice. They can play defense, watching and waiting as the current stagflationary environment erodes margins and profits. Or, they can go on the offensive, taking proactive measures to better prepare their organizations to adapt to changing economic headwinds and deliver better results for investors, customers, employees and other stakeholders.

[1]U.S. Bureau of Labor Statistics
[2]Source: CAPIQ, Teneo analysis
[3]Source: Teneo client example
[4]Source: Harvard Business Review, Company Press Releases
[5]Source: "The Everything Store: Jeff Bezos and the Age of Amazon"
[6]Source: Harvard Business Review, Bloomberg
[7]Source: Harvard Business Review, Company Press Releases

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