KPMG Customer First Podcast Transcript

Inflation

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Voiceover: Welcome to the Customer First Podcast, from KPMG's Global Customer Center of Excellence. We work alongside the network of KPMG firms to help clients deliver profitable growth, by putting their customers at the heart of their business.

The Customer First podcast brings you the latest thoughts and market examples from KPMG professionals and guests on how today's businesses are becoming more and more customer centric. Today, we are talking about inflation and the impact on the front office

Julio: Hello, my name's Julio Hernandez and I'm the Global Service Line Lead for Customer and Operations and I also have the privilege of leading our Customer Center of Excellence. For today, we're going to be talking about the customer in the context of inflation. Inflation is rampant, it's accelerating, and there are a lot of activities and a lot of underlying reasons that we think that's going to continue for a period of time. This inflation is having a huge impact on consumers. It's causing major impacts to input costs for businesses, and many businesses are responding in very different ways. Some are raising prices, some are changing their value propositions, but there's also a reticence to raise prices because they want to hold on to their customers. They don't want to push them away.

We're going to talk about the customer in that context, we're going to talk about what businesses are doing in that context. We're going to talk about the importance of brand, the importance of loyalty, and tactics that companies can take moving forward.

Julio: Today, we have Yael Selfin, who is the economist from the UK member firm at KPMG. And we also have Edgar Molenaars, who is a partner in our customer and brand strategy team in the Netherlands. I'm super excited to have both of them talk to us today. Now with that, I'm going to turn it over to Yael, to give us some context of what's happening with inflation around the world.

Yael: Hello everyone. It's been an interesting time for us economists, because we had the global pandemic that turned lots of things around. And then as we emerge out of the global pandemic we had, all in one go, a lot of increased demand and we still had problems with supply chain and all that higher inflationary pressure.

So we've started seeing inflation going up across the world, for probably over a year now. But then coupled with that, we had an additional shock now with the war between Russia and Ukraine and that triggered a spike in some energy prices in some markets, as well as other markets with grains and other food commodities, as well as metals, putting yet further pressure on inflation.

And the worry is that it's not only those commodity prices, but it's also wages that are going up with a very tight labor market, across many countries, seeing wages going up steeply. And then with that is collation inflation, the risk is it we'll see that spiral of higher price increases, rising wages, all contributing to relatively high inflation, something that we haven't seen to that extent in some time.

So just giving you a little bit of a few numbers, if you like, just to share where we are, our latest focus of our economists across the world expect inflation in the world to average around 6.5 this year, which is quite high actually for a global figure with 8.2 inflation projected on average for the US, 6.2 expected in the Netherlands and 7.9 in the UK on average, and then looking at other countries in Asia, we have projections for 5.4 in India. And, fairly high 14.5 projections for Nigeria. Just to give you an example of what we're likely to deal with this year.[1]

Now, for most of the economies, the expectation is that for next year, inflation will start moderating. So, for the world as a whole, we expect inflation to fall on average to 3.4% and that is likely to be reflected across the board. So this is very much a short-term spike that we're expecting at the moment, but nevertheless, our clients will have to deal with that.

Julio: So, Yael, with this inflation rate of 8.2% in the United States, 6.5% globally, and also looking at governments starting to raise interest rates, consumer's debt service cost is also going up, there's going to be pressure on the wallet.

So with this inflation and the input costs and consumers being under more pressure, Edgar, I would love to understand from your perspective, what you see your clients doing around pricing. Is it the right time to raise prices? Or how are they thinking through that?

[1] https://home.kpmg/xx/en/home/insights/2022/04/global-economic-outlook.html

Edgar: Of course we do see a pressure on prices, and clients moving towards price increases in general. But there's another effect that I see as well.

So the immediate question that we are answering for our clients is how to reduce their portfolios or how to streamline the portfolios from a brand perspective. So that is in one way a positive effect, because that would have been necessary anyhow, and they take this opportunity to do it now for obvious reasons. But yes, of course, to my earlier point, there's also this move towards price increases, which is understandable from the perspective that was just shared, on the increase in terms of the ingredients or the parts that you use or need for your end product.

But the question is: are you able to explain this to your end consumer in a way that it's still okay with the price increases? They're not stupid. They know that they're going to face the consequences of the overall economic climate, but to me, it's much more about how to explain this, how to communicate this in a transparent way in order to prevent a drop in demand, to the extreme.

Julio: Edgar, how are you seeing companies communicate to their consumers? If we're talking, especially in a business to consumer environment. Are they being as transparent to say: "we're raising prices because inputs are up", or are they trying to just gradually raise prices? What are some of the tactics you're seeing out there?

Edgar: Unfortunately, I'm much more seeing the second example that you refer to. So gradually increasing prices without actually explaining it, with the effect of consumers complaining about it. Consumers complain about an incredible increase of prices in supermarkets, without an explanation, which is the worst thing to do from a brand perspective. But it's remarkable that we do not tend to learn from mistakes that we made in the past, because we've seen it over and over again in many crises, and the same mistakes seem to be made, which is quite weird to see actually. I've heard about an example. I think we discussed that last week actually, was your example, Julio, of a brand that increased its fees, its subscription fee, which to one extent is pretty soon, but to the other extent, if you are pretty open about it and transparent about it and you're able to explain why the price, or in this case, the subscription fee, needs to be increased, you should come out as a winner because of that. And again, supermarkets and all the brands are just not doing that to that same extent. And as a result, consumers move towards fighter brands or private labels and a lot of that. And it's pretty difficult to win those ones back after this whole situation is over.

Julio: Yes. Yes. Well, it's interesting too. When I think about how I'm seeing some of my clients respond, not only are they thinking about the pricing issue, they're also thinking about the elements that drive the cost within their products or services. So in certain cases, folks who are changing their value proposition in terms of the service levels, trying to really understand the trade-offs that consumer's willing to make. So they may have a little bit longer wait time. They may, instead of running a shuttle every 10 minutes, they might run one every 15 minutes in an amusement park. Things like that that they're doing. But what's very interesting too, is if you think about the last 40 years when as the world has really globalized, as the supply chains have become really efficient, except for literally the last 18 months, what you saw is people looking to get the input cost downs.

You could go to a super mega store and really get items that were manufactured in a low-cost location. But given just the recent supply chain breakdowns, given some of the geopolitical efforts going on, I think our clients are having a hard time looking for a cheaper place to build stuff and buy stuff and make stuff. And so now all of a sudden the pressure's there.

So Yael, I'm just curious, what are you seeing on that dimension? Because clearly input costs are going up, but also what I call 'the globalization of the world' and really the efficiency of the world is really suspect right now in terms of manufacturing it and looking for the lowest cost location to produce something.

Yael: We're seeing the supply chain resilience as a big theme for our clients, because what we've learned is that not only you can have certain places that are effectively shut so we have production in the Ukraine, for example, especially for car manufacturing, clients that have been shut, so customers need to look for other supply routes, but also you have these short closures because of COVID. So we've just had another closure in China now that will impact supply chain yet again, so the need to be more resilient in terms of supply chain is very important, and companies are looking at different ways in which they can make their supply chain more resilient and cost is no longer the only thing that they're looking at.

So as I think about being a senior executive in a company, regardless if they're serving business clients or they're serving consumers, I think that you really, at this point in time, really have to bring you're a-game to bear. You have to bring your general management experience not only around sourcing, not only around manufacturing, not only around distribution, but also around marketing and alignment, making sure your value proposition is correct, because they are challenging times.

Julio: We also talked a lot about these input costs being significant increasing. So I envisioned that our clients are investing in digital means to try to take down their costs structure. I.e. trying to automate things where they can remove quotients of labor because labor is expanding and the labor market is tight. They're looking for better ways to engage with the customer, in terms of digital channels, apps, other digital means. So Yael, I'm just really curious from your perspective as an economist, where are you seeing or how are you seeing clients invest capital after this cost takeout? So we've seen the last three years, digital acceleration just increase. Do we envision that continuing in the current environment context?

Yael: Well, I think we'll have to see it continue because the labor market is, especially in certain economies like UK, US, labor market is likely to remain relatively tight. So we would need to find other ways to increase production. We also need to work on productivity more generally, on labor productivity so that the investment is necessary.

The only issue that we have is some headwinds, in terms of not only the squeeze on profits with the rising cost, not all of it is labor, but we also have rising interest rates with central banks now starting to increase interest rates in earnest. And that is going to be a little bit difficult for companies to invest.

So when we look at a company's plans for future investment, there's a bit of a mix there. They need to be more careful where they put their money and much more strategic where they are investing for the medium term, given that there will be shortage of a lot of things.

Julio: What's interesting to me, as a person who spends a lot of time thinking about the front office and linking it to operations, not only do we have this inflationary pressure. And for clear reasons, petrol costs have skyrocketed, labor costs have increased, competition for labor is fierce, so people are paying higher wages. And like you rightfully pointed out, we're going to start to see interest rates increase. So that's going to be a significant impact on clients' wallets, but at the same time, the pandemic has kept people at home to a large extent for the last 24 months. And so there's this pent up demand to go out and go someplace you haven't gone.

So not only do you have inflationary pressure, but now you've got really high levels of demand. And normally you would see price would actually offset demand, but because there's been such a backlog of services that people haven't been able to take place in, it feels like it's going to increase.

Edgar, when you talk to your clients, what's their outlook around demand? Do they see it continuing? Do they see it starting to taper off or are you seeing some variety depending on the sector and segments that you're talking about?

Edgar: There's definitely a variety of segments. So in consumer goods, there's still positive outlook. And of course they all will be effective, but not to the extreme. And as we mentioned, the inflation is relatively okay in the Netherlands. It's very high of course, but if you compare it to some other numbers, it's still okay.

It is also true that there's stockpile demand for services and goods. Especially in the sustainability space. People are also, because of gas prices going up, the appetite for investing in solar panels and all of that, and also refurbishing or rebuilding actually houses in terms to make it much more energy efficient is definitely on the rise. So you see a rise in areas like that.

Edgar: On the other end there's of course multiple industries, which has been mentioned already. Cars, for instance, there's still a demand for cars, but if there's no supply in terms of aluminium and all of that and people need to wait long for cars, then they will keep on driving their current one.

So there's definitely more hesitation in terms of being positive, for the near future in industries like that. But in the consumer goods area, I still see a lot of positivism amongst our clients and hopefully they're right of course.

Yael: I'd say, I just wanted to add to that. I'd say here, at least in the UK, we're starting to see clients beginning to worry about customers going on a strike or partial strike. That it's all good when you explain why prices are going up and especially, we had an incident here where we had a shortage of lorry drivers and there was a need to increase wages quite significantly to attract them. And customers bought that because we had quite a lot of surplus savings here in the UK, but in other economies where households couldn't go out and spend during COVID, so they had extra cash. That is gradually dwindling away.

We're seeing consumer confidence falling quite significantly. There's more concern about the outlook and therefore, there's a point where you could already see demand here falling as a result of the increase in prices. But also it's not just the rising prices, it's the rising costs generally. And if your basic costs are rising, you may need to forgo some of the more discretionary spend. So even for those customers that are not increasing pricing, they could still see a fall in demand going forward.

Julio: Right. So Yael, when you talk about that though, the way I envision it is you look at the equation, you look at your value proposition, you say, okay, if my input costs are coming up, are there things I can do to manage that? So that's one element. The second is okay, I can go ahead and I can try to take price when I need to take price, raise prices, or I can shrink the size of the products and services I sell so that they still don't have the impact, right? But Edgar something that the clients have to think about is they're trying to avoid the substitute. They're trying to keep their customers, they're trying to keep their book of business if you will, so to speak.

So what's the importance of having a great brand in a high inflationary period and in terms of stickiness?

Edgar: Well, theoretically it's very important. However, what we also see in times of crisis like this, that the immediate effect is to reduce marketing expense, which seems to make rational sense, and also seems to make sense from a financial perspective. But the real issue is not necessarily that you will see an effect on the strength of the brand itself, but the immediate fact is in terms of the saliency of the brand. So it's not as available from a mental perspective as it should be. I would argue that, of course, a very strong brand is important, but we also know that you do not improve the strength of a brand on the short term. It will take you much longer than that. But the immediate effect of reducing your marketing spends, as a result, a considerable lack of awareness, has a much stronger negative impact than if you have a mediocre brand or a strong brand or whatever. And it's one of the effects that we usually see in crisis like this, that brands immediately reduce their marketing spends.

So there's no strong evidence yet that this is happening, but it's most likely to happen because of the historical reasons that I referred to. The other usual effect of crises like this is indeed increasing prices or, in order to improve the affordability of products, which is not necessarily not increasing prices, by the way, in this case, to improve affordability, we need of course, to reduce prices.

Again, a reflex which is logical, but not very intelligent to do, because it will reduce your brand equity as well. It would be better to consider, to your earlier point, Julio about improving your value proposition. It could also be the size of certain products, in order to improve the affordability. But having said that, you need to be very open and transparent why you do this, because if you're kind of misleading your customers, changing your packaging, reducing the size and kind of giving the impression that it's still the same, it will have a negative impact on your brand equity.

So, with that in mind, even strong brands need to be focusing on improving affordability, but not in a bad way. So doing something on size, be open about it to make sure that you keep your current clients, because again, when they've left, it's pretty difficult to win them back again.

Julio: Right. I think right now it's super critical to think about a couple of things. I think one is it's important to think about, what is your brand? What do you stand for? And who do you want to win with? You don't have to win with everybody, but who are the customers or the segments that you really want to win with?

Number two is: what is the equity that you have with those customers? Call it loyalty, call it inertia. Who are they, and why did they stay with you so that you can serve them better? And how are you going to protect that piece of your franchise in the short term, so that when things get better and as Yael mentioned, as inflation starts to subdue into the next fiscal year, based on the estimates that we're sharing right now, you'll be in a better spot.

So as I'm advising my clients, I'm saying, Hey, think about who you need to win with and how you're going to win with them. Think about how you build your business around those customers, so you can value engineer and really try to navigate the next period of time so that you can get out on the other side with still, a good cohort of customers that are loyal to you. I think that's really important in terms of the path forward.

I can recall back during the shocks of the late seventies, when petrol prices went up significantly, that gas stations re-evaluated their value proposition and had people pump their own gas. And so you may not want the convenience of someone dropping something off if you can't afford it.

On the other hand, companies might embrace technology like drones, which are probably much more energy efficient to deliver that and take the quotation of labor out. So I think we're going to see a lot of interesting experimentation at the margin to see what actually works, because I don't think someone woke up one day back in 1965 and said, oh, let's have people pump their own gas. I think that the environment set the context for that happening and people changed.

As we head to the top of the discussion here, I'd just really liked to understand, Yael, if you're advising your clients about how to think about the next 18 months to two years, and their customers and their investments, what advice would you give to them?

Yael: I'd say that is, we're likely to see quite a lot of volatility. We're just coming out of a pandemic that changed a lot of things, probably permanently, in the way people work, the way people shop. And now we're heading towards another, potential quite significant pivot when you look at the geopolitical environment. So that's more on your distribution network that will have a big impact. So these are huge times of change and I think, it is worth revisiting your business model. Not necessarily changing it, it's really down to each business, but those who need to change, and change now, will probably reap more benefits, because it's times like this, when you have so many changes and so much uncertainty, that if you get it right, you get it right. And if your competitor gets it right, you may lose your business.

Julio: Yes. Edgar, any closing thoughts?

Edgar: Yeah, I'm very interested how consumers will react in a broader sense of the word. On the short-term, we will see the conflict consequences as we discussed. But it might have a deeper effect on consumers and they might re-evaluate what they really think is important in their lives. So they might go back to more the basic parts of how to be happy and how to live your life in a way that is appropriate and also right for yourself and all of that. And that doesn't necessarily mean that we will spend less or whatever, but the shift might be much bigger than we think at this point.

Julio: So as I, think about the current environment, what I would say is we have many of the tools that we've developed over the last 15 years that are available to us. The difference is that the environment's a lot more turbulent. It's a lot more unpredictable. So with that in mind, I advise my clients, I think you need to stay close to your customers and really understand what's important, really drive those customer insights. You need to spend time thinking about who do you want to win with? And why do you want to win with them? And shape or refine your value proposition, your brand, your packaging, your service levels to accommodate those customers, and then do everything you can to value engineer your business, to deliver that in a way that's going to be sustainable over the long-term.

And while that might've been easier to navigate a very smooth river a few years ago, right now it is a bit turbulent. The water's churning and it's going to require our Chief Marketing Officer, our Chief Sales Officer, Chief Customer Experience Officers to work very closely with supply chain and finance to be able to execute and deliver on that. It's going to be interesting times.

As it's been said, historically, inflation can be a heck of a foe and our clients are all going to have to navigate over the short term.

Yael and Edgar, I want to thank you for joining me today to talk about the consumer in the context of this inflation.

So with that, thank you for listening to us today, stay safe, stay well, stay healthy.