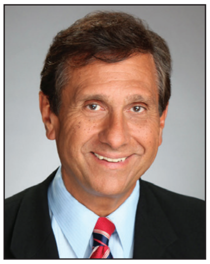
By Dan Dooley

The Perfect Economic Environment for Significant Profit Improvement



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Most news articles highlight how tough it will be on businesses to make money and for consumers to afford gas and food given the elevated levels of inflation in 2022.[1] This article takes a contrarian view relative to the effects of inflation combined with the national labor shortage and the ongoing supply-chain disruptions on many U.S. businesses. Today is the perfect economic environment for significant profit improvement for many businesses, despite all the escalating cost headwinds facing many manufacturing and distribution businesses.

The Escalating Cost Headwinds of 2021-22

Tight Labor Supply

One of the most severe impacts of COVID-19 has been a significant reduction in the permanent workforce. Popularly called the "Great Resignation," millions of workers who were employed in 2019 have "permanently" left the workforce.[2] Also, a sizable number of workers have "temporarily" left the workforce to take a sabbatical or pivot to other careers. As a result, the U.S. unemployment rate has fallen below 4 percent, which many economists view as full employment, in most every labor market in the U.S.[3] Businesses are struggling to find workers amid this "full employment" environment, causing a labor shortage that shows no signs of abating in 2022 and may persist for years. Many companies have had to reduce their capacity/sales levels due to the labor shortage despite having a significantly higher customer demand.[4]

Not surprisingly, hourly wages have steadily increased in 2022 as employers compete for workers, especially lower-paid, less-skilled employees. Nevertheless, Amazon managed to double the size of its workforce between 2019 and 2022 from 800,000 to 1.6 million, and has contributed to a rise in market labor rates for unskilled labor, now as high as $20 per hour in many parts of the U.S.[5]

Before COVID-19, the U.S. was debating the wisdom of a $15-per-hour minimum wage, and certain states and cities acted to increase the local minimum wage.[6] Today, this debate is a moot point in most of the U.S. due to increases driven by basic supply-and-demand economics rather than legislation.

Supply-Chain Disruptions

Almost all U.S.-based retailers, distributors and manufacturers have substantial supply-chain dependence on such Pacific Rim countries as China, Indonesia, South Korea, Tiawan, Malaysia and Vietnam.[7] Many Pacific Rim countries are sources of product for U.S. companies, with China being the largest by a wide margin. Pacific Rim sourcing was primarily driven by the search for low-cost labor. However, when COVID-19 hit Asia in December 2019, China and other Pacific Rim countries reacted with some of the most severely restrictive government policies starting in 2020. These government policy changes, combined with the impact of COVID-19 on employees' ability to go to work, created major production-disruption issues for businesses located in this region. This disruption has continued well into 2022 due to the continued COVID-19 situation.[8]

Beginning in 2020, as a result of these supply-chain disruptions, products have been delivered

1 Chad Otar, "How Will Inflation Affect Small-Business Owners in 2022?," *Forbes* (May 2, 2022), *available at* forbes.com/sites/forbesfinancecouncil/2022/05/02/how-will-inflation-effect-small-business-owners-in-2022; Greg Iacurci, "There Is 'Nowhere to Hide' for Consumers as Inflation Hits Food, Gas, Housing," CNBC (March 10, 2022), *available at* cnbc.com/2022/03/10/theres-nowhere-to-hide-for-consumers-as-inflation-hits-food-gas-housing.html (unless otherwise specified, all links in this article were last visited on June 7, 2022).

2 Thomas Ahearn, "'Great Resignation' Sees Record 4.5 Million Workers Quit in March 2022," ESR News (May 3, 2022), *available at* esrcheck.com/2022/05/03/great-resignation-4-5-million-workers-quit-march-2022; "The Great Resignation of 2021," ClearStar (Nov. 29, 2021), *available at* clearstar.net/the-great-resignation-of-2021; "Job Openings and Labor Turnover Survey," U.S. Bureau of Labor Statistics, *available at* www.bls.gov/jlt/#data.

3 Clive Crook, "Full Employment," Bloomberg (July 6, 2018), *available at* bloomberg.com/quicktake/full-employment; Scott A. Wolla, "Making Sense of Unemployment Data," Fed. Res. Bank of St. Louis (February 2016), *available at* research.stlouisfed.org/publications/page1-econ/2016/02/01/making-sense-of-unemployment-data; "The Employment Situation — May 2022," U.S. Bureau of Labor Statistics (June 3, 2022), *available at* www.bls.gov/news.release/pdf/empsit.pdf.

4 Paul Davidson, "Where's the Tuna Melt? Worker Shortages Mean Smaller Menus, Limited Choices and Fewer Shows," *USA Today* (Feb. 4, 2022), *available at* usatoday.com/story/money/2022/02/04/labor-shortages-limit-consumer-choices/6645242001; "Job Openings and Labor Turnover — April 2022, " U.S. Bureau of Labor Statistics (June 1, 2022), *available at* www.bls.gov/news.release/pdf/jolts.pdf.

5 "Average Unskilled Laborer Hourly Pay," PayScale, *available at* payscale.com/research/US/Job=Unskilled_Laborer/Hourly_Rate; Michael Maciag, "Where Wages Are Lowest and Highest in America," *Governing* (Feb. 27, 2015), *available at* governing.com/archive/gov-metros-where-wages-are-lowest.html.

6 Eli Rosenberg, "Biden Wants to Raise Federal Minimum Wage. Trump Doesn't. A Look at Their Debate Disagreement," *Washington Post* (Oct. 23, 2020), *available at* washingtonpost.com/business/2020/10/23/debate-minimum-wage-increase; "H.R.582: Raise the Wage Act," 116th Congress (2019-20), *available at* congress.gov/bill/116th-congress/house-bill/582/text; "History of the Minimum Wage in New York State," New York State Dep't of Labor, *available at* dol.ny.gov/history-minimum-wage-new-york-state.

7 "United States Imports by Country," *Trading Economics*, *available at* tradingeconomics.com/united-states/imports-by-country; "Association of Southeast Asian Nations," Office of the United States Trade Representative, *available at* ustr.gov/countries-regions/southeast-asia-pacific/association-southeast-asian-nations-asean.

8 "China April Factory Activity Contracts at Steeper Pace as Lockdowns Bite," Reuters (May 1, 2022), *available at* reuters.com/world/china/china-april-factory-activity-contracts-steeper-pace-lockdowns-bite-2022-04-30.

well past their due dates and in less-than-ordered quantities. Container freight from the Pacific Rim to western U.S. ports has been delayed, and freight costs have skyrocketed. Logistics experts expect that a shortage of Pacific Rim products will continue through 2022 and deep into 2023.[9]

Logistics and Transportation Disruptions

Logistical disruptions have made mainstream news as of late, with events such as the blockage of the Suez Canal by the container ship, Ever Given, and the significant cargo ship backlog at Long Beach in California. The global shipping market is a very fragile and delicately balanced ecosystem, as port capacity is tight. Significant disruptions such as the Pacific Rim cargo container traffic jam in California will take quite some time to rebalance and normalize. This is especially true given the ongoing impact of COVID-19, which has cascaded around the world at least four times over the past 24 months. Ocean freight costs have tripled, lead times have doubled, and delivery date uncertainty has considerably increased.[10]

Within U.S. ground freight transportation, the multi-decade trucker labor shortage has finally reached a crisis level. Many trucking companies, as well as captive trucking operations, are so short of drivers that their customers are on delivery allocation or customers are choosing to pick up product *themselves*. Truckers' wages and benefits are being significantly and permanently increased with truckers in high demand, and it is unlikely that their wages will decline post-COVID-19.[11]

Inflation Expectations

There is a general understanding and acceptance that most basic goods and commodities in 2022 are going to cost more than in 2021. This includes food, gas, housing, consumer products and most everything else we consume or use. The Consumer Price Index increased 7 percent in 2021, and a similar increase in 2022 is occurring with 8.3 percent being the latest April numbers.[12] Customers certainly dislike price increases, yet we are at a point in time where everyone gripes about prices but nevertheless expects inflation.

A Path to Significant Profit Improvement

The most obvious action for companies to take is to raise prices to offset the increase in costs. This is a great first step, but there is an even better approach one can take to permanently increase profitability. This involves the following steps: (1) increasing prices more than your cost increases; (2) rationalizing and discontinuing low-margin products/stock-keeping units (SKUs) to simplify operations; and (3) terminating relationships with low-margin customers to improve overall margins.

The core concept is that when your capacity is limited, you should dedicate all of your attention to your most profitable customers and most profitable SKUs. Think of the current economic conditions in the context of needing to *allocate your scarce capacity* to service customers. If you need to allocate scarce capacity, you clearly have a great deal of pricing power right now to do so.

Increasing Prices

To determine what your gross profit margin is per SKU, per customer, etc., you must have a sound understanding of your product costs. This understanding is critical, as you must increase prices for low-margin products at a much higher percentage than products with already higher margins. Similarly, you will want to increase prices on complicated, low-volume products by a much higher percentage than simple, high-volume products.

Given inflation expectations, you also need to incorporate an estimated impact of future cost increases into your pricing *today*. Avoid being perpetually behind in price increases during an inflationary period of rising costs, as it is difficult to make up for lost margins.

Decreasing Products/SKUs to Simplify Operations

Apply Pareto's 80/20 rule[13] and develop a report that shows annual sales and gross margin percentage by SKU/part number for the last 12 months in descending annual sales order. Then, add a column for cumulative annual sales for each SKU starting with the top sales SKU. Focus rationalization efforts on the SKUs with low annual sales. You'll likely find that a small percentage of SKUs (usually less than 20 percent) generate a large percentage of your annual sales (usually greater than 80 percent) (*i.e.*, "Pareto's Rule").

If a company has not rationalized its product offerings for many years, you will typically see over 50 percent of SKUs that are sold at extremely low volume. Discontinuing these low-volume SKUs will have a small impact on overall sales (often less than 10 percent impact). These SKUs should be discontinued immediately unless these laggards are exciting new products with minimal sales history or they are strategic SKUs that are important to a major customer. Reducing SKUs by 50 percent with minimal loss in sales will tremendously simplify operations, save inventory investment dollars, and save on costs more than any gross margin lost.

Terminating Relationships with Certain Customers

Conduct a similar "80/20" analysis as you did in product rationalization, but instead evaluate annual sales by customer. Terminate relationships with low-volume customers unless they are new or strategic in nature. Rationalizing your customer base will allow you to focus more resources on your best (most profitable) customers. Often, as much as 50 percent of customer base in the aggregate provides 10 percent or less of your annual sales volume. In addition, evaluate difficult, mid-sized customers that exhibit problems such

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9 *See* Alfonso Castro, Aubrey E. Kauffman, Deborah L. Thorne, John T. Gregg, Michael Thierhoff, Patrick E. Mears & Renate Müller, *Interrupted! Understanding Bankruptcy's Effects on Manufacturing Supply Chains* (ABI). Purchase a copy today at store.abi.org.

10 "Freightos Baltic Index: Global Container Freight Index," Freightos Data, *available at* fbx.freightos.com; "Transit Time Calculator for Sea, Air and Port to Port Shipping," Freightos, *available at* freightos.com/freight-resources/transit-time-calculator (go down to graph).

11 "Databases, Tables and Calculators by Subject," U.S. Bureau of Labor Statistics, *available at* data.bls.gov/timeseries/CEU4348400008?amp%253bdata_tool=XGtable&output_view=data&include_graphs=true; Nicolás Rivero, "Is Walmart Really Turning Trucking into a Six-Figure-Salary Job?," *Quartz* (April 8, 2022), *available at* qz.com/2152463/is-walmart-really-turning-trucking-into-a-six-figure-salary-job; Samantha Raphelson, "Trucking Industry Struggles With Growing Driver Shortage," NPR (Jan. 9, 2018), *available at* npr.org/2018/01/09/576752327/trucking-industry-struggles-with-growing-driver-shortage.

12 Gwynn Guilford, "Inflation Slipped in April, but Upward Pressures Remain," *Wall St. J.* (May 11, 2022), *available at* wsj.com/articles/us-inflation-consumer-price-index-april-2022-11652218520.

13 "Pareto Principle," Investopedia, *available at* investopedia.com/terms/p/paretoprinciple.asp.

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as excess product returns, last-minute order changes, special packaging or handling requirements, and/or payment issues. Selectively, either terminate the most problematic customers or raise prices significantly to offset these excess costs.

An Example of How This Works

Hypothetical company "ABC" had the following economic profile in 2020 and 2021. The company was not shut down by government-mandated COVID-19 restrictions, but it has been adversely affected by 2021-22 cost escalation, as shown in Exhibit 1. Thus, management took the following actions:

Exhibit 1: ABC's Economic Profile

	2020	2021
Sales	$100M	$95M
Gross Margin %	25%	20%
EBITDA	$7M	$2M
Inventory	$12M	$12M
SKUs	1,000	1,000
Customers	100	100

(1) price increases averaging 10 percent; (2) SKU reduction of 500 (50 percent); and (3) customer reduction of 25 (25 percent). These changes resulted in a $5.5 million annual EBITDA improvement, a $2 million inventory reduction, and a much simpler business model, as shown in Exhibit 2.

Conclusion

This year is a unique point in history, where many companies have limited capacity and significant pricing power relative to their customers. Many businesses and industries are able to focus on the allocation of scarce capacity. This is a unique opportunity to increase prices, rationalize your products, and rationalize your customer base to take advantage of demand exceeding your ability to supply.

The only caveat is that you must walk a fine line between taking advantage of your current negotiating leverage and being perceived as profiteering. This could create enemies that will look for an opportunity to get back at you. The bottom line is that business owners and managers need to look at the present situation as a unique opportunity to improve their profitability to reasonable levels after decades of being forced to take price reductions to keep their businesses running. abi

Exhibit 2: ABC's Results

	2020	2021	2022	2022 vs. 2021 Results
Sales	$100M	$95M	$87M	($16M) due to reduced SKUs/customers and +$8M due to price increases
Gross Margin %	25%	20%	28%	8% improvement
EBITDA	$7M	$2M	$7.5M	$5.5M improvement
Inventory	$12M	$12M	$10M	($2M) reduction
SKUs	1,000	1,000	500	50% SKUs discontinued
Customers	100	100	75	25% customers terminated