

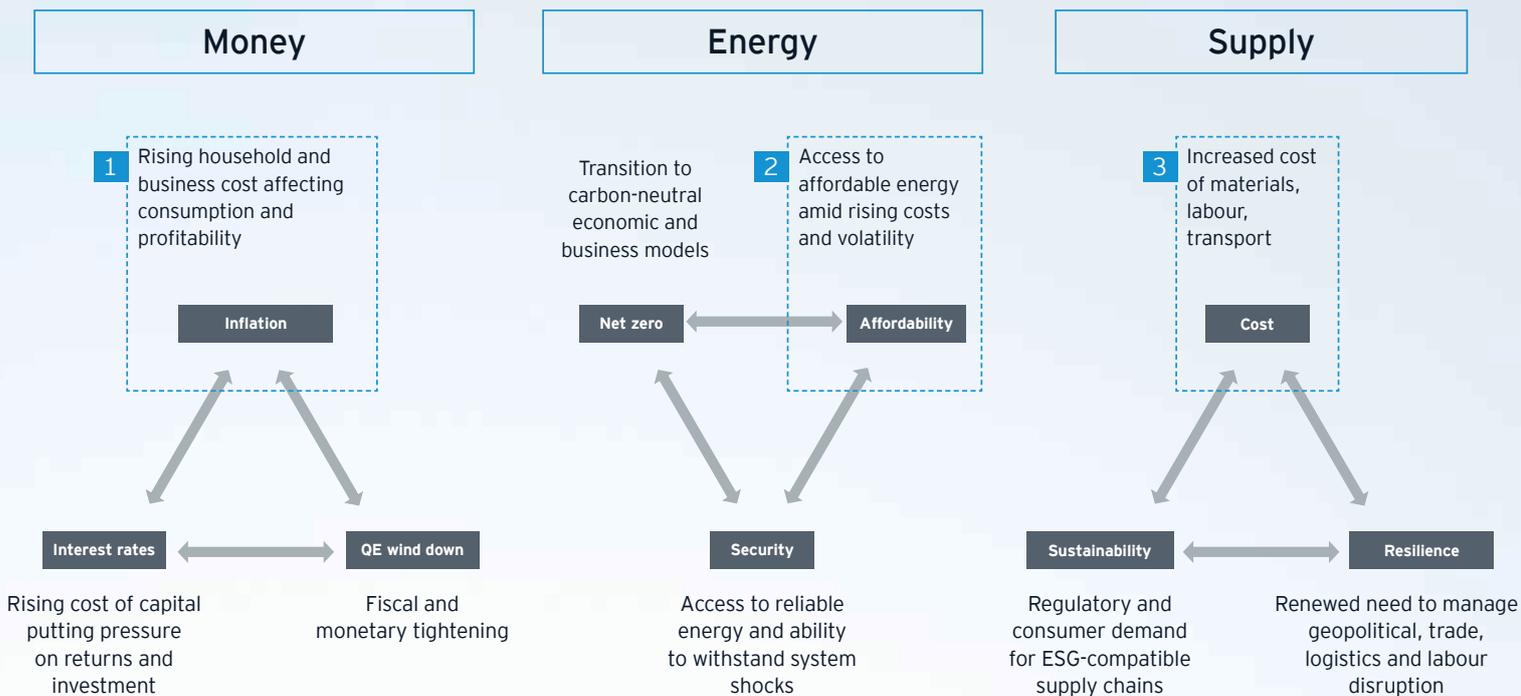
Managing the trilemmas: understanding and responding to industrial inflation

February 2023

Trilemmas series

Businesses will continue to see inflation of 10% or more in 2023 - here's how they can thrive

This is the latest publication in EY-Parthenon's 'Trilemmas' series. How businesses manage the below three uniquely interacting 'trilemmas' will largely determine their success. These trilemmas summarise the vast majority of external pressures facing companies across sectors at the moment, and are a useful starting point for firms wanting to identify pressure points, manage downside risk and seize opportunities.







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Key points

- ▶ The outlook for inflation and interest rates is stabilising which is very positive for businesses and consumers.
- ▶ However, over the next two years the inflation facing businesses look set to diverge from the inflation facing consumers.
- ▶ In the UK, inflation could drop to around 4% by the end of 2023, whereas industrial inflation (PPI) will fall, but could remain in double digits at 10.2%.
- ▶ In the event of further pressure on commodities including energy, PPI inflation could be over 13% by the end of 2023.
- ▶ Between 2020 and 2023, PPI inflation will have increased by close to 50%, meaning that by the end of the year, it will on average be 50% more expensive to produce in the UK than pre-pandemic.
- ▶ To avoid margin erosion and liquidity challenges, businesses need to take a series of steps across scenario-planning, forecasting, cost-control, procurement optimisation, portfolio prioritisation and pricing strategies.

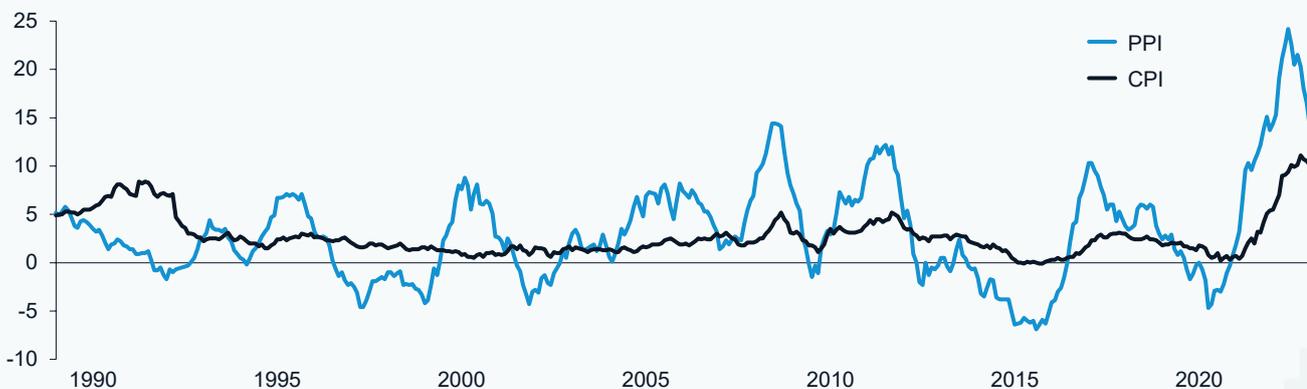
¹ [Producer price inflation, UK – Office for National Statistics \(ons.gov.uk\)](https://ons.gov.uk)

Trilemmas

Industrial inflation (PPI) is set to outpace consumer inflation in 2023

Last year saw consumer (CPI) and industrial (PPI) inflation reach decade highs. In the UK, CPI peaked at 11.1%, in October which was in line with EY-Parthenon's mid-range scenario set out in July and would have likely hit 15% in the absence of Government intervention over energy cost, which was our upper-end scenario. PPI inflation peaked at 24.6% in June. In the US and eurozone, inflation peaked at 9.1% and 10.6% respectively. In Germany, PPI inflation peaked at a whopping 45.8%.

PPI and CPI historic rates (%)



Whereas CPI inflation takes the headlines, PPI inflation in many cases provides a better insight into businesses' cost exposures and therefore needs to be a focus. This is particularly true for manufacturers, its investors, and businesses with manufacturing supply chains. Whilst the UK is a services economy, it still relies in large part on its manufacturing base, economically and politically.

PPI and CPI: Understanding the difference

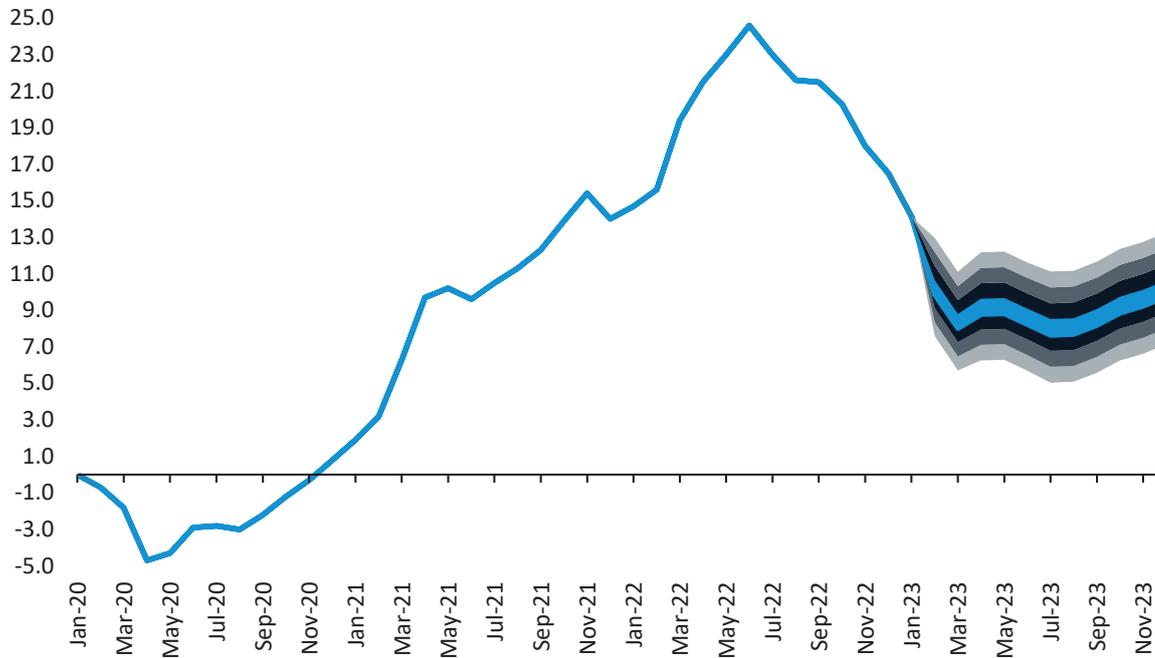
	Producer Price Inflation	Consumer Price Inflation
Measures	<ul style="list-style-type: none"> ▶ Price changes of goods bought and sold by UK manufacturers ▶ It excludes non-manufacturing firms and service costs incurred by manufacturers (e.g., wages and rent) 	<ul style="list-style-type: none"> ▶ Price changes of goods and services bought by UK consumers
Composition	<ul style="list-style-type: none"> ▶ A weighted basket of manufacturing goods from c.4k respondents (e.g., gas, oil, metals, chemicals, food) 	<ul style="list-style-type: none"> ▶ A weighted basket of c.720 representative goods and services from 140 UK locations (e.g., food, clothing and transport)
Relevant for	<ul style="list-style-type: none"> ▶ Firms producing goods that purchase significant inputs (e.g., manufacturing and FMCG) ▶ PEs or companies invested in firms with a large physical supply chain of goods 	<ul style="list-style-type: none"> ▶ Macro-economic indicator

Many businesses are still relying on forecasting, cost pass-through and procurement models that fail to accommodate for tailored inflation exposure, meaning their forecasts are not prepared for significant input price fluctuations, and consumer versus producer inflation divergence.

Our scenarios show that over the course of 2023, PPI inflation will continue to drop from its 2022 levels but creep up to 10% at the end of the year in a central scenario and above 13% in a scenario where commodities come under further supply-demand stress.

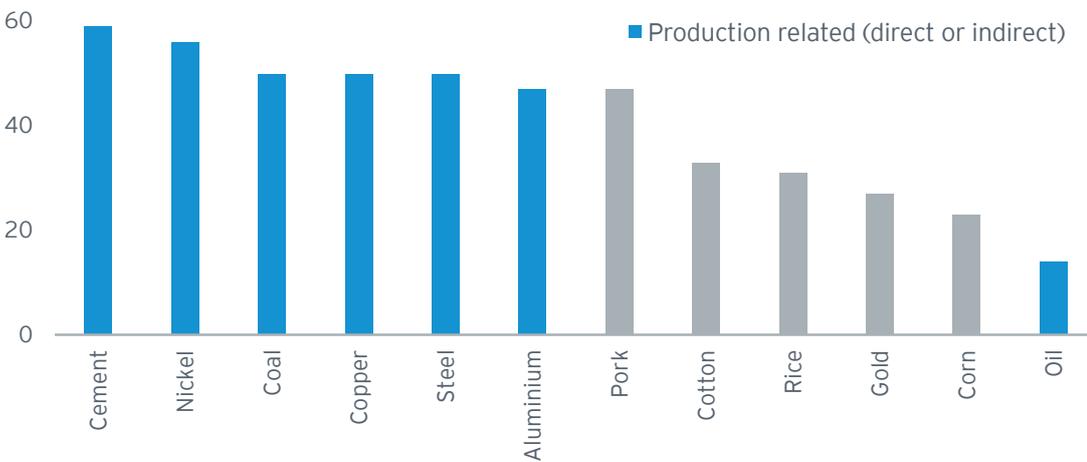
Our initial forecast for January PPI inflation appeared to be moderately conservative compared to the actual figure released by the ONS, leading us to believe our forecast for the remainder of 2023 is also built using a similarly conservative method.

PPI Forecast (%)



The resistance to falling producer prices is driven by a boost in demand from the re-opening of China which could potentially send prices rebounding, as well as continued supply volatility of gas prices, commodity prices and food prices caused by the continued exposure to geo-political shocks and the risks around gas storage. Wage increases are less of a factor for PPI than other inflation measures, but still feature and will require attention from businesses.

China's share of world demand for global commodities (%)

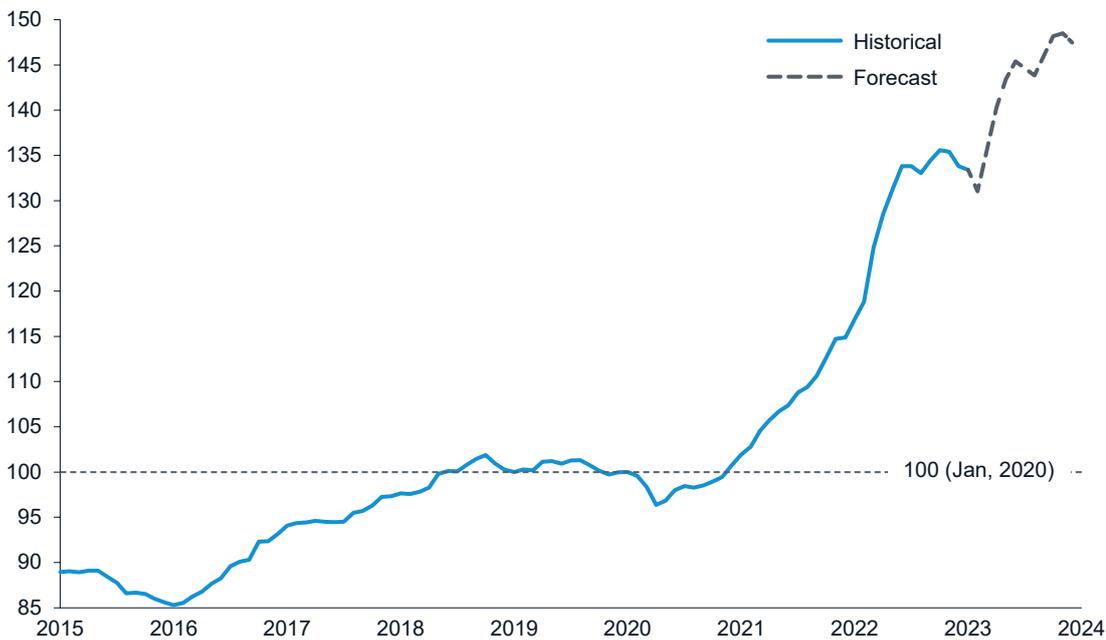


⁴ Bank of England (2022)

Businesses need to understand their exposure to these costs

Like CPI, PPI measures price increases not price levels. Perhaps most striking is the compound effect of recent high PPI inflation, meaning high embedded costs for businesses. Between 2020 and 2023, PPI inflation will have increased by close to 50%, meaning that by the end of the year, producing in the UK will on average be 50% more expensive than it was pre-pandemic.

PPI (indexed to 2020)



For comparison, the three years to 2019 saw PPI inflation rise by only 7%, less than a seventh of present rises.

In practice, the above dynamic means that for many businesses demand has to rise markedly in order for current margins to be maintained - which is problematic as we're entering a period of reduced demand in many sectors. Though eventually, CPI and PPI will converge, businesses will likely need to take additional actions in the meantime.



Businesses need to act now to build resilience to cost base increases and margin erosion

There are a number of actions that businesses can take to protect value and margin, which EY is helping clients to execute.

Diagnose

- ▶ **Forecasting:** Create bespoke inflation metrics for your business to understand the rate of inflation you are facing, noting it could well diverge from CPI.
- ▶ **Contracts:** Review supply contracts to understand cost pass-through to your business, in particular review the specific cost pass-through provision in contracts even if that provision has been in place for some time.

Protect

- ▶ **De-risk cost exposure:** Review your energy exposure and strategy to mitigate short term volatility and plan for elevated costs in the longer-term. Take steps to hedge commodity exposure.
- ▶ **Capital and liquidity:** Identify cash flow requirements, working capital release and opportunities to strengthen the balance sheet.
- ▶ **Financing:** Conduct cost and EBITDA scenario planning to reduce the risk of interest cover and leverage multiples unexpectedly deteriorating, which in turn may trigger breaches of financing covenants.

Optimise

- ▶ **Margin:** Control total costs (even in areas of low exposure to inflation), rationalise your portfolio (identifying products which become loss making), maximise value engineering.
- ▶ **Pricing:** Go granular with pricing and promotions, considering pricing strategies (including increases) based on your exposure to inflation and your supply chain pass-through. Time price changes based on consumer and client expectations.
- ▶ **Capital deployment:** Optimise and sequence capex, avoiding dated supplier inflation provisions (particularly for capital projects).
- ▶ **Labour:** Deliver an employer value proposition to manage wages and retain talent, focussing on employer brand and affiliation value, career development and job content.
- ▶ **Technology:** leverage technology across the business to achieve productivity gains and reduce cost, including using platform-based approaches. As well as identifying new sources of revenue as part of tech ecosystems (for example electric vehicle charging ecosystems connected auto OEMs to power suppliers and technology companies).
- ▶ **Acquisition and partnerships:** For example, identify where integration and acquisitions of suppliers into the business can reduce cost pass-through, improve security of supply and create new profit pools.
- ▶ **Policy:** Identify where regulatory and government support can reduce costs (for example on energy) or support capital or operational changes and investment (for example for technology or labour).

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