INNOVATING *Against* INFLATION

A Special Report By

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0. Introduction

Let's be honest. Inflation isn't just coming; it's already here:

- US consumer prices have already jumped to their by their highest amount since 1982 (a surge of 7.5% in January, 2022)
- Producer prices have jumped, too - by nearly 10%
- The response to the invasion of the Ukraine, including sanctions, has pushed gas prices up further, breaking past predictions, and will have an ongoing flow-on effect on supply chains

But this is just the beginning. The economic environment will becoming increasingly volatile as other issues arise:

- Maintaining current standards of living will become more expensive, despite already increasing wages, as inflation drives up the cost of everything. Unless their wages increase, workers will feel stressed, find it harder to focus, and be less productive… ultimately reducing business productivity
- Political factions will continue to focus on servicing their own parties and interests, running up state debts and forcing currency instability, affecting interest rates and costs of capital
- Consumers and businesses will have less discretionary income, as a result of reduced productivity and increased costs, forcing changes in strategy, operations, and financial management

In short, this *will* affect people like you - owners of private businesses with multiple-million dollars annual sales - and the people in your life.

Chances are you're already feeling these pinches and pains of the early stages of this inflation. You're probably stressed (or at the very least, concerned) about what is yet to come, and how you're going to respond to minimize the negative impacts inflation has on you as it begins to affect your suppliers, your customers, and your staff.

If this captures your recent thoughts and feelings, you'll find this report valuable.

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That's because in this short report, you'll discover how to think about leading your team away from "business as usual" so you can innovate in ways that make inflation irrelevant, finding yourself new sources of growth, profits, and cash flow.

Specifically, you'll learn new ways of thinking about your situation, and understanding your business.

But before we go further, a warning: reading this report won't be enough to get you ahead of inflation. That's like reading a restaurant menu online, and expecting to feel full.

Instead, as you read through this short report, please take notes about how you can apply its contents to your business. Because if you do, you'll find yourself better equipped to lead your company in a way that secures its future, supports your family, and keeps you competitive.

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1. How To Think Of Inflation The *Right* Way

Most people hear the word "inflation" and start worrying.

They see expenses sky-rocketing, feel the tightening of customer purse strings, and hear the negative discussion at every turn. It's like the end of the world has arrived, and nobody can do anything other than strap in and hope it's a quick death.

While there's some truth in this, it isn't the whole picture.

Instead of thinking about inflation as a giant evil, ready to destroy everything you've worked so hard to build, I want you to start thinking of inflation like a weather condition that you respond to.

Just like you can't control whether or not it will rain tomorrow, but you can control whether or not you grab an umbrella, you can't control inflation, but you can take steps to minimize its negative impacts on you.

(Another metaphor that might help is surfing. You can't control the size and speed of the waves at the beach, but you can position yourself to surf them instead of getting wiped out.)

Inflation isn't an evil thing, and judging it emotionally will not change whether or not it becomes a bigger part of your operating environment.

Instead, you want to think of it as a shift in your operating environment. And to best manage your affairs within this operating environment, you'll need the right perspectives and tools.

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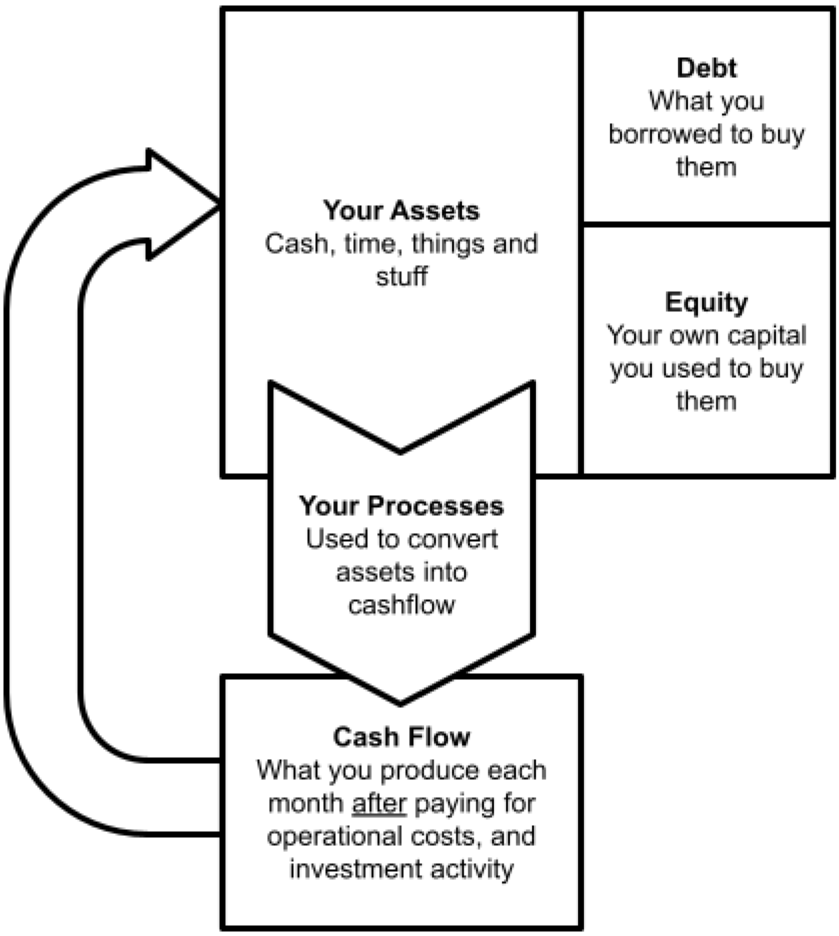
2. The Strategic Response: How Will Inflation Affect Your Assets, And What Do You Plan To Do About It?

Before we go further, let's get back to basics, so you can think about your situation as clearly as possible.

Your business is essentially a collection of assets (cash, employee time, and other things and stuff). You paid for these assets using debt or equity (your capital). And you use these assets in ways that create more cash flow than it consumes in a given period. This gives you more assets, so you can repeat the cycle.

Here's how you can visualize the way this simple approach works:



A simplistic overview of how your assets produce cash flow and more assets

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In your business, for example, you might use contracted employee time, a machine, raw materials, and processes to produce inventory, which you then sell using more employee time, producing cashflow for your business.

Or perhaps you're a successful software company. In this cash, you use your contracted employee time, your computers, and software, to produce software which your clients pay for online, producing cashflow for your business.

Whatever your basic setup, it always follows the same steps:

1. Have some assets
2. Use those assets, with processes, to produce:
    a. A sale to a customer, or
    b. An end asset, which you then use in conjunction with other assets and processes to produce a sale to a customer
3. Cash flow, which is a function of the way in which you manage the promises of payment you receive from customers, the promises you make to pay suppliers, and how you manage your inventory.

Within this framework, a few ratios and relationships begin to emerge. For example:

- At what rate, or ratio, do you turn assets into revenue?
- How efficient are you at serving that revenue, creating a profit?
- How long does it take you from issuing an invoice to getting paid?
- How long does it take you from receiving a bill to pay it off?
- What is the relationship between the assets you have, and the operating cash flow you build?

With this simple framework in mind, you need to ask yourself…

"How does inflation actually change market conditions,
affecting the way my assets can best produce cash flow?"

For example, in 2020, changes in market conditions due to COVID restrictions put pressure on many alcohol companies. With the closure of bars and restaurants, they lost a major function of their assets for turning assets into cash flow.

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The smart ones who realized the changing circumstances adapted, shifting how their assets produced cash flow; they began producing hand sanitizer instead of beverages. And many of these smart, innovative companies began to make a lot of money.

In the same vein, you need to look at your assets, and ask how the changing market conditions are redefining what's the best way for you to use them to produce cash flow.

With the companies I advise, I have them get away from the abstract idea of inflation and identify exactly how it will affect them through questions like

- How do you think inflation will specifically affect your business, community, customers, and market?
- Does inflation open new, better product and services opportunities which you can begin offering to your existing customers?
- How can you better match your existing skills and strengths to the current conditions?
- What skills and strengths may you need to invest in so you can better manage in future conditions?
- Will your products and services become more in demand, enabling you to charge higher prices, or take advantage of the economies of scale, by continuing to do what you're already doing?
- Or will your products and services become less desirable, meaning you either need to re-position your product or enter new markets?
- Will inflation erode your market, creating a slow death spiral for all who remain in it, meaning you should transform or adapt your assets to new markets and offerings?
- As inflation grows, will more competitors enter your market? How will you differentiate what your assets produce to win?

Your answers to these questions will guide you to develop your goals and strategy, helping you to identify what your company and employees should be doing *now*.

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3. Innovate In Your Operations

Once you've decided *what* you're going to do with your assets (your strategy) in response to inflation, you need to look at *how* you're going to do it.

For example, if you've determined your business is relatively inflation proof, you likely believe your best strategy is to continue what you're already doing. While this is unlikely to be true, if it is, your next innovation is to do the right things the right *way*.

And if your business requires a major overhaul of its goals and strategy to adapt to inflation, then you'll want to make sure that your company is doing the new right things in the new right ways.

For example, I advised a leading online homewares company who had plateaued on growth.

They had reached multiple-eight figures in revenue, but had started to stall out. At first it was a strategic issue - the market had shifted. In response, they designed a new strategy that better capitalized on their strengths, and better leveraged their assets and relationships.

However, despite having adjusted their strategy to something more suitable to the new market conditions, they simply weren't seeing results. And this was because they were still operating "the old way":

- They knew what activities produced revenue, but they weren't doing them to the highest possible standards
- They knew what activities produced revenue, but they weren't doing them as frequently as they could be
- They knew what activities produced revenue, but they spent time doing tasks that didn't increase the performance of the company

To rectify this, I worked with the owner to build out a new organizational and incentive structure that supported this new strategy.

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By rebuilding the organizational structure we made sure we had the right team, and the right capabilities, to bring it to life - and incentivized them to behave in the way that would produce results.

At this stage, we had a theory. We had a structure. But now we needed to drive execution and bring it to life.

To do this, we supported the new organizational structure (including KPIs and capabilities) by implementing key management rhythms. These created a high performing environment, where the staff was results-oriented, data-driven, and fully accountable.

The result? The company doubled revenues as the team transformed from slowly getting things done into a high performing team that achieved results.

If your operations need to be innovated on, there are some things you need to consider.

Specifically, with the companies I advise, I have them translate their strategy into concrete, actionable steps by asking questions such as:

- What are the outcomes we want to achieve?
- What are the key actions that must be taken to achieve those outcomes?
- Who is going to be responsible for those key actions being done?
- How will we measure if that person is successful in executing those key actions?
- How will we measure whether our key actions are getting the outcomes we want?
- How frequently will we make our measurements?
- Where do we get the team to execute this plan, and how will we engage them?

Through these questions, you can increase:

1. The quality of the performance you get from your team and systems
2. The frequency of the performance you get from your team and systems
3. The clarity around which activities drive performance, and which activities simply soak up time, energy, and effort

In turn, this drives operational excellence, leading to an increase in cash flow - whether

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as a result of increased profits on existing sales, growth in sales on existing expenses, or a combination of the two. All great things in a high inflation, and highly volatile, environment.

Now, depending on the answers you come up with in response to the questions above, you may need to perform a complete overhaul of your organization. You might need to put people in different roles, give them new tools, or use new management structures to bring your strategy to life, and increase your performance.

That's ok. As long as you do it the right way, getting buy-in and engagement from your team, you can unlock incredible performance and innovation.

Personally, with the clients I advise, I find the strategy and operational process is best managed with a three step process:

1. Collection of insights (subjective and objective)
2. Distribution and group assessment of those insights through a leadership team, allowing a full and accurate shared context to be built
3. Ideation and identification of meaningful focus for the organization, turning into a clear strategic and operational plan.

By involving leadership in this process, you not only improve your understanding of the context you're operating in (Step 1 and Step 2), which results in better plans of action, but you also get leadership buy-in. The leadership team can then use other tools and structures to align their team towards this focus.

For example, I use a specific step-by-step process with my advisory clients to produce a "G.O.S.T." plan. This plan, based on best practices from Private Equity, ensures the team knows what to do, who needs to do it, and by when, to produce results.

This plan is then supported by a small handful of results-oriented meetings, and tools like briefing and back-briefing. The impact of these meetings and tools is that the entire company "sings from the same hymn book", creating alignment, which naturally leads to increased performance.

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4. Show Me The Money! Financing The Change You Want To See In The World

The final innovation you need to make sure you get ahead of inflation is to innovate how the finances of your business look, and work.

This is the final piece in aligning your business productively with an inflationary environment, so you can thrive in a way that secures your future - ensuring the company won't fall apart.

Now let's start by being honest. If you're like most private business owners, finances are a bit of an afterthought.

This is because finances are complex and messy. Most accounting doesn't seem to tell you what to do, it's just a bunch of numbers thrown on a page. And the easy "next step" solution to most problems is to either drive more sales, do a quick cash collection, or tap the line of credit at the bank to get you through the rough patch.

That stops today. If you want to truly be an innovative organization, and get ahead of inflation, you need to get a grip on your finances, and then match them to the operations you'll be executing to fulfill your strategy.

But before you can do this, you need to understand exactly where you are in financial terms. This begins by looking at them in a detailed, analytical way, which means answering questions like:

- Based on your debt to equity ratio, and the assets you hold, is your balance sheet healthy or unhealthy?
- Are your assets and liabilities appropriately matched, or have you used loans that don't match the lifespan of your asset, eating up cash flow?
- What is the maturity of the debt you're carrying? Does it all mature at the same time, or have you staggered it into the future?
- How liquid are you? What does a 10%, 20%, or 30% increase in costs do to your liquidity? What if your sales dropped 15%, 30%, or even 45%? What if both happened at the same time?

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- Does your profit and loss statement show a high performing company, an average company, an underperforming company, or a struggling company?
- What impact would an increase on interest rates have on your debt repayments, and how will that affect your profits and cash flow?
- What is your current cash conversion cycle? What do you expect to happen to it over the next 3, 6, and 12 months? How will you drive that change?
- What proportion of your revenue comes from what proportion of your clients?
- What proportion of your fixed expenses should be variable? And which of your variable expenses should be fixed?

Yes, this is difficult. But it is imperative, and here's why:

Some years ago, an American company approached me for help. Despite having a record year of sales, they had lost money, and cash flow had basically dried up.

I spoke with the owner of the company on the phone for around an hour, performing a subjective assessment. Based on the information he provided, I felt I would be able to help. But first, I wanted to make sure the company was healthy on a financial basis.

The owner of the company sent over his financials for the past four years (balance sheet, profit and loss, and sales data). I entered his data into a custom-built tool I'd created, and sources of his problems were immediately clear:

- His cash conversion cycle had grown out of control, forcing him to take on debt to cover shortfalls in cash. This eroded his equity and free cash flow, and was quickly driving him into a position where the company would be completely insolvent and sent off for liquidation.
- Certain SKUs were losing him money, eating up all the profit he made elsewhere, and eventually pushing him into a loss making position. (Worst of all, some of them were best sellers, which gave the impression they were helping. But despite their top line impact, their profit-destroying structure meant that if he'd kept selling them, he would've gone out of business).
- His expenses and revenue weren't connected as they should be. Some costs had spiraled out of control as a percentage of revenue, others weren't earning a return, and ultimately his company was losing money because the financial

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structure was neither optimized, nor focused on bringing the strategy to life.

In short, while his strategy and operations were good, his finances were a mess... and his success was going to bankrupt him if he didn't get a handle on them.

Based on my analysis, we got to work. I drew on specific insights to advise him on how to innovate the way in which his finances were managed.

The results were dramatic, and came quickly. Within 12 months:

- Operating cash flow from revenue grew from 1.5% to 16%
- Cash conversion cycle dropped by 22%
- Gross margin grew by 27%, freeing up capital for reinvestment and creating an immediate profit

Naturally, he was happy - especially as the cash piled up in the bank, improving his liquidity. Since then, I've continued to advise him on his business and provide outside eyes that have allowed him to adapt the company's finances to coming conditions.

As for you, innovation in your finances comes down to understanding how your company will make money, and then arranging how the money flows through your company structure to support your strategy and operations.

To understand if you need to innovate on your finances, begin by asking yourself these questions which I use with advisory clients:

1. If strategy is not changing, is current performance good or bad relative to historical performance?

If the business is changing completely, this is somewhat useful but not entirely relevant. If your strategy is good, but your operations are changing, this can be fairly useful. And if your strategy and operations are good, but your finances are in trouble, this is a powerful question.

When answering this question, your goal is to understand the trends and relationships in everything from line items on an income statement to how cash flow is managed by the company.

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- If you are only making minor changes to your business, you want to see if you are getting better, or worse, at managing profits and cash flow
- If you are making major changes to your business, a historical analysis will show you where you weren't doing as good a job as possible in managing profits and cash flow

Running through this analysis often finds quick, big wins. The kind that can absolutely transform the security and predictability of your business .

Remember the company I mentioned earlier. They had the right strategy and decent operations, but were financially struggling when the owner first came to me. But by analyzing the way finances were managed, we were able to transform the financial health of the company.

2. What is the purpose of our planned and existing expenses, and how do they contribute to the company's goals and strategy?

When advising companies, one of the most important things I have them do is work through their finances in a systematic, structured way. This is *incredibly valuable* to any company who does not have a high performing, full time CFO.

When I advise my clients on this process, I have them look at how every single expense contributes (or doesn't) to the company's strategy and goals, what they're *actually* paying for with each expense, and what return or impact they are expecting to see from that expense.

On more than one occasion this activity has shown us where we're unnecessarily paying multiple suppliers for the same thing - allowing us to quickly cut expenses, improve margin, without negatively impacting business performance or making customers unhappy.

At the same time, we begin projecting what expenses we will actually need to make our future plans a reality:

- Should we be re-allocating capital towards marketing, and under what constraints?

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- Do we need to invest in extra headcount to match up with expected demand?
- Do we need to reshape our labour force, either by investing in new training for our team members, or reducing headcount?
- Will we need to acquire the help of consultants, third party service providers?
- Should we be re-negotiating terms and pricing with suppliers and customers, so we can improve margin, cash flow, or both?

3. Can we increase prices by at least 5%... dramatically increasing profit in the process?
The honest truth is that most businesses don't increase prices on a regular basis. Most haven't increased prices in years. And as a result, the only increases they see in profit are through growth against their fixed expenses.

But increasing prices even just 5% can do wonders for your profits. It's a small enough number that most clients won't even bat their eyelids. In fact, most of them expect it given the inflationary world we're living in.

Now, to encourage you to actually follow through and increase your prices, let's look at how it plays out…

Let's say your business has $20,000,000 in sales per year. As you're in an expense intensive industry, your EBITDA margin is 8%. This gives $1,600,000 in EBITDA for the year. That's your baseline.

Now let's say you bump prices 5%, and everything else stays equal. In a best case scenario, you'll see sales increase to $21,000,000. And because your costs didn't increase, that extra $1,000,000 in sales will drop straight to your bottom line… giving you $2,600,000 in EBITDA for the year - an increase in EBITDA of over 50%.

That's an extra $1,000,000 which you can use for business growth, to pay down debts, to further secure your retirement, or simply treat your family in a way that shows them all your hard work has truly been worthwhile.

And you get to do this <u>without</u> having to do any extra work in your business, work

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longer hours, or burn the candle at both ends.

4. Based on what we know, what do our next 13 weeks of cash flow look like?
With my advisory clients, I guide them through putting together a 13 week cash flow model. This powerful tool helps them "look into the future" and see challenges and opportunities with their cash flow, preventing issues in the future, and understanding how changes to the business affect their cash position.

We then look at whether we need to:

- Change the way our receivables are handled
- Change the way our bills are handled
- Change the way we order and maintain inventory levels
- Change the way we finance operations
- Build better relationships with suppliers
- Incentivize customers to pay faster, or on more favorable terms

(This is also a great tool to have on hand when speaking with your bankers when seeking more credit. It shows that you are paying attention to cash movements in your business, and are adept at managing them, which opens more fruitful conversations.)

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5. Stop, Review, Respond: Bringing It Together

As you've read through this report, you've discovered three critical areas you need to review if you want to prepare your business to thrive in a high inflationary environment; your strategy, operations, and financing.

But understanding this conceptually isn't enough. You have to take action on the content that has been shared, monitor your action, and adapt to ensure you're on the right track.

For example, as part of my advisory business, I do a one day intensive with all clients. We use specifically created tools and processes to work through the concepts in this report, and produce a clear plan of action.

My clients find the quality of work they produce this process to be of a higher quality than doing it alone, and find there to be a lot of benefit in having the clarity provided by outside eyes (not to mention that they make better decisions, faster, by tapping into my experience and knowledge).

You're welcome to reach out to me and discuss whether this is a good fit for you. Maybe it is, maybe it is not. But whether you take advantage of my experience, tools and processes to do this, or seek to do it yourself, it is imperative that you do *something*.

Block out a day. Prepare your research and analysis in advance. Sit with your leadership and guide them through an appropriately structured meeting to ensure they contribute, they learn, and help shape the company.

And finally, when you're crystal clear on what needs to be done, manage your operations and finance in a way that ensures it is done.

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6. What Next?

If you're still reading, it's safe to say that you're still thinking through your business and how you can improve your performance in an inflationary environment. You're probably also becoming more aware of the complexity you need to think through to adapt your business - as well as how many mistakes you're likely making.

If this is something you're interested in, you and I should speak about how I might help you and your business as an advisor. I routinely advise well-suited clients with eight-figures in revenue, helping them secure the future of their business by driving innovation across strategy, operations, and finances.

For example, clients I have advised have seen results that include:

- Increasing cash flow 10-fold within 12 months through operational and financial innovation, leading to unsolicited offers for total buy-outs from private buyers at high multiples
- Increasing revenue 7-fold within 18 months through strategic and operational innovation, leading to unsolicited offers for partial buy-ins from private equity firms at double-digit multiples
- Increasing revenue 10-fold within 6 months through strategic, operational, and financial innovation, leading to the owner being able to step back from operations and replace themselves with a general manager
- Doubling revenue within 12 months, despite supply chain issues, and enabling the owner to finally take a holiday to a foreign country for two weeks (without checking his phone) by innovating in operations

I want to be clear - I don't believe in a hard sell. I only want to help people where it is clear that I can be of help. So if this is of interest, and your company has eight-figures in revenue, please feel free to contact me via email at rob@robhanly.com, and include a short overview of your company and how you think I might be able to help.

Looking forward,
- Rob Hanly

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