Transforming in Turbulence:

Tackling the Squeeze on Corporate Profitability

The Middle East Lens

Long-held business assumptions about the operating environment have been turned on their head. COVID-19 was an unforeseen global calamity, forcing a rapid transformation in ways of working and ushering in supply chain and inflationary shocks across the world, to say nothing of the fatalities and societal impacts. Then, just as the world was emerging from the pandemic, the unthinkable happened with the war in Ukraine, sending inflation rates across the globe to the highest seen for decades and seeing a steady increase in interest rates from their entrenched rock-bottom levels. Adding to this is a darkening of the general economic outlook and the likelihood of lower or negative economic growth across most of the world.

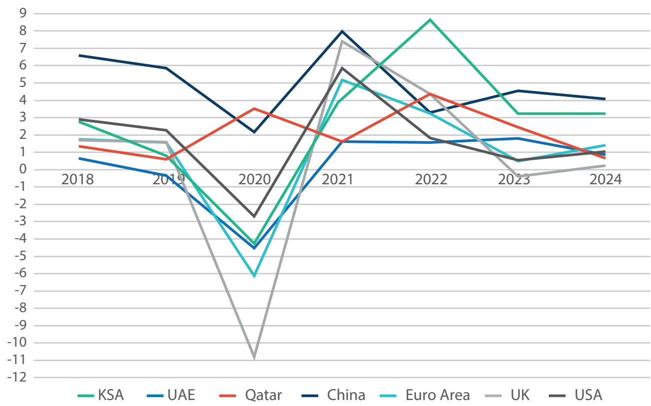
Substantially More Challenging Macroeconomic Environment

The International Monetary Fund (IMF) might have slightly upgraded its outlook for the global economy during Davos,[1] but businesses today are fighting through arguably the most complex set of corporate challenges in living memory, and they are expecting one of the most significant global downturns since the global financial crisis in 2007. Some of the most severely affected companies are in consumer-facing sectors, and many need a dramatically different approach to running their business and operations to address this situation.

The economic forecast is worsening around the world and despite signs of resilience and the fight against inflation, GDP growth remains lower than expected.

Figure 1: Economic Outlook Remains Bleak

Real GDP Forecast %

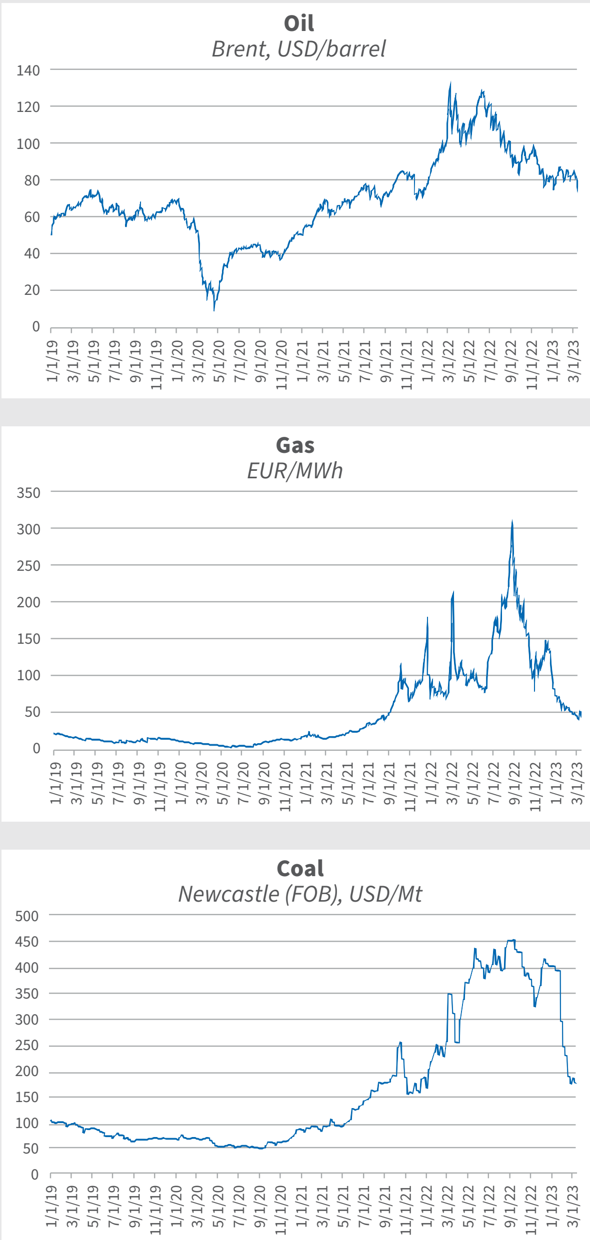


Source: OECD Economic Outlook. IMF

New Economic Reality Across Global Supply Chains

Decades-high inflation levels have dropped from their peaks, but inflation rates are still very steep by historical standards: 8.5%[2] in the Eurozone and 10.4% in the UK in February 2023.[3] Similarly in the GCC region, CPI for UAE and Qatar is between 4.5 and 6.0% as compared to the deflationary rates immediately preceding the pandemic. In KSA the government has been forced to announce subsidies to reduce the impact of inflation on low-income households. China's abrupt ditching of its zero-COVID policy and rapid reopening could also lead to further inflationary pressure on energy and raw materials.

Figure 2: Energy Costs Have Come Down Substantially, but Are Still Elevated



Source: OECD Economic Outlook, Interim Report March 2023

Inflation is set to have a harrowing impact on businesses for some time to come.

This is also apparent in new research by FTI Consulting, which revealed that inflation is the number one risk in 2023 and beyond for global CFOs, with 77.3% indicating that inflation poses a high or medium risk to achieving their objectives in the next 18 months.[4]

The situation is especially acute for consumer-facing companies, from car manufacturers, to durable consumer goods, consumer electronics, and high street retailers, to mention a few of the sectors heavily impacted. As businesses weather the impacts of macroeconomic challenges and the weakening pricing power that affects corporate profitability, corporate revenue forecasts are bleak.

Topline revenue is haemorrhaging as people are holding back on discretionary spending because of the significantly inflated prices they are paying for essentials, such as energy and food, and for mortgage bills that have hiked up in response to interest rates that have progressively risen from historic lows to tackle inflation.

Revenues are also being further eroded by the stack of unsold inventory many consumer-facing companies have built up after the easing of stock shortages during the pandemic, especially stock relying on complex global supply chains.

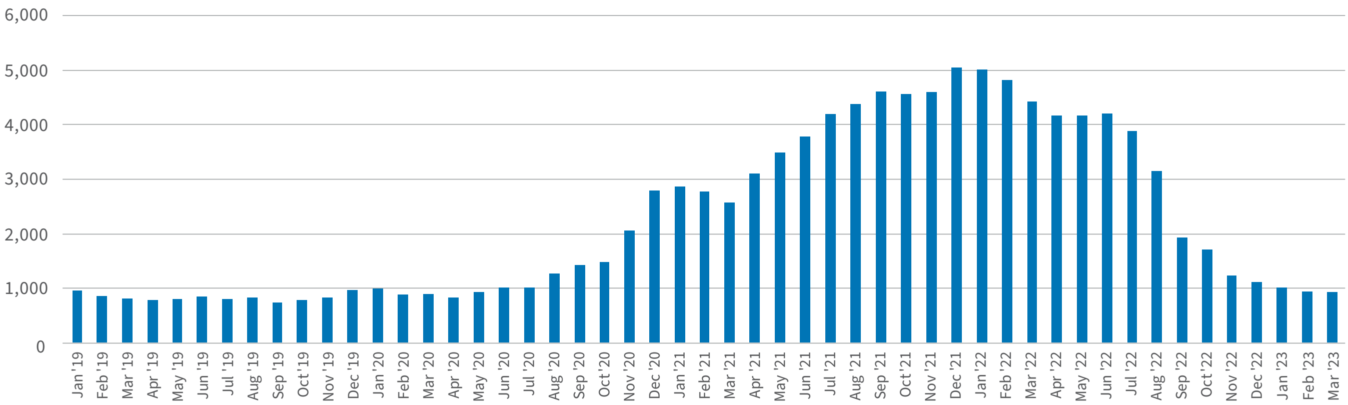
> *"The combination of lower economic growth and soft consumer demand, coupled with a tight labour market driving up compensation, as well as substantial cost increases in areas such as energy, raw materials, freight, and various overheads makes up a complex cocktail of challenges for consumer-facing businesses in many countries…"*
>
> **MICHAEL WEYRICH**
> Senior Managing Director

At the same time input cost pressures across the board remain intense. Freight rates have dropped from their pandemic peak, but costs are still high.

Many categories of raw materials are in short supply because of the pandemic and the war in Ukraine driving up costs to unprecedented levels. Costs have come down to some extent but are still historically high.[5] With localisation driving the need to increase local production, the supply chain challenges are further concentrated within the region.

Figure 3: Freight Rates from China Have Peaked but Are Only Slowly Moving Towards Pre-Pandemic Levels

Shanghai Containerised Freight Rate Index



Source: Statista, January 2023

Workforce Challenges Across Sectors

Substantial wage increases to help staff manage inflation and the cost of living — and attract, recruit and retain them because of labour shortages and changing post-pandemic working patterns — are a further operational and financial constraint.

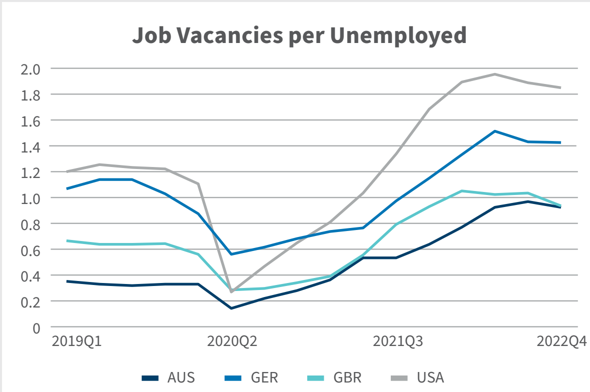
Whilst we are beginning to see wage growth level off in a number of countries, workforce costs remain exceptionally high for many businesses. In the Middle East businesses have so far resisted large compensation increases but face increasing pressure going forward.

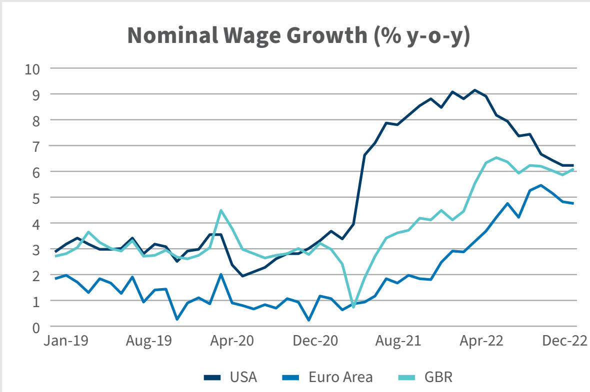
In addition, low unemployment and a high number of job vacancies are impacting most major economies, highlighting significant labour shortages. These shortages are made more challenging by localisation, increasing the need for local talent participation in workforce. Further, GCC countries have a significant gender imbalance with men making up majority of the workforce, and a need to increase the participation of women through national programs and campaigns.

Workforce challenges are impacting businesses across the globe and across different sectors in similar ways, including:

— **Agriculture and Food:** The sector faces a lack of local talent in all key areas including agriculture science, agri-business management, veterinary science, agro-ecology, and food processing, despite high unemployment. Many youth do not believe agriculture and food can provide a viable career path for them due to the perception of the sector as low-skill.

Figure 4: Labour Markets Remain Tight



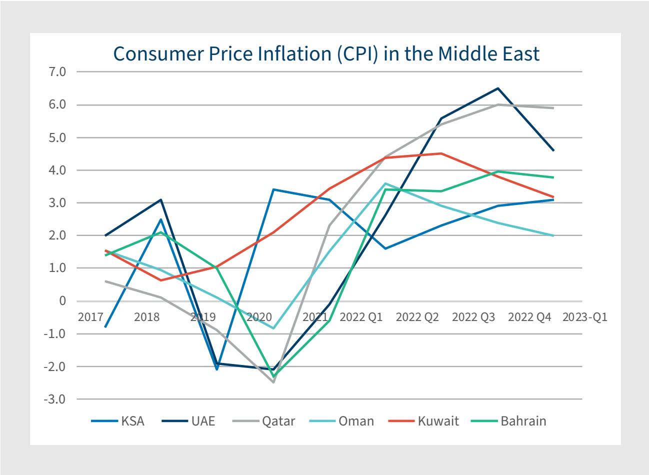


Source: OECD Economic Outlook, Interim Report March 2023

- **Healthcare:** GCC countries remain highly reliant on foreign workers for a wide variety of trained healthcare staff. The difficulties in retaining and managing a motivated expat workforce at a time of a near global shortage of healthcare personnel remains a significant challenge.
- **Tourism:** In 2022, 1.2 million jobs in tourism were affected by staff shortages at a time when tourism and travel is witnessing a rebound in the GCC and globally, According to the World Tourism & Travel Council, one in six tourism jobs were vacant in 2022, the result of a shortfall of 250,000 workers.[6]
- **Aviation:** Research by Oxford Economics revealed that 2.3 million jobs have been lost in the aviation industry following the outbreak of COVID-19.[7] A number of GCC countries (especially KSA) and aviation businesses in the region have ambitious investment and expansion plans, which remain highly reliant on availability of trained staff across the board - pilots, crew, engineers, agents, baggage handlers etc. Following a flurry of redundancies by airlines globally during the pandemic, recovery of staff numbers is set to be challenging, with Boeing recently forecasting that more than 2.1 million personnel will be needed over the next 20 years (including 612,000 new pilots, 626,000 new maintenance technicians, and 886,000 new cabin crew members).[8]
- **Construction:** Alongside difficulties procuring and affording raw materials, the construction industry is facing huge challenges recruiting skilled workers. This is particularly acute in UAE and Saudi Arabia, where there are a large number of ongoing or planned infrastructure projects, compounded by increasing pressure on GCC countries to further improve working conditions for migrant workers.

The accumulation of forces presents a difficult picture for businesses across the world. Input costs have risen at an extraordinarily high rate, meaning huge external cost pressures for leaders to manage. Coupled with wage inflation and a competitive talent market creating pressure internally, for many businesses, it truly feels like they’re caught between a rock and a hard place.

Figure 5: An Accumulation of Inflationary Forces is Putting Unprecedented Pressure on Businesses Around the World



"Consumers in the GCC region have been impacted by rising rents and costs of food and key goods. As a result, many are reducing consumption, searching for lower cost/best value products or switching channels to save money."

VIKAS PAPRIWAL
Senior Managing Director

Consumer Price Index, Producer Price Index and Wage Inflation

Note: Wage inflation and PPI % Increase does not extend to 2023 for all geographies due to a lack of available data at the time of publication (April 2023).
Source: OECD Data, National Bureau of Statistics, Financial Times, Trading Economics, CNBC

Unprecedented Squeeze on Corporate Profitability

Passing on all cost increases to customers is in many cases not a viable option for companies because of market competition, so for companies stomaching the rises it means taking a direct hit to the bottom line.

"Businesses in the GCC are under pressure due to changes in consumer demand and preferences, inflation, wage expectations, and commodity prices that still remain uncertain. Businesses more than ever before need to actively monitor and manage their cost base for this new reality."

DAVE PHILLIPS
Senior Managing Director

Financial stress and insolvencies are on the up across the UK and Europe as companies struggle with cash flow and covenant breaches. In the Middle East, many companies (especially the non-oil sector) face higher borrowing costs due to globally increasing interest rates and higher operational costs due to weaker GCC currencies vs. the strong US dollar. At the same time, recent legislative changes to bankruptcy laws in KSA and UAE are likely to make restructuring easier and more efficient.[9]

Many more companies are in the category of being established and profitable for years, but suddenly facing a financial strife.

Additionally, a significant issue for many businesses is that their management teams have little experience in operating outside of the more predictable, stable business environment, with its market growth and low inflation, limited restraints in labour supply, stable supply chain costs, and almost non-existent interest rates they have enjoyed for years.

Current pressures mean that a business's financial situation can deteriorate very rapidly — it's sink or swim, a moment of truth for many leaders. We have seen multiple situations, where multi-billion-dollar global organisations went from being profitable to loss making in a matter of months partly because of substantial market changes and cost increases and partly because their management had little experience steering through these highly challenging times.

Restructuring Mindset Is Required: Four Key Dimensions

Today's highly unusual and uncertain environment requires a completely different way of operating, planning and budgeting for global businesses with complex supply chains.

A crisis, semi-restructuring mindset based on a rigorous and highly analytical approach is required.

There are four key elements to how companies should respond: instill tighter business controls and disciplines, refocus and challenge sales and marketing activities,

Figure 6: The Four Key Dimensions to Manage Today's Disruptive Forces

challenge and streamline all cost categories across the business, and aggressively manage the supply chain.

1. Tighter business control is about taking a razor-sharp focus on financial and operating processes. Core items include more robust and granular forecasting and budgeting, and far more frequent monitoring of profit and loss and balance sheet movements, as well as of costs and working capital. Companies need to be thinking from a much more short-term perspective — reviewing and forecasting on a weekly or monthly basis, rather than quarterly or half yearly — to ensure they are fully on top of their financial situation and can spot major changes and problems as they arise.
2. Sales and marketing functions must double down on the top line and margins. This means scrutinising items such as product range and profitability, pricing and margin leakage, return on marketing investment, and sales force effectiveness. Equally vital is thinking hard about how to forecast sales volumes in such an unpredictable environment and what volumes to manufacture given inventory levels and softer and changed consumer demand.
3. Critical central cost management measures will include seeing how the organisation's structure could be simplified, where headcount could be reduced, productivity enhanced, and management processes and the overall operating model improved. Again, companies will likely need to take a shorter term and more tactical view on these as opposed to a longer-term and more strategic view of three to five years into the future.
4. Managing the supply chain must include reviewing existing supplier agreements to optimise and manage costs. One solution is to retender contracts, involve new suppliers and negotiate better terms

and conditions. Some contracts may need to be terminated entirely. Other important elements to put under the microscope are landed costs, the insource/outsource mix, expenditure rates and the overall efficiency of the supply chain.

Given the current environment is unchartered territory for many executive teams globally, a radically new way of managing and controlling the business is required to navigate through these times. Companies that do not change and adapt can face dramatically reduced operational and financial performance within months, leading to dramatically weaker liquidity and cash flow. As a result, many companies will require help getting into shape to survive. We've seen some global businesses require wholesale assistance across almost every aspect of their business.

Moving on From Survival Mode

Consumer-facing companies need to take control and act quickly. Survival mode is where many businesses are at, and this means their priority must be to get on top of and manage the situation. With the right approach, management teams that lack the depth of experience for the moment will be able to reinvent their business and make it more resilient to sustain it through these torrid times and make it fit for growth as the economy gradually returns to a more certain and predictable footing.

"Companies can move from well performing and profitable to loss-making and troubled in a matter of months without the right approach, controls and systems in place…"

HEIKO RAUSCHER
Senior Managing Director

Our Experts. Our professionals are true leaders in their fields, working with leading global corporates, private equity funds and portfolio company management teams to respond to complex and urgent situations and shape and deliver ambitious value creation plans. We combine in-depth industry and functional knowledge and experience with a hands-on, action-focused approach.

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Endnotes

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