StrategicCFO360

The CFO Leadership Council

LEADING THROUGH INFLATION

A PLAYBOOK

for every CFO and C-Suite leader looking to help their company prosper—or even survive—in the difficult, uncertain days to come.

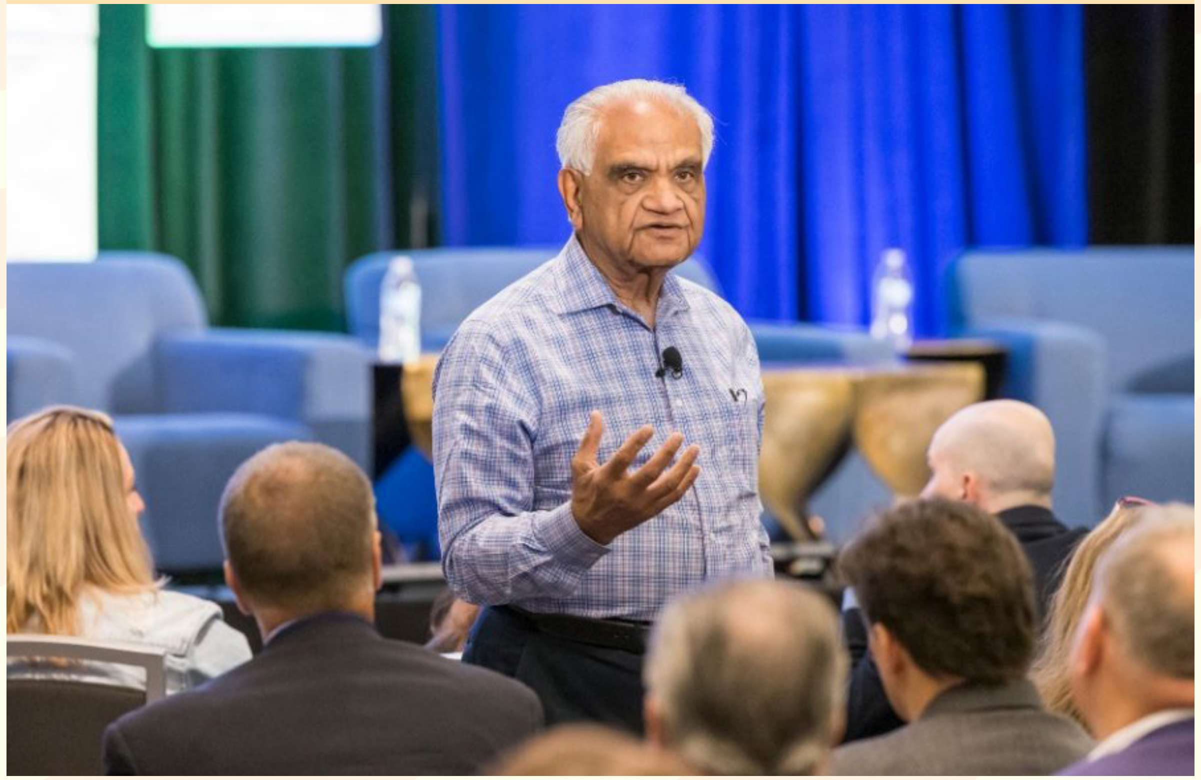
BY RAM CHARAN

About Ram Charan

Ram Charan is a world-renowned business consultant, author and speaker who has spent the past 40 years working with many top companies, CEOs, and boards of our time. He has authored over 25 books since 1998 that have sold over 2 million copies in more than a dozen languages. Three of his books were Wall Street Journal bestsellers, including Execution, which spent more than 150 weeks on the New York Times bestseller list.

His real-world solutions have been praised for being practical, relevant and highly actionable – the kind of advice you can use Monday morning-in areas such as growth, talent development, corporate governance, and moneymaking models for the digital age. He serves as a special advisor to Chief Executive Group, the parent company of The CFO Leadership Council and StrategicCFO360, and is a regular contributor to the firm's publications, including *Chief Executive* and *Corporate Board Member.*

His latest book, *Leading Through Inflation* will be released this fall.
More information at: ram-charan.com/books/



The CFO Leadership Council

About The CFO Leadership Council

We are a professional association whose mission is to empower senior financial executives to realize success in their careers, as well as for the people and companies they lead. Our members realize this success through the collaborative and energetic community we foster, which helps them build a professional network of their peers, as well as involves them in engaging discussions, both in-person and online, that deliver pragmatic and tangible insights on business and leadership issues.

Founded in 2006, The CFO Leadership Council began as an informal gathering of finance executives who wanted to build lasting connections with their peers in a comfortable, confidential setting. Originally named "The CFO RoundTable," our close community has grown significantly over time and, to date, includes 27 chapters and nearly 2,000 members who actively drive the organization through their feedback and insight.

In addition, our sponsors and partners are a select group of industry leaders who help to enhance our stellar reputation. And, keeping in mind our original goal of offering programs "for CFOs, by CFOs," we continue to provide the best monthly in-person events, featuring expert panels and interactive sessions, as well as fresh, online content that drives meaningful conversation and leadership development amongst our membership.

For more information or to join your local chapter: CFOLeadershipCouncil.com

StrategicCFO360

About StrategicCFO360.com

StrategicCFO360.com is a new online publication and sister community to The CFO Leadership Council. Both are part of the Chief Executive Group, longtime publishers of *Chief Executive* magazine (since 1977) and *Corporate Board Member* magazine, two of the most widely-read publications in American executive leadership.

Through original research, thought-provoking and pragmatic journalism, timely e-newsletters as well as live events and a peer network for top-level finance professionals, StrategicCFO360.com aims to help you be a more influential, strategic leader within your organization at a time of deep disruption and change. We welcome your ideas, your insights and your feedback. Being a CFO isn't easy right now. Let us know how we can help.

For more information: StrategicCFO360.com

ALMOST 50 YEARS AGO, as a young professor, I was hired by General Electric to design and teach a unique course to their managers at its fabled Crotonville training center. The subject was one of the most painful, difficult challenges that any business leader can face: operating a profitable, growing concern in a time of strong inflation.

For GE, it was an urgent mission. In the rampant inflation of the early 1970s, the firm's highly coveted AAA credit rating was in peril as the company bled cash. They were hardly alone. Inflation was crippling nearly every company in the world, while also stalling the ability of the middle class to get ahead economically, let alone stand their ground. It was still nearly a decade before Fed Chair Paul Volcker's crushing regime of interest-rate hikes would break the inflationary fever in the early 1980s.

Now, inflation is back. Every day, we hear of companies raising prices—from Starbucks and Coca-Cola to Procter & Gamble and Nestle. It isn't just big consumer brands. A recent survey found that 61 percent of small businesses in the U.S. had raised prices for their goods and services in January—the highest percentage since 1974.

Thanks to a unique confluence of events—including an extended period of near-zero interest rates flooding the world with cheap money, Covid-driven government spending boosting consumer demand, and supply chains strained and broken by disruptions in production, transportation and talent shortages—the U.S., and much of the rest of the globe, finds itself in an economic situation not seen in a generation or more. Will central banks be able to get a handle on inflation before it gets out of control? Will supply chains unsnarl? Will people costs flatten?

It is too soon to tell, but my gut says no—at least not for a few years. That is why there is no more urgent need for business leaders right now than to get ahead of the inflation bogeyman. Corporate leaders of the past few decades have been spared the tremendous difficulties that come with trying to drive a business in an inflationary period. Few executives likely have any memory of how to do it at all. Now they will be on the front line. It's one thing to talk about inflation at the macro level and another to keep your business healthy as the world as you know it comes unglued. The key challenge is to grasp the reality, change your organization's psychology, and act and react quickly to the direct hits to you, your customers, ecosystem partners and the entire value chain. The dire effects of inflation happen quickly, and a recession—which could soon result from Fed action to rein in an overheating economy—compounds its effects.

Inflation consumes cash, eats margins and lulls managers into a false sense of security as inflated revenues rise. A company's situation can erode very quickly, leading to takeover or bankruptcy. Those who are fast to react and flexible in their approach can not only survive but prosper in this challenging environment as they seize opportunities afforded by less nimble and smart competitors. Those who react slowly or choose the wrong strategy and tactics will be weakened and may even go bankrupt. The ultimate goal is to emerge from a period of inflation and recession stronger.

Preparing a company to battle this sudden rise of inflation is one of the most difficult tasks that will ever confront management. Not only must the company be prepared structurally and financially, it must also change its dominant psychology. How management thinks about inflation and the company's responses to it will determine whether the company thrives and how it gets ahead of the competition.

Chief Executive Group, parent company of StrategicCFO360 and The CFO Leadership Council, asked me to revisit my work from 45 years ago and redesign it for the current moment, when customers rule, the world is digitally interconnected and information is viral.

Whether you are a CFO, CEO, CHRO or a member of the board of directors, this article is about what everyone must do to manage in an era of global inflation and slowing economic growth. It lays out a brief framework for how the entire company must shift its psychology, strategies, tactics and resources to minimize the effects of this corrosive economic environment, while watching for the opportunities that will arise as competitors fail to meet the challenge.

Keep in mind that inflation can retreat as quickly as it pounces. Any aggressive action the Fed takes to tame it is likely to cause another sudden shift, this time to a radical slowdown in the economy. The mechanisms and agility you develop to adapt to high inflation will be equally useful to adjust to the next big shift. With either scenario, make no mistake: The time to act is now.

INFLATION-ERA LEADERSHIP

As most CFOs can attest, a successful chief executive's dominant psychology in good times is aggressive, optimistic and oriented toward one goal: profits, EPS or EBITDA. In my experience, many CEOs do not pay deep attention to the balance sheet—working capital, cash, borrowing, financing and refinancing and Capex. No one will face greater challenges in managing successfully in an inflationary environment than CEOs. They must not only oversee a major shift in the way the company does business but also a major shift in the psychology and focus of every manager. The CFO will play an integral role in this.

The priority must now become growth of real volume, real revenue, not inflationary revenue. A balance sheet in this environment may require—because of cash flow needs—giving up cash-inefficient customers or market share. That means focusing on certain segments of your market that are more profitable and letting others go. Even the more profitable segments will generate less cash than before, so you need to think about how this will impact capital allocation. This can be difficult for some CEOs to deal with psychologically. So, a reminder: The goal is not market share gains for the sake of market share gains, but cash-efficient market share gains that are durable.

To start, the CEO should consider taking the top team for an off-site to discuss and learn the lessons of what inflation has done throughout history, especially in the 1970s in America and Brazil. The goal is to help everyone transition their thinking to a world where the cost of capital and the cost of doing business are both going up at the same time. As a result, you will have two choices: to absorb the impacts or rethink your business model. Pricing, receivables, inventories, narrowing the product scope if necessary, selecting your customers far more carefully—all of these possibilities are now on the table.

Be prepared: You may need to deliberately shrink or exit cash-inefficient businesses and become smaller and more focused. The way the company measures performance, like market share gain and pure revenue growth, may have to be reprioritized and changed. You will have to know the real volume versus the revenue because increases in price disguise

THE 5 PRIORITIES FOR THE COMPANY

Keep your eye on some essential priorities. The most important thing is continued cash flow generation, forecast on a very conservative basis. With that, make your cash outflow forecast on most likely risks. Out of the net cash flow, the company should prioritize efforts in the following way:

1. CONTINUITY OF THE BUSINESS. What is required for the longevity of the business and winning against competition? It could mean advertising money, short-term innovation to justify higher product pricing, certain kinds of marketing expenditures or certain kinds of expenditures for reducing costs and breakeven points. Whatever capital expenditures or operating expenditures–Capex or Opex–are necessary to preserve the future, while not destroying the present. That's the number one priority.

2. DIGITALIZATION OF THE BUSINESS. This is existential. If you don't digitize, you die. You must never lose focus here, no matter what happens. Your ability to react quickly depends critically on real-time data and analytics. Pre-Covid, people were slow to do this. During Covid, those who had done the work prospered, and those who did not were hurt. In an inflationary period, connecting your enterprise digitally so you have real data on your customers and their spending is mandatory. You must increase your speed of reaction to change.

3. FIXING BOTTLENECKS. Eliminate friction and bottlenecks everywhere, especially in the supply chain. The drag on the business from slow cycle times and inventory in the pipeline will become more expensive as inflation grows.

4. INNOVATION–BUT MORE FOCUSED INNOVATION. Overall, you must not lose the innovation mindset in the company. Understand what the consumer is willing to pay more for and focus your efforts there. It's okay to be incremental unless something big comes in your sector that you can't ignore. The greatest innovation mistake companies made in the 1970s was not to increase the price but rather shortchange the product (remember the shrinking candy bars?). That strategy backfired and hurt many brands for decades. Your products and services must remain fresh and new and show that they are of high value to justify a high price.

5. CAPEX FOR BUILDING CAPACITY IF YOU NEED IT, AND NOT IGNORING MAINTENANCE. Many people postpone maintenance. Don't. It will come back to haunt you at the wrong time. Think about how inflation will change not just your company–but your industry–and work backward from there.

and distort that volume. To protect real profitability, you'll need to revisit key contracts—and change those that lock you into a situation that could lead to a cash shortage. You will need to do all of this and create two or three scenarios right now for 2023.

Revisiting long-term contracts for inflation is a very difficult task. It requires courage, logic and excellent relationships with customers. But it must be done.

For public companies, there will be a contraction of multiples in the stock market as inflation comes along. Investors will discount for lower growth and segregate those that have high debt, those that cannot manage their working capital and those that did capital allocation in the context of zero percent interest rates, as interest rates potentially rise beyond 7 percent or 8 percent.

Your market cap will be based increasingly on your real volume, real margins and your real cash flow. If you can top your competition on that basis, you will attract more capital and more investors. So, it is essential that you focus on the market cap and work backwards. What is the right level of debt, of margins, of receivables, of costs—and real prices?

For private companies, which lack the opportunity to be scrutinized by outside analysts and investors, it is even more important to dive into these details.

Not having a working capital/cash goal is perilous now, because the most insidious part of inflation is what it does to working capital, trapping cash in receivables and inventories. Almost all customers will do their very best to extend their terms of payment—from 60 days to 90 days to even 180 days or more—and in an inflationary period, this cash trap is costly. Working capital—and these customer relationships—must be managed closely.

The CFO and CEO need to think through how they will handle this. They should discuss whatever else could be coming in the next eight quarters and how they'll adapt, including how the company will handle cash generation and capital allocation under various inflationary scenarios—and not just for the first year, but sequentially, cumulatively, for three years.

The CFO can do stress-testing for a variety of scenarios for liquidity purposes. For most companies, this exercise will not be easy, because for most companies, there are too many demands on cash. The board and CEO should create a framework for priorities to determine how cash should be allocated.

The CFO should be ready for sharp questions, such as: If the inflation rate goes from X to Y, what would that do to our cash position and competitive position? If inflation continues, what are the risks to liquidity, if any?

The CFO should be ready for sharp questions, such as: If the inflation rate goes from X to Y, what would that do to our cash position and competitive position? If inflation continues, what are the risks to liquidity, if any?

You may also want to commission an outside study of how inflation will impact the company's end-to-end value chain. No two companies will be impacted exactly the same way by inflation, but since so many companies are linked to one another, it's critical to understand how it will impact everyone in your ecosystem.

As part of this, it is essential to understand how pricing increases and accounts receivables will affect many companies as a backdrop to your company's own operations. This extends beyond the changes themselves to the architecture of the changes—who is leading, who is lagging—not just in your sector but in the context of many sectors and subsectors.

Cash management is the keystone of managing in inflationary times, and you need to have a clear picture of where the cash is coming from and where it is going. Board members and executive leadership should have input into ways to reduce costs and lower their cash break-even point and their cash consumption. They should share any information they have about B2B customers whose financial position could adversely affect the company's business.

Pricing policy is second only to cash management as a priority. An understanding of the pricing mechanisms in place and the availability of a dashboard that gives any member of the executive team or board an instant update at any time makes the task easier and allows everyone to keep a closer watch on financial developments. This is especially true for cash-strapped companies in low-margin businesses, particularly those that have high debt with restrictive covenants.

No matter what, you must continue to build the future even as you focus intensely on the day-to-day immediacies. A disciplined approach to people development and innovation will position the business to leap ahead once inflation subsides—which, in my view, could be five years. How would you become a better company with a better ranking in your industry? That's an essential question to always keep in mind.

PRIORITIES FOR FINANCE AND THE CFO

Cash is king in an inflationary environment, and finance is the keeper of cash. The CFO must understand clearly where the cash is going, ride close herd on receivables and take a proactive role in setting terms for customers. Developing online dashboards to monitor key financial metrics, especially cash on a daily basis, is essential.

It is going to get increasingly difficult to collect receivables. In many companies, this function is delegated to small departments in finance, often staffed by low-level, low-paid employees. In an inflationary period, this is a ticking bomb, because, as I said before, collection of receivables in a B2B business is critical—it is the major cash trap for the company. The time is now for the CFO to build a strong department to manage receivables and working capital, led by a talented manager who reports directly to the CFO.

At public companies, the firm's IR people must learn in detail from the CFO and others how the company's performance indicators will be affected by inflation and an economic slowdown and must convey that information accurately and fully to investors.

For the CFO, it is also essential that they are communicating constantly, taking initiative to show, persuade and get everyone educated on inflation—including the board—especially how different rates of inflation in the sector may change the conditions of the company. This is a time when the CFO cannot communicate enough: What are the facts? What are the numbers? Where are we advancing, where are we stumbling? They should be measuring how well people throughout the organization—and the board—understand all of this.

They've got to lead the development of different scenarios, different remedies, what the options might be in different situations. Meanwhile, they also have to have a handle on daily cash inflow, report what's happening, manage the balance sheet and not incur too much debt. During a period of rising inflation, debt is a killer.

People may tell you, "We have a low-priced debt, let's keep it." But ask yourself, "What is my cash generation capacity in the inflationary period?" If it's very good, keep the debt. Watch the payment schedule. But if your generation capacities are weakened, then you've got a problem, and you need to rethink what's on your books.

Finally, the CFO has got to show how the business model needs to change. A few essentials:

- The CFO must work closely with sales and marketing on pricing policy to understand how pricing will affect the entire value chain.
- The CFO must drill down to evaluate customer balance sheets and financial conditions to determine which ones are most likely to falter.
- The CFO should act as mediator between manufacturing and purchasing and sales and marketing, helping them guard the company against shortages or delays in delivery of supplies while resisting the urge to build inventory, a sinkhole for cash.
- The CFO should help ensure that the entire senior management understands the changing priorities when budgets are being set.
- The CFO must keep the board and CEO informed on a real-time basis of any significant deviations from financial expectations, including such events as customer or supplier defaults.
- It's important to be clear that the CFO is not the CEO or the chief operating officer. They're an adviser. They should not have operating people reporting to them.

On the boards where I serve, we're asking the CFO and the CEO to lay out various scenarios for how the business might operate at various levels of inflation. When they do, look deeply at their assumptions, how they see consumer behavior changing. How will the end-to-end value chain need to change based on these changes? What would they recommend the company do? I'm recommending to boards I work with that they spend three or four hours with the CFO, asking them to take directors through their thinking on these topics. After that, they'll know if their CFO has the ability to lead in this time or if they don't.

COMMUNICATION IS KEY

At the very top of the organization, the first and most important task is to communicate, communicate, communicate. Once is never enough. Repeat the seriousness of the challenge confronting the organization and the urgency with which that challenge must be met with total candor, honesty and credibility, both internally and externally. The CEO should lead this effort as both an educator, ensuring the senior team understands the challenge and consequences of failure, and a social engineer, overseeing the coordination of the various functions so information flows freely and quickly from every silo, acting as a lever for the culture. Management must counter confusion and anxiety created by the media, particularly social media. This is of great importance.

When communicating, there are three essential principles to follow: Did the recipient receive the message the way it was intended? (Measure that.) Did you get the recipient's reaction to your message? (Be sure.) What new behavior of the recipient did you discover?

(Find out.) True communication is not a one-way PowerPoint presentation in which the recipient absorbs less than 20 percent of the message.

The CEO can start by rallying the team, saying, "We're going to win in this new environment," and communicating how the team is going to win. Yes, you're going to take some costs out. Yes, you're going to change some KPIs. And you're going to have to have information come to you unfiltered from the ground so that you know what is happening with customers and with your cash position. They must make sure this message is clear—no filtering, no hiding bad news, assuring employees that they are not just being defensive and making shoot-from-the-hip decisions on narrowing the focus and cutting costs. They must continue to communicate about innovations, new products and new ideas, too.

Let's be clear: Chasing revenue growth and market share without watching cash is a disaster during inflation.

Working in conjunction with the CFO and CHRO, the company's internal communications people should create a website or dashboard accessible to all employees and updated at least fortnightly that presents an analytical picture of the company, its competitive position and the steps it is taking to execute its strategy. It should also include macroeconomic news, such as Federal Reserve policy statements and actions and relevant international news, including price increases in various companies and industries, to educate employees and partners, giving them the context of your company's moves. It may be appropriate to establish a hotline to respond to employee concerns and queries.

Externally, people in charge of internal and external communications need to adopt an attitude of more transparency to reduce anxiety within the company and build a relationship of trust with media outlets.

Communications staff should be proactive in establishing links to both national and local media, demonstrating that the company is methodical, solid and has a realistic view of the environment in which it is operating. The media is confused about the economy, so the communications people should work with reporters and editors to demystify the company's situation and how the company sees the current economy and be able to clearly show how the company is working through these challenges.

At public companies, the firm's IR people must learn in detail from the CFO and others how the company's performance indicators will be affected by inflation and an economic slowdown and must convey that information accurately and fully to investors. Any misstep that hints at cover up or distortion will be disastrous in the investment community.

Unfortunately, most IR people's understanding of what is going on in their industries and more globally is very inadequate right now. That does not allow them to communicate clearly what—or why—the company is doing what it is doing in the context of the larger world.

The IR person must be able to do this, to communicate clearly and unambiguously to the investment community about how the company is positioning itself. They need to build a record of outcomes from the company's actions, showing, for example, where price increases stuck and where they didn't, and be able to explain the company's next moves as a result of that.

IR should be attuned to the investment community and able to seek out big investors who understand the company's situation and its prospects in the post-inflation world and are willing, as a consequence, to invest in the company.

The trust part of investor relations is very important now. Be sure your IR people are spending 80 percent of their time with the buy side. Buy-side people need to know that an inflationary period is here and what you're going to do. Your IR person has to be savvy to extract information from investors about what is really happening in the industry. The subsectors investors are moving toward will tell you how inflation is playing out across the industry and economy.

It is imperative to have your IR person—and perhaps the CEO, as well—reach out to critical investors to understand their assumptions about the economy and the industry they operate in. Ask them for their views. Then educate them on your company's views. They can say: "I'd like to give you our worldview of the industry under inflation." Getting at the reality of what the buy-side people are thinking will be the most important thing an IR person can do to help the company.

SALES AND MARKETING

Pricing must not be controlled by the sales force. The dominant psychology of the sales and marketing departments in good times is to capture as many customers as possible and make every sale that is possible, often without thinking too hard about whether the sale is profitable or the customer is sound. They have a psychological aversion to raising prices, the result of frequent customer pushback and demands for discounts.

To help manage the situation, two innovations are needed in the structure of your company:

1. A pricing unit, which is forward-looking, gathering data and building models. This should be a cross-functional unit that reports directly to the CFO and marketing leaders.

2. A unit responsible for managing working capital, which reports directly to the CFO.

These two units must work together, collecting information about prices across many different companies in many different sectors to form a context for the company's pricing strategy.

In an inflationary period, delaying price increases can be a disaster. The company needs a pricing philosophy and methodology that shows with precision when, where and by how much to raise prices, fully cognizant of the consequences to volume, market share, revenue and margins. This will require close consultation between sales, the CFO and the CEO.

Start by making sure the executive vice president for sales and marketing is aboard with leadership's views and plans. If they can't understand what you're after or don't grasp the urgency, the CEO will have to make a change—fast. Many of them have not lived through this. They will find it very difficult to have the courage they'll need to make tough changes, like shifting their people's KPIs to focus on raising prices and gaining cash or being more directly involved in collecting receivables.

The CFO and the CEO can't expect these departments to change on their own. They must create training sessions to help get the marketing and salespeople prepared to operate in this new environment. For example, one retail company I work with was having a difficult time increasing prices selling to Walmart, one of their biggest customers. So, we got a former Walmart executive to come and role-play with the team, showing them how to increase prices. This is the kind of work you'll need to do.

With B2C companies, most will announce price increases gradually, not all at once. The key is to get ahead of the curve, not fall behind the curve. Many companies will balk at ramping up prices, taking a wait-and-see approach. They will absorb rising costs and try to grab market share from rivals. This is a mistake. Even if they weather the first year this way, as inflation persists, they will have deeply eroded their cash position, making them vulnerable and unable to catch up with rivals who were faster and bolder at raising prices.

Who will increase prices first, without delay? Those that go first will hurt the whole industry, but even if this feeds the larger inflationary spiral, you have no choice. If you do not move, you will be weakened for the months and years to come.

R&D: A NEW ROLE FOR INNOVATION

R&D, USUALLY FOCUSED ON the long term, tends to have a dominant psychology that sees itself apart from the day-to-day problems that besiege the company in an inflationary environment. R&D wants stable employment to prevent the disruption of ongoing projects, and it doesn't want to be the pawn of finance. But the new circumstances leave no room for complacency anywhere within the company.

Most R&D resources fall into one of three categories: long-term, "blue sky" projects that may yield important breakthroughs, projects aimed at making incremental changes in products or processes, and projects aimed at using new technologies to change product attributes or processes. A fresh look at the allocation of total R&D resources going forward three to five years is the first step in adjusting to the new environment.

The first priority of R&D in this economy is to focus innovation efforts—above all else—on the continuity of the business, on the products and services that will justify the higher prices that you will demand in the market.

In consultation with the CEO and CFO, R&D leaders must decide which resources and projects are to be preserved and which jettisoned. Remaining projects should be rank-ordered in terms of importance to the company in the post-inflation, post-recession world. And a determination should be made about partnering with other companies on some projects in order to free up research talent to concentrate on critical projects.

Work with marketing to determine which projects can be slowed and which need to be sped up to take advantage of market opportunities and competitive changes.

Be alert to opportunities to bring in new talent that will enable the company to profitably diversify product offerings or find more efficiencies in operations.

Companies—B2B or B2C—who have invested properly in digitalization over the past decade will now find they have a huge advantage over less digitally mature organizations. The ability to change prices dynamically at the level of individuals or single transactions has an overwhelming impact on margins and cash flow, while the data generated from these systems allows for continuous adjustments to the company's projections and product mix, all huge competitive advantages at a time when knowing what the customers can—and are—willing to pay for is more essential than ever before. This is why I say that digitalization of your operations must remain a top priority, no matter what.

Whether you are a B2B or B2C company, your attitude toward customers must change as well. While the customer is still king, not every customer is a customer worth having. The CEO must know what is happening, not only to his company's direct customers but to their customers as well. The leader has to have the psychology and the mechanisms to delve deeply into the customer's problems to help find solutions but must also have the fortitude and judgment to decide which customers are worth keeping and which should be dropped.

You must evaluate each customer, especially in a B2B business. What is this customer's cash pain point, how are they going to absorb inflation, and how will they change their pricing and modeling? The same goes for understanding your competitors. A competitor who can't or won't raise prices, eliminate unprofitable products or evaluate customers may enjoy a temporary market advantage but will invariably weaken over time. The game isn't won or lost in the first innings. You should map your whole value chain to model how inflation will impact your business model and the business model of every link in the chain. Use this information to show customers why you need a price increase and how they can recoup that in their own business model.

Let's be clear: Chasing revenue growth and market share without watching cash is a disaster during inflation. Customers who don't pay in a timely way are customers you can't afford to have for long. It is essential that you examine the value chain for each set of customers. Start looking right now at which customers—particularly in a business-to-business sales situation—have high debt. They will have a cash shortage. Work with them immediately to prioritize paying you.

Changing products will be at the heart of changing your business. If you had 35 varieties of one product, you're going to have to narrow that down. But, as I said before, you can't afford to dilute the brand by letting quality suffer—those who lived through the inflation of the 1970s have vivid memories of shrinking candy bars and soda cans. They left a bitter impression on customers that was hard to shake, even decades later.

In an inflationary environment, the board of directors has an obligation to delve deeper, to ensure that the CEO and CFO are probing how inflation will affect the entirety of the company's value chain and establishing mechanisms to contend with those impacts.

The overall point is this: You have to look deeply at your company, product by product, customer by customer, channel by channel, and find out where you actually make the bulk of your money—and eliminate anything where you don't have high cash profits.

Every decision must take cash into account. You must look at cash profits, not paper profits, not percentages. Hard cash profit—because managing inflation is managing cash.

HUMAN CAPITAL AND THE CHRO

It will never be more true that "people are our most valuable resource" than in the days, months and years ahead. Now is the time for the CEO and board to bring a laser-sharp focus to the evaluation of senior people to ensure that they fully understand the nature of the environment and are willing and able to take the offensive, adopting flexible strategies and tactics and, if necessary, sacrificing resources for the sake of the company's overall situation. Those who are not prepared to meet the challenge should be replaced.

As I have written before, 2 percent of the people in a company have 98 percent of the impact. Work with your CHRO to make sure management knows who they are, and make sure they're overcommunicating with them to help them understand how the world is changing—what the goals are, how success will be measured, the centrality of cash—and how they must change with it. Nurture your 2 percent first and have the 2 percent nurture the rest.

This is a period when HR has to demonstrate leadership in a very clear way. A slowing economy amid inflation will result in newspapers, television and blogs filled with reports of layoffs. Aggressive competitors will try to poach talent if they find themselves in a weak position. HR needs to ensure that the dominant psychology of the company is fighting inflation and getting ready for the competitive environment that will emerge post-inflation and post-recession.

The CHRO has to do the right things about employee anxiety, and whatever cost reductions you plan will have to be done properly—because every company will want to reduce the break-even point. Dealing with people with dignity, with honesty, that's essential.

HR can tilt its own resource allocation toward education about inflation. Training programs that bring home the realities of inflation to every person in the company are needed to create the climate to survive and thrive. Those programs are best taught by senior executives, who will gain insight into their own psychology as a result of teaching. Training in customer relations, pricing and the internal effects of inflation are valuable approaches.

HR must ensure that people have clarity about the company's goals and how they will be compensated. In a non-inflationary environment, incentives are typically based on one indicator: bottom-line results, usually stated as operating profit. In inflationary times, cash has to be dominant, and compensation formulas would have at a minimum four indicators: cash, operating profit, working capital and customer satisfaction.

Managers may resist or skirt new and different compensation plans that take into account high rates of inflation or slow rates of economic growth. HR needs to get managers to participate in crafting the new compensation plans to achieve buy-in. When that doesn't happen, HR must defend the plans and be sure they are executed fairly.

Compensation plans need to be revamped to reflect the realities of inflation. The typical senior executive's three- to five-year compensation plan providing 25 percent fixed and 75 percent variable is a sacred cow that should be killed off in the new environment and replaced with a more realistic plan.

HR needs to work with the CFO to be sure that unit performance is evaluated on real numbers, not inflated numbers. That will ensure that talent will not walk away, especially when there are allocation issues among units.

HR also needs to keep the board apprised of needed changes in the skill mix at high levels, suggesting shifts in geographical or business unit leadership that would provide the most or best opportunities to take advantage of the new environment that results post-inflation. They should also be alert to talent that may be lured away and to opportunities to bring in new talent.

Boards should insist the CHRO makes a presentation of their priorities, what the outcomes will be and how they will manage inflation. The CHRO should be able

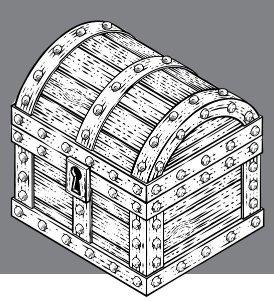
OTHER ESSENTIALS

GENERAL MANAGERS. In an inflationary period, general, regional and country managers share some of the same tasks as the CEO. They must communicate the urgency of the challenge and understand the overall effects of inflation on their operations. Help them develop a point of view on inflation based on an understanding of the causes in your markets. Project inflation assumptions out one, three and five years. Develop contingency plans for worse-than-expected conditions, either in inflation or economic growth. Redesign key performance indicators by which they evaluate their teams—those KPIs must include cash and cash-related items. Target weak competitors who don't recognize the dangers of inflation or who can't cope.

LOGISTICS. Plan for the worst. Reexamine the supply chain from vendors to you, and from you to retailers and distributors, with the assumption that energy prices are going higher, perhaps much higher. Does a supply chain designed for $50-a-barrel oil work in an environment of $100-a-barrel oil? What happens if the chip shortage continues for another two years? Factor in deteriorating infrastructure, congestion in freight terminals and other bottlenecks that could slow or disrupt movement of supplies and products. Be sure the people doing your pricing understand how logistics is changing and what impact that will have on operations.

LEGAL. In B2B, legal contracts are very common, which gives the customer the upper hand to hold you to the terms of the contract, which, in many cases, was crafted before inflation was on anyone's radar. This is why the legal department has to be in lockstep with other departments as they fight to adapt to the new realities. Push to include flexibility in new and existing contracts to reflect the need to renegotiate terms more frequently in conditions that most managers have never experienced before. Work with your best customers and suppliers to streamline the contracting process. Anything your company can do to make it easier for suppliers or customers to do business with you will give you a competitive edge.

MANUFACTURING. Everyone knows manufacturing is suffering in most industries these days. Supply chain issues, lack of available talent in the plants, exaggerated prices in logistics. Wherever there is an assembly line, there is lack of balancing. This volatility is not going to be alleviated soon. Meanwhile, customers are clamoring to receive your output. The job of the manufacturing managers has become more demanding. Often, they have to decide which customer to supply first.



to present their plan for human capital the same way the CFO does for the company's finances. This is a good way to test whether you have the right CHRO for the days ahead.

THE BOARD'S ROLE

Like their CEOs, boards—in both public and private companies—are not practiced at leading through an inflationary period. When the last such era occurred in the U.S., most of today's CEOs were in their teens or 20s. They have no experience in dealing with the insidious chain reaction of price increases and labor costs. In good times, directors tend to give CEOs a great deal of leeway to do as they see fit, consistent within an overall strategy the board supports. Unless things go seriously awry, the board takes a long-term, above-the-fray view of the company's operations.

In an inflationary environment, the board of directors has an obligation to delve deeper, to ensure that the CEO and CFO are probing how inflation will affect the entirety of the company's value chain and establishing mechanisms to contend with those impacts.

The board should ask the CEO and CFO to bring that information to the board. A board meeting devoted solely to a discussion of how inflation and recession will affect the company is mandatory. Consider a retreat for the board to have management show you various scenarios of the inflation for your sector—not the whole economy—because there are certain sectors that are going to be affected more negatively than others.

That's important: The inflation rate will vary sector by sector, subsector by subsector. Don't get caught up by one single number for the whole U.S. or the whole world. Granularity will make the difference here.

The most critical task for the board is to approve the right short-term goals out one to two years for management to achieve. Most boards have already made a big mistake by not explicitly setting a cash goal for management, instead relying on EPS goals and/or EBITDA goals.

The board's compensation committee has the important but complex task of deciding how to compensate the CEO and senior management under inflationary conditions. That task becomes even trickier in the face of a recession or markedly slower economic growth. The board should not rely on consultants for this work, since most consultants have not been through a period of inflation in 30 years and may not themselves understand the new behaviors required to survive and thrive in those conditions.

To do this work correctly, the board's compensation committee must look at the company's financial statements, not only in nominal dollars—inflated dollars—but also in real dollars. Only by looking at the numbers on a real dollar basis will you be able to determine the actual economic value that management has created or destroyed, and it is on that basis that compensation decisions should be made. It is essential to also understand how these numbers were achieved—what did management sacrifice to get there? What were the cardinal decisions the team made to achieve its goals? And, in so doing, did they undermine the future? A healthy discussion that includes the CEO and CFO on these topics will be useful to everyone.

Plan to review strategy at least three times annually, not necessarily to change it, but to understand how the landscape is evolving, which components of the portfolio might be vulnerable to significant decline or where sudden opportunities may appear. The long-term focus is always on how to emerge stronger in the post-inflation and post-recessionary environment. It is possible.

Leaders will now be tested differently than they were before Covid or during Covid. This period demands resilience and determination. Being defensive is easy. My advice: Go on offense. Look into the future and gain ground when the economy moves out of inflation. Make this era a period of opportunity. It can be done. CE