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Financial trends in 2023 – 4 things every business leader should know

It is difficult to remember a more uncertain time in which to manage or run a business. Politics and economics are conspiring to make the job of the business leader even more challenging. It is however important, more than ever now, to remain optimistic as a business leader and ready to lead the business through what is shaping up to be a prolonged period of uncertainty.

At a practical level, this is the right time to take appropriate actions to protect the business and ensure its financial stability. If the past 12 weeks are anything to go by, no one will be able to predict what the next 12 months will bring. There are however financial trends that will impact business. Knowing what these are, and understanding what you can do, will help your business to weather the storms ahead.

Inflation will (relentlessly) gnaw at your margins

Over the past 20+ years, inflation has been confined to a topic of discussion best left for the classroom. It is understood that most businesses have to contend with cost increases from time to time, but it is important to understand that inflation is different. Inflation is a *persistent* rise in prices (costs). Cost increases therefore get “baked in” to negotiations with suppliers, many of whom will want to rebase their commercial agreements on an annual (or more frequent) basis, thereby reinforcing price increases to create an inflationary spiral. This presents a particular challenge for those businesses operating in price-competitive markets. Such businesses have to expect inflationary pressures, around 10% in the UK currently, to continue for *at least* the next 12-24 months. It is important to work through strategies to accommodate the higher cost environment to ensure the business remains profitable. This could include revising product pricing upwards or taking actions to limit cost increases. For example, can the business lock into longer term supplier agreements, or find opportunities to lower per unit costs? It is even more critical during inflationary times to scrupulously monitor cash flow. Keeping a sharp(er) focus on pricing strategies of competitors will enable you to act without delay to align your prices especially where your cash flow may be at risk. Whilst maintaining prices when competitors are raising theirs is often seen as a winning strategy to win market share, this will only succeed if the business is cash-rich or has high-margins. It is more likely that a business will be unable to cover the relentless cost rises driven by inflation.

2. Interest costs will siphon more and more cash from your business

To break the cycle of UK inflation, the Bank of England has already raised interest rates half a dozen times. Interest levels, currently at around 2.25%, rise because the Bank needs to take away more of the money in our pockets to dampen demand. Whilst, as mortgage holders, we may feel the pain only when existing fixed rate deals expire, business borrowing is typically more volatile. If your business currently has borrowings, now is the time to revisit and reassess whether you need to seek out alternative finance sources. Businesses have three sources of funds, namely external borrowing, new (shareholder) capital or retained profit. If the business currently has borrowings due to mature in the near term, say within the next 1-3 years, you should work through the impact of a doubling and quadrupling of interest rates on your business. Remember that interest is an outflow of cash that *must* be paid to avoid risk of foreclosure. Lenders often change their outlook and willingness to continue lending in times of uncertainty. You should therefore plan for different outcomes including current lenders refusing to renew loans, or potential lenders now refusing to lend. Sounding out potential investors now and setting out the longer term prospects for the business may help you line up new capital in time for when it will be needed. Whilst retaining (full) ownership of the business is seen by many entrepreneurs as a “non-negotiable,” this must be viewed dispassionately through a lens of business survival and long term success. If, under different interest rate scenarios, a cash crisis could be looming for your business, now is the right time to review your funding options. Remember also that preserving funds within your business, for example by deferring or cancelling planned dividends, retains vital cash in the business and can send a powerful signal that gives stakeholders confidence in the longer term stability of the business.

3. Weak exchange rates will reduce long term business profitability

Businesses that rely on imports are suffering from higher costs of supply due to the decline in the value of Sterling. Whilst exchange rates typically move up or down daily, the value of the Pound may not rebound any time soon from its recent lows. Whilst in theory, higher interest rates ought to have resulted in an appreciation of the currency (because interest rate rises incentivise overseas investors to demand UK currency), the rises have come at the same time as rising interest rates in the US and in Europe. This together with the UK’s decision around Brexit, as well the government’s “current” plans around fiscal policy may together be colluding to undermine confidence in the long term prospects of the UK economy. Of course, no one can be certain what will happen with exchange rates, but business leaders would be wise to plan in the expectation that a higher cost base, brought about by lower exchange rates, is here to stay. Identifying opportunities to reduce cost of supply, for example by seeking out domestic sources of supply should go hand in hand with a detailed analysis of the cost base. Business costs can be analysed by “type”, to classify into “fixed” or “variable” categories. Fixed costs do not vary with sales activity whereas variable costs, such as costs of selling stock, do. Businesses with high fixed costs suffer from high “operational gearing,” which means they are affected more acutely whenever trading profits decline. Investigating opportunities to reduce operational gearing will help the business manage in times of higher product costs.

4. Customers will “eat away” at your working capital

A business must be *profitable* if it is to prosper and reward entrepreneurs for their many years of effort. Many businesses may, on paper at least, be profitable but still find themselves with insufficient cash to meet their operational needs. The cash (working capital) cycle explains how much cash is needed (and for what period) to avoid liquidity problems. Customers are typically offered credit terms by a business in the same way as suppliers give credit to a business. In uncertain economic times however, a domino effect often takes hold. Businesses not paid by customers are unable in turn to pay their own suppliers. Even dependable customers will delay (or default) on their payments, and this will swiftly impact the ability of your business to pay its suppliers. Modelling the likelihood of customers delaying payment will help to identify cash shortfalls early. To address the challenge, consider changing terms of trade, starting with less dependable customers. Cash on delivery and/or offering early payment discounts may be a wise strategy to replace existing credit arrangements. And limiting how much credit is given to any customer will dampen the impact of customer defaults. Wherever possible however, you should continue to honour existing payment terms with suppliers to maintain good business relationships and prevent working capital issues becoming a widespread contagion.

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