

Surviving Tough Economic Conditions

Introduction

With a globalised COVID-19 virus killing hundreds of thousands of people, creating massive economic disruption, and heightening geopolitical tensions – the world seems to be a more fragile place. Yet, there are lessons we can take from all of this - learnings which can make your business stronger, more resilient, and more realistic.

The first lesson is that a highly interconnected and complex world is also a fragile one. In such a world, some of the so-called “Black Swan” events, or those that seem highly improbable, are in fact inevitable. And some of these events will be incredibly harmful. If this assertion is true, then it makes sense to literally “expect the unexpected”.

Uncertain Environment:

- Pandemic and health crises
- Geopolitical conflict
- Energy crisis
- Climate change
- Inflation
- Cyber attacks
- Remote work

You need to review the impacts on your business of both its **external drivers** and also its **internal variables**, which are specific to the business. These are shown in the diagram below.

EXTERNAL DRIVERS

- Economic growth
- Government policy/regulation
- Demographic change
- Market size and growth rate
- Commodity prices
- Consumer spending
- Rate of technological innovation
- Inflation
- Cost of borrowing
- Social attitudes

INTERNAL VARIABLES

- Mission, vision, strategy
- Business model
- Customer satisfaction/loyalty
- Productivity
- Cost structure
- Quality
- Talent
- Time to market
- Reputation/trust
- Access to capital

Lessons on Resilience

This leads us to a second lesson: that *resilience thinking is core to both organisational strategy and design*. Traditional Business Continuity Planning and Risk Management frameworks are necessary but insufficient to deal with an uncertain world. **Research and practice both indicate that we need two sides to our resilience thinking:**

- This includes traditional risk thinking in preparing for foreseeable challenges. However, “fortification” strategies also include ways to buy time to respond – for example, the maintenance of capital reserves.
- When faced with an unexpected challenge some organisations can respond faster, and more rationally, than others. These are the entities which are inherently more adaptable. Adaptability becomes as important as efficiency in designing organisations.

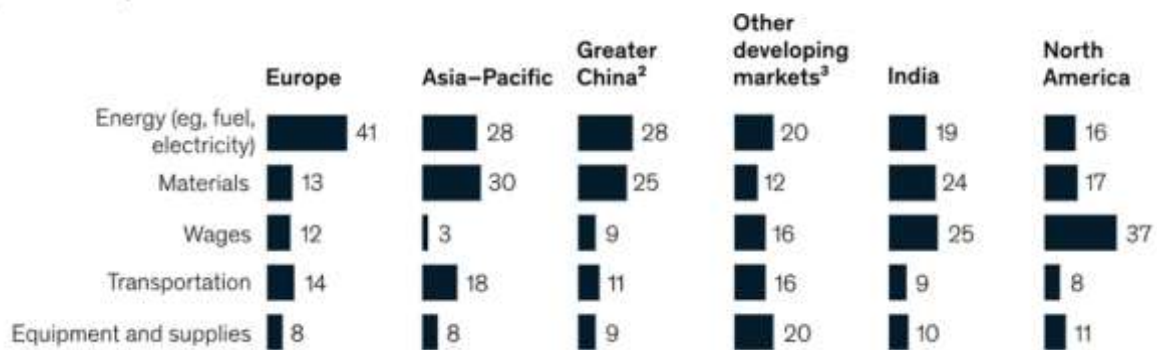
Fortunately, there was some cause for comfort in the resilience of several major Australian enterprises. It turns out that our banks were heavily fortified (great capital reserves), and many leaders have commented that their level of adaptability has been better than expected. However, we have also seen organisations suffer from decisions to reduce cost at the expense of resilience. For example, some offshore service centres proved ineffective or entirely absent, and some supply chains broke down. Furthermore, if we had suffered an early and severe outbreak, we would not have had the medical supplies to cope. So, we could and should do better on resilience.

McKinsey & Company conducted some great research in compiling its *Economic Conditions Outlook* quarterly update. There was interesting information provided regarding two important business concerns that was analysed by global regions. There were some interesting differences highlighted around the world on these two factors:

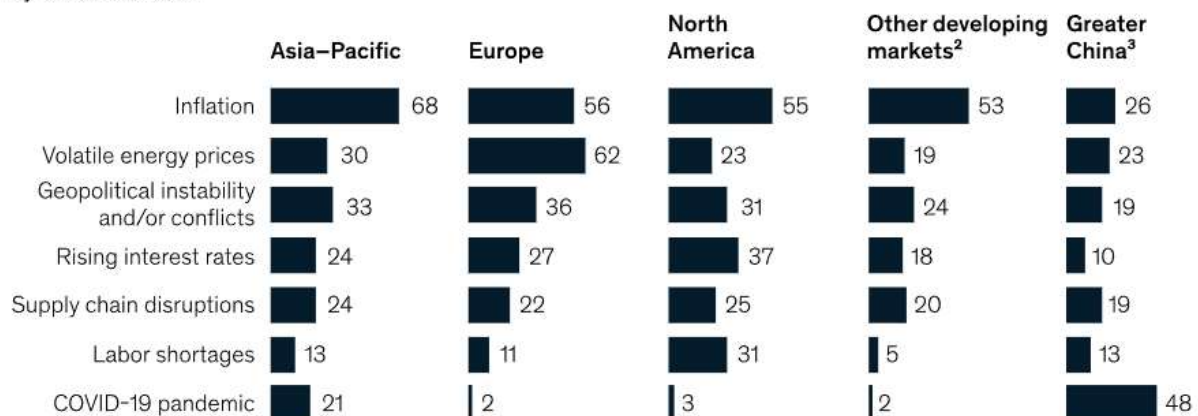
- **Areas of the business organisation most affected by cost increases in the past 6 months to September 2022; and**
- **The foreseen causes of the greatest potential risks to economic growth in the next 12 months for business.**

The two diagrams below summarise the survey results for these factors.

Area in which organization has been most affected by cost increases, past 6 months,¹ % of respondents, by office location



Potential risks to economic growth in respondents' countries, next 12 months,¹ % of respondents, by office location



Source: McKinsey & Co – “Economic Conditions Outlook – September 2022”

If you would like a copy of the full report by McKinsey & Co please click on the link [HERE](#).

Rapid Adaptation

We have also learnt that some lack of adaptation displayed by businesses was, at least in part, due to **self-imposed limits to change**. We know this because we found that, when push came to shove, **we could adapt faster than we had thought**. Consider a simple example – for over a decade there has been a slow-moving discussion and debate about whether psychological services can be delivered online. Well now they are, with the potential for major benefits if we can offer such services to remote communities via our now ubiquitous video-conferencing platforms. We should be changing a lot faster now, because such changes make our services, our economy, and indeed our population, much more resilient.

In delivering such changes we have also learnt that **we can collaborate in surprising ways**. This has been an important part of our ability to adapt quickly. Rather than locking ourselves into fixed and immutable positions we have seen the reasons to work together for the greater good. This idea, that our self-interests are served by supporting the organisations that sustain us, has been at the heart of our adaptation success.

Unfortunately, early signs of this enlightened attitude collapsing as people and functions position themselves for the “new world”. This is folly given that the crisis is not over, rather it has just moved to a new phase in which economic and social disruption is a certainty (and further infection waves are a real threat).

We are in the most disruptive economic period since the GFC. Some economists actually argue it is a deeper and longer-term shift.



Changes to Business Operations

However there have been positive changes made to address some of the concerns noted in the diagram above. Business management and leaders are implementing changes more swiftly than in the past and that is reaping rewards for those businesses that have been acting to adapt to the changing business climate despite the challenges and ongoing headwinds being experienced.

The table below shows some examples of changes that have been made in different business sectors to good effect.

Examples of changes happening in different economies

Manufacturing	Supply chain	Retail	Service industries	Mining
<ul style="list-style-type: none"> Near sourcing Automation Product innovation Energy management systems Inventory management Overhead cost reduction 	<ul style="list-style-type: none"> Work on resilience in organisational operating models Inventory management Productivity improvements Mergers & acquisitions 	<ul style="list-style-type: none"> Shift to online - rebalancing of operational focus Supply chain changes Incorporating new consumer demands 	<ul style="list-style-type: none"> Removing human labour - save humans for dealing with other humans - through automation and process change 	<ul style="list-style-type: none"> Automation Addressing climate and other environmental and cultural concerns

Despite this some companies are experiencing real pressures on their operating margins because they have been unable to (or have felt they were) to increase their prices quickly enough to keep up with many of their key input costs. The diagram below illustrates this further and provides an illustrative example of the margin squeeze over a period.

Some organisations are finding themselves in nasty "value traps"

- Organisations are unable to raise end-prices faster than input costs

The construction industry is a stark example of this:

- With fixed prices for services, yet rapidly rising input costs;
- The forward pipeline of the construction industry is starting to look tenuous, and;
- Some builders (perhaps many) are starting to report order book cancellations.

It is worthwhile noting that **construction represents 9% of Australia's GDP²**

² Source: Australian Industry and Skills Commission (2022). Construction Industry Overview. <https://tasksandindustryinsights.aisc.net.au/industry/construction>

The margin compression challenge is not just limited to construction

Illustration ONLY

Revenue Growth vs Cost Growth 'Jaws' Ratio



Of course, there are a range of factors that contribute to the overall operating margins compressions that relate to three key areas of business operational management:

- Direct material costs (inflation) and wage pressures (cost of living demands) – these will vary in impact between different business sectors.
- Business disruption factors for example, lack of experienced staff and understaffing, supply chain issues extending lead times for delivery and completion of work and changed customer demand (cost of living impacts).
- Business practices previously adopted that may now be having adverse consequences for the business.

The diagrams below show these margin compression factors and the Australian inflation changes over the past 25 years to September 2022.

Key Contributors to Margin Compression



Input Prices

- Massive **spikes in energy prices**
- Salary pressures** pushing up costs – but this may be to pragmatically unsustainable levels
- Trends towards **localisation** (by necessity)



Disruption

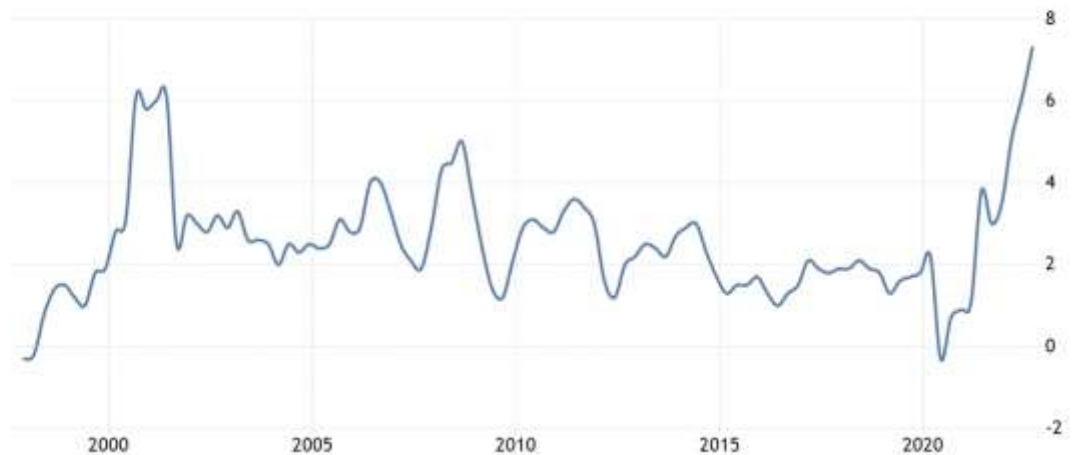
- Staff **shortages**
- Staff **absenteeism** (ongoing pandemic)
- Supply chain** disruption
- Potential **decreasing demand** in some markets



Business Practice

- An **overhang in inventory** as it was "front loaded" by some retailers based on expected ongoing supply constraints. This, ironically, might be helpful as price drops might result
- Orders locked in at lower rates – reducing margins

Australia Inflation Rate Past 25 years



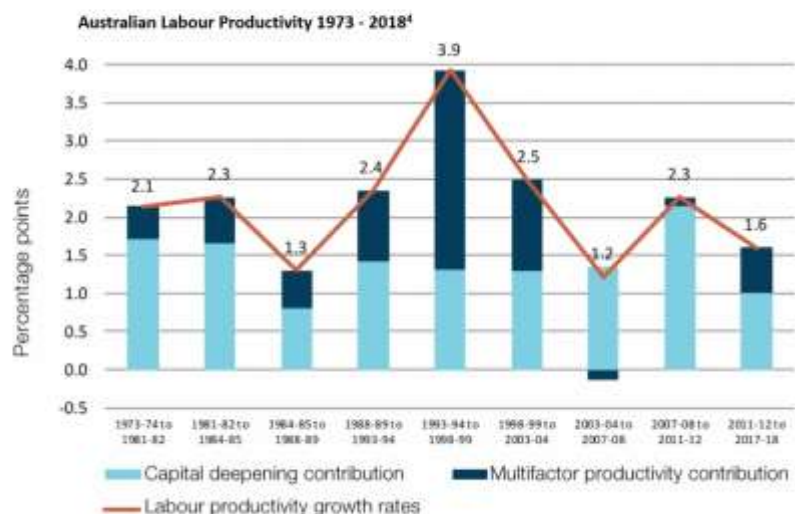
Australia's low productivity position – which has been stuck at this level for a long period of time now – further exacerbates the problem for many businesses too, as shown in the table below.

However, some companies have made or started to make changes to address the issues discussed in this article. The second diagram below elaborates on some of the positive changes that are being made in relation to:

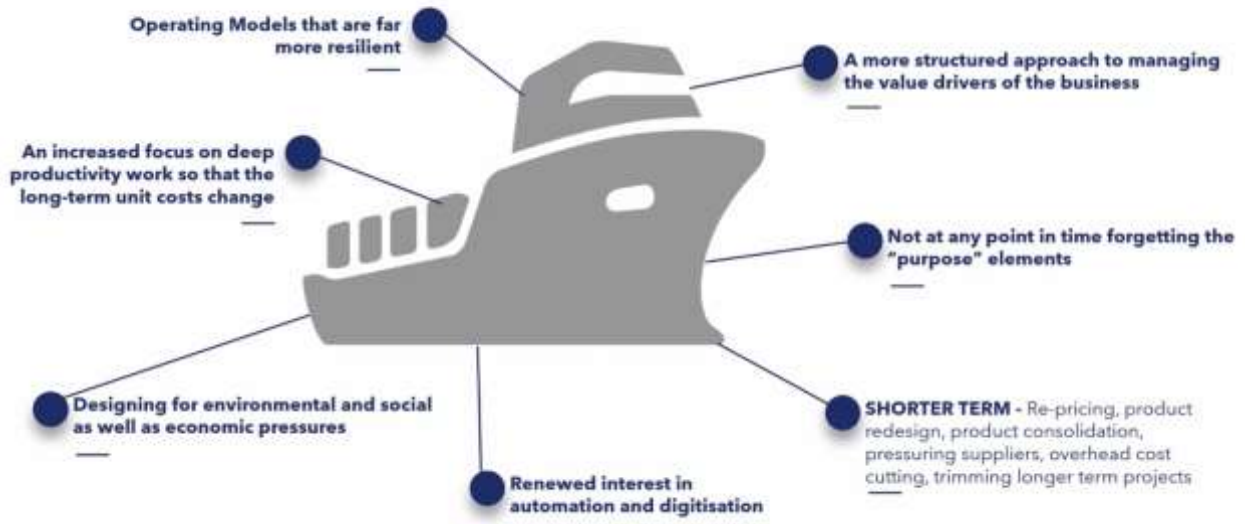
- Business Operating models.
- Refocusing on ways to improve business productivity.
- Better managing the value drivers of the business.
- Getting back to alignment of operational matters to the real business purpose.
- Taking some short term strategic and operational changes within the business to adapt to the forces in play.
- Looking at the benefits of automation and technology changes that will assist the business operations.
- Seeing how ESG (Environment, Society and Governance) factors may be something the business must now embrace where relevant.

Unfortunately, Australia has a long-term problem in improving productivity, we have a poor record over recent decades

Outside of reforms from the Hawke/Keating years ('93 - '99 period in graph), there has been nothing that pushes productivity higher than 2.5% for over **40 years**



In this context, many enterprises are seeking to change deeply



Re-Visit your Business Operating Model

The fix for both waste and system problems usually involves multiple elements of the operating model

What is an Operating Model?

- An **Operating Model** is the combination of roles, skills, structures, processes, assets and technologies that allow any organisation to deliver on its service or product promises
- It is in effect the **way the business is set up to deliver VALUE** (both in terms of the customer and in terms of the business)
- The **aspirational view** of how the business is to be set up to deliver against future or changing markets, environment and technology demands is sometimes called the **Target Operating Model**



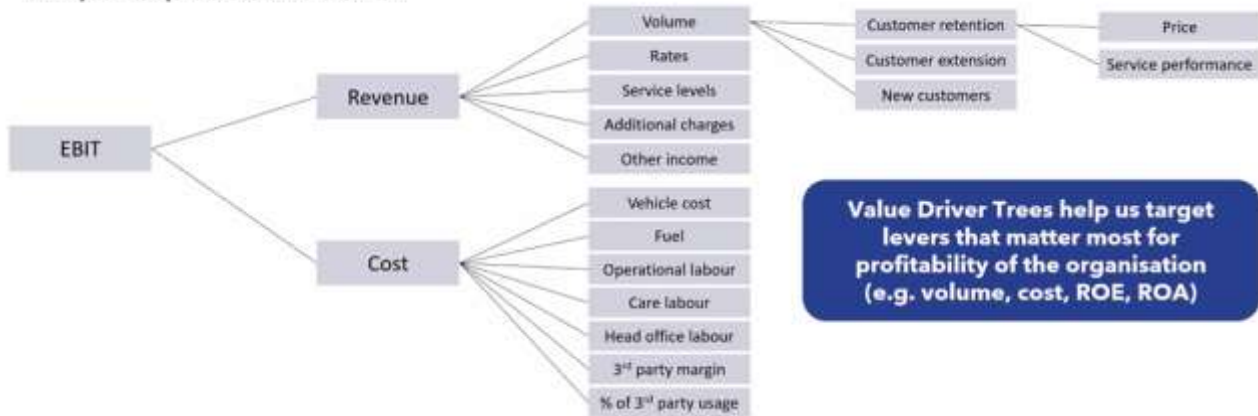
Operating model thinking helps to address a broad range of "vulnerabilities"

- Supply Chain Disturbances**
e.g. supply chains with no local alternatives
- Outsourced and offshored critical services**
e.g. without a backup (or matched) capability onshore
- Long and inflexible service contracts**
- Heavy reliance on narrowly trained personnel**
e.g. cross-training weakness
- Limited safety stock**
- Narrow sources of revenue**
- No ability to scale up or down**
e.g. fixed workforce, bandwidth, technologies or critical supplies
- Heavily bureaucratic processes**
e.g. multiple signoffs and decisions by committee
- Innovation Challenges**
- Recruitment**
- Declining Productivity**
- Turnover**



Business Value Drivers – Review

Example - Simplified Value Driver Tree



Conclusions – Action Steps, Building Resilience & Scenario Planning

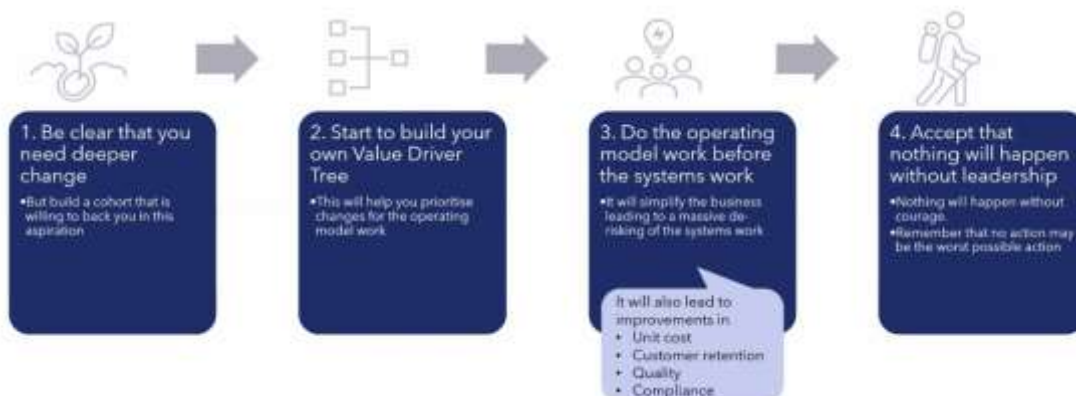


The word **resilience** comes from the Latin *resilire* (“to spring back”). Resilience is viewed as the ability to bend but not break. For individuals, it is thought to have genetic underpinnings but there is a complex interaction with personality traits and environment that fashions the defining robust outlook. The resilient individual has a positive sense of themselves, an ability to confront adversity and the capacity to find hope and meaning in life.

With resilience comes strength and action; without it comes weakness. Resilient people and businesses face realities with vigour, make meaning of hardship and improvise solutions. They more readily tap into hope, are more optimistic and eschew negativity. Even when under pressure, they are distinguished by a continuing curiosity about life’s events and changes. A key marker is that they keep moving forward.

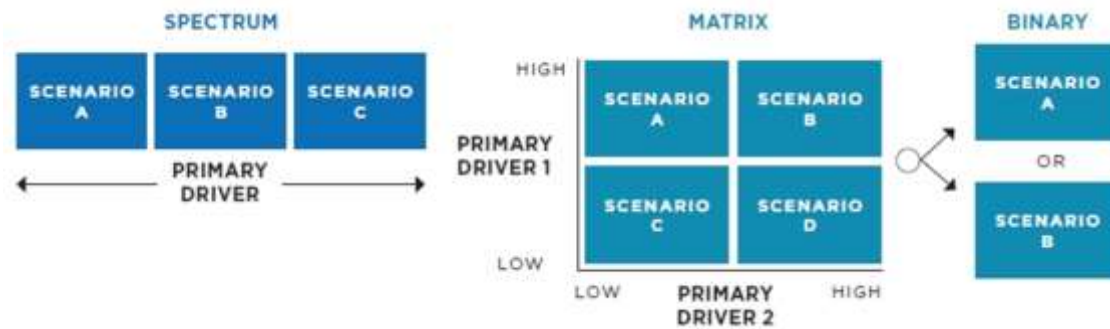
So, what should you do right now?

Accept and preferably get energised by the challenge!



It can also be very useful to use **Scenario Planning Analysis** to assist you in the whole process of your business review, linked to your key business drivers. Three possible approaches can be used to apply scenario planning in your business (see the diagram below):

- Spectrum.
- Matrix; and
- Binary.



A useful ideology for showcasing the importance of the scenario planning is the “**RAISE**” philosophy developed in Canada, for assisting with the implementation of scenario planning:

“RAISE”: Resilient + Adaptive + Innovative = A Sustainable Business Enterprise

The RAISE philosophy can help guide a business enterprise towards a unique strategy that provides an ongoing sustainable edge, through embracing the key components of:

- **Resilience:** Organisations today must demonstrate their resilience in the face of constant turmoil and disruption. They need to respond quickly to these constant and unexpected external changes while at the same time sustaining regular business operations.
- **Adaptive:** Organisations more than ever need to be adaptive in their ability to adjust to these ongoing market shifts in the competitive landscape. Given this changed environment, they need to be nimble and flexible enough to “proactively” respond to any and all competitive or market changes.
- **Innovative:** Opportunities to innovate are typically a primary contributor to enterprise success and longevity. However, it is one area that many fail to adequately explore or execute upon.
- **Sustainable Enterprise:** Embracing such drivers as key components of an enterprise’s strategic and operational plans and decisions, can help ensure an organisation’s sustainable competitive edge.

Additional Resources

Some additional information in relation to this topic that may be of interest for you are the following:

- **“Build a More Profitable Business - A Financial Management Guide for Entrepreneurs”** produced by BDC which can be accessed [HERE](#).
- **“Strategy and Planning – a Recovery Toolkit for Businesses”** which can be accessed [HERE](#).
- **“The Global Lighthouse Network Playbook for Responsible Industry Transformation”** – a whitepaper from McKinsey & Company which can be accessed [HERE](#).
- **“Scenario Planning Applying A Six-Step Process To Your Organisation”** which can be accessed [HERE](#).
- **“The most important problems Australia’s CEOs are solving for growth today and tomorrow”** – a summary of the PWC’s Australia’s 25th Annual Survey of CEO’s which can be accessed [HERE](#).

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