Rising Prices in Nigeria:

What should businesses do?

HIGHLIGHTS:

- Prices of goods and services have been on an uptrend in Nigeria as inflation for July 2023 came in at 24.08%, the highest recorded in decades. This has implications for consumers and businesses.

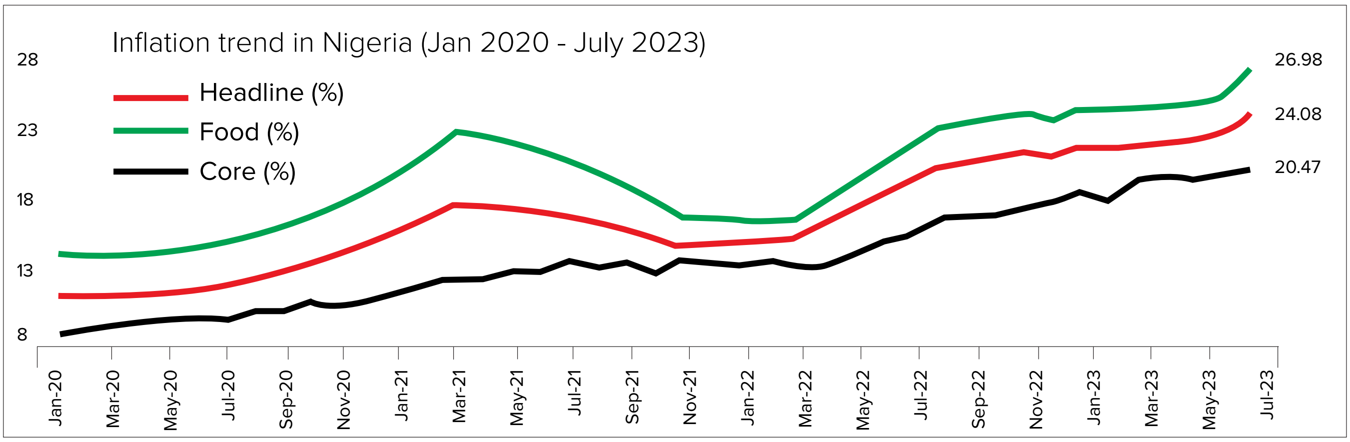
- Main drivers of the recent inflationary pressures are the hike in food prices, expansionary monetary and fiscal policy, Naira depreciation and of course the removal of subsidies on refined petroleum products.

- Not all inflation is bad; but when price increases get out of control, it affects just about every area of a business, including the ability of managers to plan.

- We expect inflation to peak in 2023, before a decline to below 20% in 2024. In the interim, businesses must adopt adaptive and proactive measure to maintain resilience.

- To cope with inflation, Nigerian businesses can renegotiate contracts and change product pricing model in the short run. Long-term strategies would entail backward integration, digital transformation, amongst other strategic initiatives.

Inflation in Nigeria has increased unabatedly from 12.13% in January 2020 to 24.08% as of July 2023, an 85% increase in the Consumer Price Index (CPI) from 310.2 points to 575.3 over the same period. In theory, inflation erodes purchasing power of the consumers, creates economic uncertainties, impacts real return on investments, and induces wealth redistribution in favour of debtors. In Africa and other less developed countries, high inflationary trends have been linked to poverty, currency depreciation, social unrests, food crisis and many other negative outcomes. According to the National Bureau of Statistics (NBS), headline inflation rose by 24.08% in July 2023 making it the highest rate in decades. The World Bank estimated that high inflation has pushed an additional four million Nigerians into poverty in the first five months of 2023.



Source: NBS

The July 2023 inflation report by the NBS showed core inflation reached an all-time high of 20.47% year-on-year (y/y) and 2.11% month-on-month (m/m), indicating intense inflationary pressure in the non-food and non-energy components of the CPI. Rising food cost has been a key driver of inflationary pressure in the country, with food inflation hitting a record 26.98% in July 2023, the highest since the CPI series began in 2009. The persistent rising price of goods and services in Nigeria hurts consumers and businesses and requires immediate policy actions to reverse this trend.

Amidst soaring prices, Nigeria's economic growth rate slowed to 2.51% (y/y) in Q2 2023 compared to 3.54% in Q2 2022. The agricultural and industry sectors contributed less (23.0% and 18.6%) to the aggregate GDP in Q2 2023 relative to Q2 2022 (23.2% and 19.4% respectively). Higher-than-expected inflation and slow growth may weaken the country's macroeconomic fundamentals further, hence the need for urgent policy action to calm inflationary pressures and drive more inclusive growth.

What are the drivers of inflation in Nigeria?

The NBS report suggested that food, electricity, housing, and transportation are the major drivers of inflation in Nigeria. We believe that current inflationary pressures are equally driven by growth in money supply, insecurity, agriculture value chain disruptions, exchange rate depreciation, increase in energy prices, amongst other factors.

1. Expansionary monetary and fiscal policy

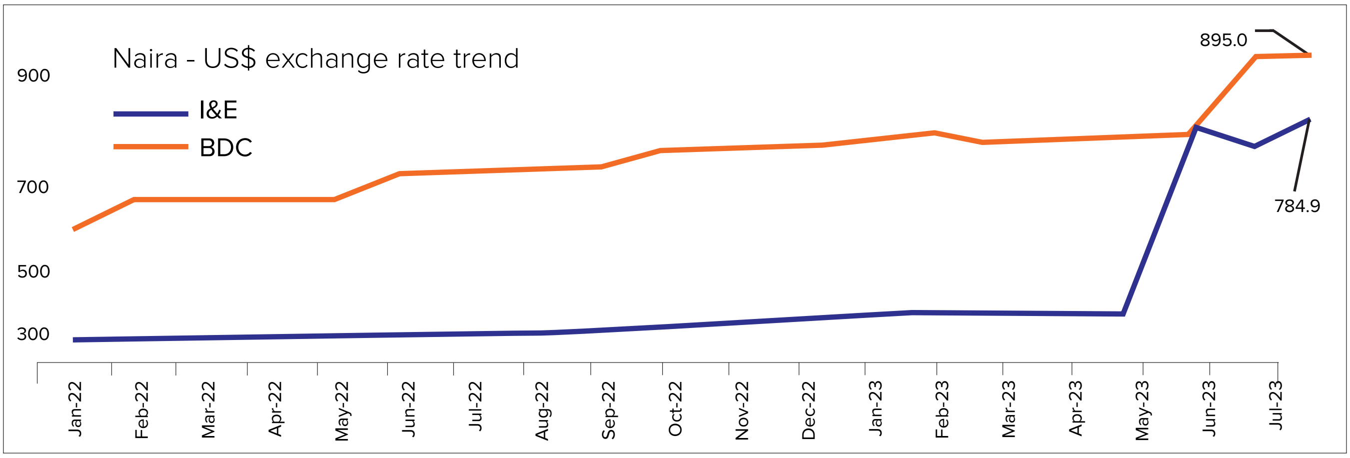
In a bid to provide fiscal cushion to the economy, the ex-president Buhari's administration pursued overtly aggressive expansionary monetary policy. Although the CBN kept benchmark interest rates high, it extended about N22.7trillion loans to the federal government through the ways and means financing. This had significant impact on the aggregate money supply which had increased from N21.7tn in January 2015 to N65.4tn as of July 2023, a 201% jump. According to the quantity theory of money, when too-much money chases too-few goods, inflation becomes inevitable.

2. Insecurity

The challenge of insecurity in many food-producing states in the country has significantly impacted food production and the entire agricultural value chain. Whilst the menace of armed banditry, kidnapping and farmland destructions remain widespread, the northern Nigeria where the bulk of food production occurs has been significantly impacted. According to UNICEF, about 25 million Nigerians are at high risk of food insecurity in 2023. In addition to insecurity which has been an issue for over a decade, the currency swap policy of the CBN in Q1 pushed many farmers to miss the opportunity to buy inputs and to plant, which is now leading to low harvests in Q3 and high prices.

3 Foreign exchange (FX) challenges

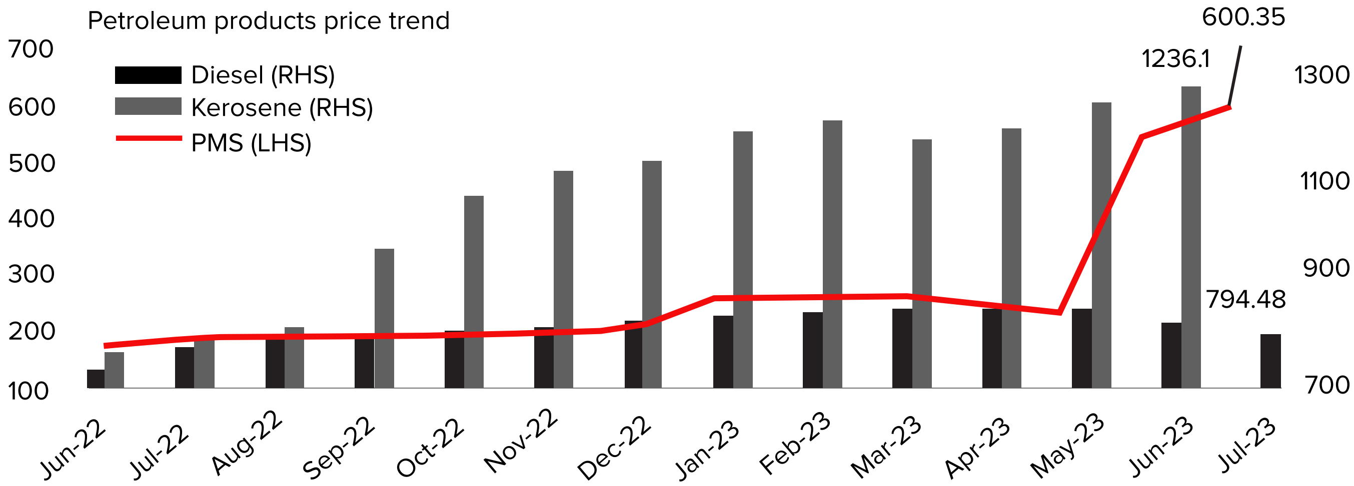
Between January 2022 and August 2023, the Naira had depreciated by over 90% (to an all-time high of N784.9/US$) at the official (I&E) window. Nigeria's average monthly import bill is estimated at US$2.8 billion, as the country remains largely import dependent for food, petrol, raw materials, and industrial equipment. Currency depreciation causes the prices of imported goods to become more expensive, thereby inducing inflationary pressures. According to the NBS, imported food inflation in Nigeria rose to a six-year high of 19.94% in July 2023 largely due to the currency depreciation.



Source: CBN

4. Higher energy costs

Energy prices are a major driver of inflation globally. The price of petrol in Nigeria has increased from an average of N176 in June 2022 to over N600 as of July 2023. Similarly, a 40% increase in electricity tariff is likely to take effect in 2023, following the adjustment of electricity pricing model by the Nigerian Electricity Regulatory Commission (NERC). These events mount significant pressure on inflation in Nigeria, as the cost of manufacturing and distribution of goods and services becomes exorbitant. More recently, the government's announcement of subsidy removal from petroleum products is bound to be inflationary.



Source: NBS

Implications for businesses in Nigeria

Not all inflation is bad; but when price increases is out of control, it affects just about every area of a business, including the ability of managers to plan. In simple terms, inflation translates to higher utility costs, higher energy (diesel, petrol, etc.) cost, higher equipment cost, rent or lease increases, greater transportation costs, and lesser quality of life for the employees as their purchasing power reduces. It also does force customers to curtail their planned spending, which could imply loss of business opportunities. The recent inflation trend in Nigeria is clearly not healthy and hurts businesses in the below ways and more:

Operating expenses

Increase in the operating expenses has become inevitable. This is driven by the jump in energy costs (particularly diesel and petrol), rent and employee wages. Businesses would have to adjust their budget to accommodate these increases.

Cost of goods and services

Businesses are experiencing an increase in the cost of raw materials and other inputs needed in the production process. Consequently, operating margins will come under intense pressure as it becomes more difficult to transfer these cost increases to the consumers through higher product prices.

Profit margins

Profitability will come under intense pressure in 2023 as inflation causes costs to soar. This is particularly true for small and medium-sized enterprises (SMEs) that might lack the negotiating power that larger corporations have.

Borrowing costs

In May 2023, the CBN raised its benchmark lending rate by 500bps to 18.5%, in an aggressive push to contain the nation's inflationary pressure. This would imply higher borrowing costs for businesses, making it more expensive to finance operations, expansion, and investments.

Labour market challenges

Workers in the public and private sectors experience a decline in their quality of life due to severe inflationary pressures. This has led to demands for higher wages from employees to maintain their purchasing power. Businesses that are unable to meet these demands could lose their key staff to competition.

Contractual agreements

Businesses with long-term contracts may find themselves in challenging situations if the contracts do not account for inflation. We will see some organisations move to renegotiate some contractual agreements if inflation persists.

Competitiveness

Inflation can affect competition within sectors; as well as the ability of Nigerian businesses to compete in the international market. Businesses that could manage cost increases and maintain quality might gain a competitive edge over those that struggle to adapt.

Business investments

Inflation elevates uncertainty which impacts business investments. Businesses might delay or cancel capital projects, expansions, and other growth initiatives due to concerns about the challenging economic environment.

Supply chain disruptions

Suppliers may struggle to meet with agreed supplies as prices rise, causing delays in the production process. Businesses may be forced to find alternative suppliers or adjust their sourcing strategies. Businesses may also be forced to reduce their production volume.

Business valuations

Inflation assumption is a major input into business valuation within the corporate finance space giving its impact on the discount factor used in many fair value estimation models. Put simply, businesses are valued less in a high inflation scenario.

Our Inflation Outlook

In foresight, we expect headline inflation to remain elevated in coming months as the combination of underwhelming food production, higher energy costs, lingering foreign currency liquidity and insecurity in major food-producing states, will continue to mount pressure on consumer prices. Additionally, planting season in the second quarter is expected to keep food supply subdued, thereby triggering food inflation. Our model suggest that August inflation will settle at approximately 24.2%, pushing the Consumer price index to an all-time high of 586 index points.

What can Nigerian businesses do to remain resilient in the short and long-term?

Coping with persistent inflation can be challenging for businesses, especially when other headwinds in the operating environment limit the room for necessary adjustments. Adaptability and proactive measures are crucial for businesses to maintain their resilience and continue to thrive in an inflationary environment. We expect inflation in Nigeria to peak in 2023, before a decline to below 20% in 2024. In the interim, businesses must explore strategies that can help them mitigate its impact and maintain their operations and profitability. Here are some immediate short-term strategies that could help businesses to cope:

1. Renegotiate supply contracts

This is a good time for Nigerian businesses to review supply contracts and renegotiate where possible to achieve some cost savings. Such renegotiation must include clauses that benchmark future adjustments to inflation and other specific cost factors. This will create room for businesses to protect profit margins in periods of volatile price movements. Effective negotiation skills, clear contract terms, and a deep understanding of market dynamics are essential components of this strategy.

2.
Reduce consumption and waste

Businesses need to seek for innovative ways to produce/deliver more with less inputs, in a bid to keep operating margins healthy. This strategy entails tweaking input combinations to deliver same (or more) output using lesser resources, whilst eliminating all manner of waste and resource redundancies.

3.
Reduce discretionary and non-strategic spending

Discretionary spending can be adjusted or eliminated without severely impacting the core functioning of the business. Cutting back on these types of expenses allows businesses to channel more resources to inputs that are critical to the survival of the business. It is important to note that while discretionary spending can be adjusted, it should still align with the company's overall goals, financial health, and strategic priorities. Some examples of discretionary spending for most businesses include marketing and advertising, travel and entertainment, Research and Development (R&D), office renovations and upgrades, etc.

4.
Change pricing model

Businesses can implement dynamic pricing, which involves adjusting prices in real-time based on the marginal increases in the production cost. Firms can offer tiered pricing options providing basic and premium versions of their product or service or offer subscription-based pricing to specific customer segments. This should help protect market share by ensuring that wider range of customer budgets and preferences are accommodated.

5. Change packaging to reduce cost

Optimizing product packaging can lead to significant cost savings for businesses while still maintaining product quality and appeal. Some examples of packaging changes that can help lower packaging costs include the use of thinner or lighter materials for packaging components, right-sizing packages to reduce the overall packaging volume and costs, switching to eco-friendly materials such as paper and biodegradable plastics, switching to standardized packaging sizes, etc.

6. Consider product quality adjustment

One of the ways businesses can protect their market share during persistent inflation is to device innovative ways to keep their prices competitive. This can be achieved by making strategic adjustments to product quality through innovative input combinations, product size reduction and reducing product features where applicable. For example, a clothing line can switch from 100% cashmere to a combination of cotton and cashmere (50% - 50%) to achieve some cost savings.

7. Change product lines

Changing or diversifying product lines can be a strategic approach to help cushion the effects of inflation for businesses. A broader product line means that firm's revenue is not solely reliant on one or a few products. This diversification can help mitigate the risks associated with market fluctuations or changing consumer preferences which is the current reality due to rising cost of living. A good example would be the introduction of cassava bread following the exorbitant prices of wheat flour.

8. Keep your employees engaged

Workers arguably feel the impact of inflation the most as their purchasing power becomes weaker. It is instructive for managers to keep employees informed about the inflationary environment and its potential immediate impact on the business and their welfare. Also offer palliatives to the employees where possible to ensure they stay to help the business remain resilient. Managers must be accessible to their associates and maintain a proactive communication stance to sufficiently address their concerns.

Long term strategies

Prices are sticky (slow to adjust) downward, especially in the long term. We expect inflation in Nigeria to remain double digit and relatively volatile in the mid-to-long term as the government seeks ways to address structural issues that fuel increases in the production cost of goods and services. Below are some strategies that could help businesses cope with inflation in the long-term:

1. Consider backward integration

By integrating backward into the supply chain, businesses gain more control over input costs. This control can help mitigate the impact of inflation on raw materials, as the organisation becomes less reliant on external suppliers and market fluctuations. Multinationals in the Nigerian FMCG space such as Nestle and Dangote have successfully implemented backward integration to maintain cost competitiveness.

2. Invest in digital transformation and process automation at scale

Digital transformation and process automation streamline workflows, reduce manual interventions, and optimize operations. This efficiency leads to cost savings, as fewer resources and time are required to complete tasks, which is especially valuable during inflation when costs are rising. Businesses can invest in Robotic Process Automation (RPA) or Business Process Management (BPM) systems to automate various routine tasks, improve efficiency, and reduce human error.

3. Implement process reengineering to eliminate unnecessary work

Business Process Reengineering (BPR) seeks to fundamentally rethink and reshape how work is done within an organization. By eliminating wasteful activities and inefficiencies, BPR can result in cost savings. Streamlined processes can give organisations a competitive edge by enabling them to respond faster to market changes, including persistent inflationary pressures.

4. Implement spending analytics

Spending analytics software help businesses to analyse spending patterns, purchasing behaviour, and procurement activities to gain insights into how money is being spent. By examining spending data, companies can identify areas of inefficiency, uncover cost-saving opportunities, and make informed decisions to better manage costs. This tool will be particularly useful in a period of high inflation.

5. Invest in clean energy

Energy transition could help businesses save substantially on diesel/petrol cost, increase productivity, reduce maintenance costs, and create safer and more welcoming environment for employees and customers. Recent data estimates that energy accounts for 40% of operating expenses of manufacturing companies in Nigeria, hence the pressure on margins whenever inflation hits. Nigerian businesses need to invest in on-site renewable energy systems and implement advanced energy monitoring systems to track energy usage and identify opportunities for optimisation.

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About Verraki

Verraki is a proudly African company partnering with enterprises and governments to accelerate the development and transformation of Africa by providing business solutions designed for Africa. We build and implement technology solutions for seemingly intractable challenges, provide advisory services to drive the capacity and motivation for change, and curate innovative ventures to unlock new sources of growth across our continent.

A fusion of two words: ‘Versorium’ (Latin for Turn Around) and ‘Meraki’ (Greek word used to describe the action of doing something with soul, creativity, pouring oneself into a task), Verraki aptly captures the essence of our company; to turn around African enterprises and governments via smart, future-focused solutions and business insights, new growth opportunities, helping to unleash their potential, turnaround their performance and achieve the seemingly impossible, with the sole goal of creating a better future for Africa.

We are committed to enabling the African (start-up) story by supporting high-impact socially-conscious entrepreneurs and catalysing self-sustaining enterprises and governments within the continent to deliver affordable services across critical sectors.

Our Strategic Cost Management Offering

Our Advisory practice provides digitally transformative services to the African market, leading the charge to deliver cutting-edge innovative solutions to organisations. Verraki’s strategic cost management offering helps organisations optimise their costs while maintaining strategic objectives, overall financial performance, and better competitive positioning. Key components of our cost optimisation advisory include but not limited to cost assessment and analysis, cost benchmarking, supply chain management, technology and automation, operational process improvement and change management.

At Verraki, we understand client needs and provide innovative new approaches that help enterprises and governments to explore new market opportunities including expansion into new regions, identification of new channels, targeting of new customer segments, or even the creation of new product categories in a way that moves them from “surviving” to “thriving.” Verraki develops and delivers the practical tools, frameworks, and organizational capabilities required to gain competitive advantage, and achieve sustainable growth, utilising customer insights, big data, and proprietary knowledge to achieve a deeper understanding of demand, customers, competitors, and opportunities.

Our seasoned executives and team have a broad range of multibillion-dollar P&L experience delivering long-term growth and optimisation vision, strategies, and management at global Fortune 500 companies.

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