



the  
**chamber**  
Leeds, York and North Yorkshire



**UNIVERSITY OF LEEDS**

Leeds University Business School

# Under Pressure

How Inflation & Rising Cost Pressures  
Are Impacting Upon Local Business

April 2011



## Methodology

The fieldwork and analysis of this special report is the product of a new partnership between the Leeds, York and North Yorkshire Chamber of Commerce and researchers at Leeds University Business School. The Quarterly Economic Survey fieldwork was conducted via email and telephone. There were 367 respondents of either business owner/senior manager status.

In addition to the survey fieldwork, the research team from Leeds University Business School undertook a series of semi-structured telephone interviews in order to provide a more detailed assessment of key QES findings. In total 10 interviews were carried out with managers who had indicated in their QES response that they were willing to be contacted. The respondents covered the range of small to medium size firms, five of which were manufacturing firms and five were in the service sector.

Questions were asked about the general performance of the respondent's business as well as their perceptions about the state of the Yorkshire Economy. The respondents described the different pressures facing their business; how these pressures have changed, how they are impacting on areas such as HR and training, as well as measures being taken to combat them. Topics such as rising competition and the effect of government policies and initiatives were also covered.

This partnership between the Chamber and Leeds University Business School will continue in the future. The survey and qualitative interviews are a key method through which we can communicate with Chamber members and identify issues of current importance. Contact details for the research team at Leeds University can be found at the end of the report.



## Introduction

The rising cost of commodities, such as oil, metal and food, has helped pushed inflation to a two year high and businesses are feeling its impact. In this post-recession period, business owners and managers are focussing on making 2011 a year for growth, however, they are also faced with the challenge of minimizing the impact that mounting cost pressures have upon their operations and trade.

Monthly inflation statistics make uncomfortable reading for both businesses and policy makers and Debate continues over whether interest rates should rise to curb inflation. When the fieldwork for the QES was carried out inflation was at 4.4%. Whilst, this fell to 4% in March 2011 it still sits at double the Bank of England's target rate.

If inflation persists at its current level it could potentially lead to a period of stagflation if combined with weak economic growth, as indicated by this quarter's QES. This results in an acute policy dilemma for the Bank Of England's Monetary Policy Committee when they meet on a monthly basis to set UK interest rates.

However, as the majority of price increases are coming from international sources (e.g oil and food) questions remain over the effectiveness of a rate rise, as it could simply add to the cost pressures facing business rather than relieving them.

This special report, in partnership with Leeds University Business School, looks in depth at the pressures on local business and the action that owners and managers are taking to deal with them. Acutely aware of the impact that passing price rises onto their customers could have on their competitiveness, businesses are looking at new ways to reduce overall costs and overheads and increase flexibility with their profit margins.

**- Mark Goldstone, Head of Corporate Relations, Leeds, York & North Yorkshire Chamber.**



# Section One | Identifying the the Main Sources of Cost Pressures on Business?

The QES results for the first quarter of 2011 present strong evidence that rising costs are considerable source of pressure for business in Leeds, York and North Yorkshire. 55% of businesses stated that inflation is more of a concern than three months ago as the rising cost of fuel, raw materials and the VAT increase take impact.

The survey reveals that over half (53%) of businesses are currently suffering pressure to raise their prices from the increasing cost of raw materials, up 14% on the previous quarter. Whilst, just under two-thirds of businesses (65%) said that they are suffering pressure to raise prices as a consequence of the rising cost of overheads, up 31% on the previous quarter.

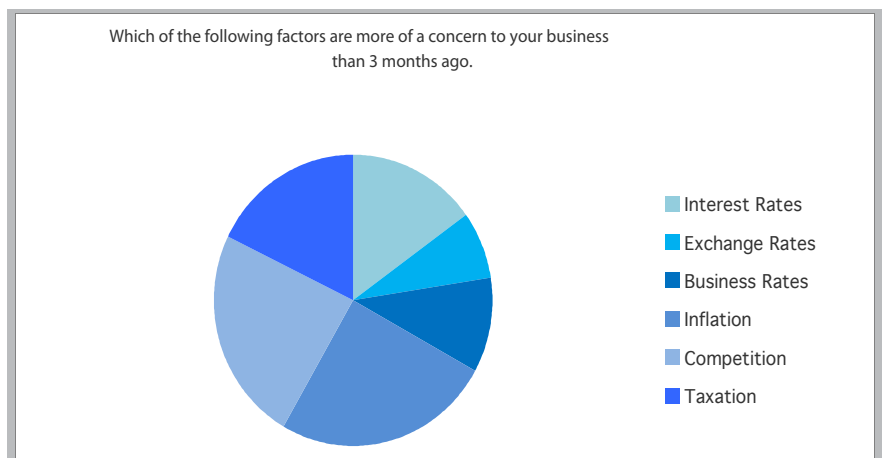
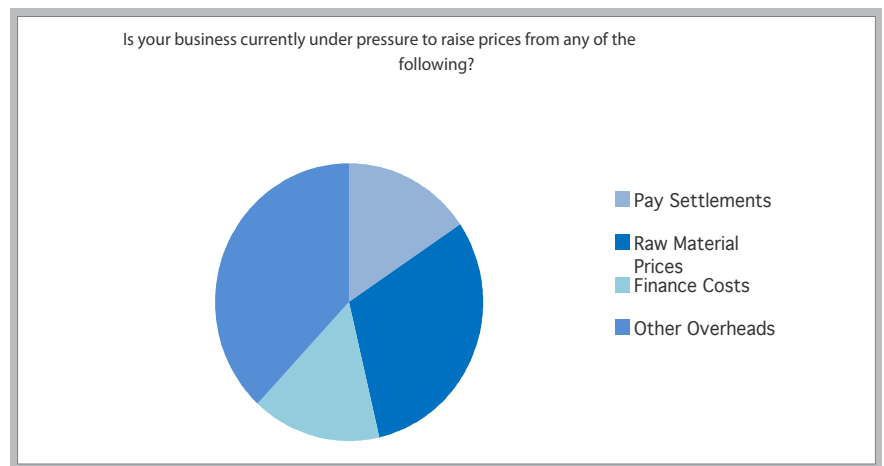
When combined with flat or falling sales levels, rising cost can create significant issues for business and owners/ mangers will have to decide whether they pass the price increase onto their customers or whether they absorb the cost inflation.

Whilst, businesses reported strong overseas sales and orders, trade within the UK market was less favourable. The majority of business reported that domestic sales for the past three months either remained constant (42%) or decreased (22%) and advanced orders either remained constant (43%) or decreased (23%).

However, with just under three quarters of respondents not currently involved in overseas markets, this indicates that the majority of businesses may face significant challenges in dealing with cost pressures.

Unsurprisingly, manufacturers are hit hardest by the rising cost of raw materials, with 79% of respondents within the sector indicating that it is a major source of cost pressure. A printing company explained how the rising price of paper is having a huge impact:

“Costs are a problem, margins have shrunk. It’s a constant battle to maintain prices. The price of paper went up by 30% last year. On average paper contributes to half the cost of the finished product, so a 30% rise on paper has a big impact on the finished product”.



As Table A shows, commodity prices have risen significantly in a 12 month period. The price of cotton has increased dramatically, which will have a big impact on clothing and upholstery manufacturers and retailers.

Similarly, wheat prices have increased significantly which will impact food manufacturers of which there is a large presence in the region. Energy prices have also experienced a large year on year rise, which will result in more expensive overheads. Manufacturer A states that the:

“Combination of the price of raw materials and increasing price of fuel are the two drivers to the inflationary factors that we’re experiencing in product prices”.

**Table A**  
**Commodity Costs – how prices have changed year on year** (29th March 2010 - 2011)

Brent Crude Oil	+40.9%
Ethanol	+59.3%
Natural Gas	+12.01%
Copper	+22.7%
Silver 5000oz	+110.58%
Gold 100oz	+27.98%
Wheat	+57.32%
Cotton	+145.53%
Lumber	+10.96%

The interviewee describes the rise in raw materials as a ‘global aspect’, which is affecting many of its suppliers many of whom have raised their prices by up to 15%. The effect of globalisation also means that businesses feel the impact of international crisis. The unrest in Libya and other parts of the Middle East have contributed to rising oil prices, whilst humanitarian disasters, such as the Japanese Earthquake, also impact on UK businesses and cost pressures. As experienced by Manufacturer C:

“The cost of raw materials has so far gone up by between 4.3% and 5% and this will get worse especially because of the problems in Japan...We’re buying components wherever we can and we’re paying the premium where we have to”

The rising cost of utilities and fuel are also cited as a concern by interviewees.

“Utilities, finance cost and fuel are the main pressures on us. These have definitely gone up over the last year”  
(Service Provider J)

“We pay £2,500 a month for electricity and our fuel bills are 30% higher than they were because we’re running generators” (Manufacturer C)

“We’re noticing the price of fuel. We do quite a bit of travelling and the price of petrol is having an impact” (Service Provider I)

“Fuel Prices are massively affecting our budgets at the moment” (Service Provider H)

## Section Two | The Impact of Cost Pressures on Pay and Recruitment

With many businesses being squeezed by rising costs and a fragile recovery, wage increases and workforce expansion comes at a difficult time. Some businesses may come under less pressure to increase salaries if the whole sector is freezing wages, such as Service Provider H:

“Pay is not a big cost pressure, because the recession is hitting all the construction firms at the same time so there’s been a relative pay freeze over the past few years”

However, other businesses may feel the need to increase wages if competitors are doing so too. Similarly, businesses may increase wages in response to the cost pressures experienced by their employees as a result of rising inflation. The potential of an interest rate rise and how it will affect employees is also of concern to one interviewee:

“I think interest rates will increase over the next 12 months...and that in turn at some stage will cause a problem with pay rates. We have to freeze pay at the moment. Although we haven’t frozen recruitment or training” (Service Provider J).

For businesses choosing to absorb price increases, freezing or reducing employment costs is one option, as Service Provider H states:

“We have to absorb the cost pressures at the moment. We’re not able to pass them because of competition so we have to freeze pay and recruitment”.

The recession resulted in businesses adopting alternative measures to employee redundancies, such as pay freeze, shorter hours and flexible working policy. There is evidence of different strategies towards staffing. Some companies are cutting back on directly employed staff. For example, Service Provider F stated:

“We decided to run a model on a partner basis so that we’re cutting out all of the costs associated with employing people, which is a seriously large cost for most businesses”.

Service Provider E saw pay as ‘the biggest single cost’ and is targeting pay increases based on performance ‘... but this is very much on an ad hoc basis’. Whilst, Manufacturer B that it has given a small wage increase as it feels that ‘staff can’t carry on without a pay rise’.

One strategy practiced by a number of interviewees is the recruitment of graduates or junior employees as a cost effective employment option. Manufacturer D said whilst it was cutting back on staff in the short term it was taking on a student from the University of Leeds for six weeks with a view to finishing the development of a product. They described the situation as beneficial to both parties as the employer gains cost effective labour, whilst the graduate or junior employee gains experience. Service Provider G echoed this point:

“(Employing graduates) gives them paid work experience and the opportunity to develop their own portfolio, bridging the gap between university and the media sector. Employing graduates gives us a really low cost and low sale price for our products”.

Interviewees also commented on the caliber of graduates that they had employed despite their junior level. Service Provider E explored the idea of graduate recruitment after they were unable to find suitable employees through traditional searches.

“Finding suitable employees has been a real problem for us and that’s what initially pushed us into looking into the graduate market. We tried advertising normally, as well as agencies for temporary staff and it was a disaster. We couldn’t find the right people, they weren’t reliable and they didn’t really want to work. It costs us quite a lot because we ended up damaging some contracts through it. So we ended up going down the graduate internship route and we ended up with some very high caliber candidates”.

A freeze on training has been necessary in some companies with 63.5% of firms reporting their investment plans for training have remained the same. One manufacturing company said that training 'is not considered unless it's an absolute necessity'. External factors were also impacting on training however, with one construction consultancy firm highlighting that changes in European building standards had compelled them to invest more in training, at a time when sales and turnover are 'significantly weaker than 2010':

“We’ve had to spend a lot in the past year and this year because the new European Eurocodes (standards relating to design and building) then came in for the construction industry so all staff will have significantly more training than they would in an average year.” (Manufacturer A)

## Section Three | How Cost Pressures Are Impacting Competition and the Way Businesses Operate

As costs increase, it can become a struggle for businesses to maintain prices. If a company chooses to absorb cost inflation it can put pressure margins, many of which were squeezed significantly as a result of the recession. Alternatively, businesses can pass on cost increases to their customers; however, this could potentially impact on competitiveness, particularly for businesses whose competitive advantage is based wholly or partially on the price of their product or service.

The QES for the first quarter of 2011, reveals that more than half (52%) of businesses feel competition is more of a concern compared to three months ago.

For businesses that face price competition, one option is to pass part of the price increase onto customers, whilst, absorbing the remaining cost inflation:

“We have the build the cost pressures into our own prices, but in a modified way. We’re certainly not passing on the costs 100%...We’re finding that our own pricing is up against stiff competition” (Manufacturer A)

In addition to rising costs, businesses are also facing increasing price competition from other businesses, which could potentially add to the pressure on businesses to reduce prices which would further impact upon margins. Businesses are facing increased pressure as a result of the recession, as struggling competitors dramatically cut prices. Manufacturer B said that it has seen companies close to the edge start cutting prices to ‘silly levels’, which subsequently resulted in them having to cut their own prices to compete – ‘they go bust and they’ve damaged us on the way down’.

Businesses are also facing new competitors that can offer lower prices. Both Manufacturers C and D said they were experiencing increased competition from overseas, particularly from emerging markets such as China and Turkey. The recession has also contributed to increased competition for some businesses. Service Provider H said that it was seeing much more competition from businesses that had never been in their market before, but has entered it 'because their own market had shut down'. Whilst, Service Provider E said that it was experiencing more competition because of the increased number of freelancers;

"Because of the number of redundancies, a lot of people have decided to set up on their own, which does fragment prices"

The research indicates that instead of reducing prices to compete businesses are marketing themselves on quality or niche services. Offering bespoke products allows Manufacturer B to increase its prices and compete with other businesses. Whilst, Manufacturer D said that it faces a lot of competition from overseas, so its strategy is to focus on the quality of its products:

"We don't cut corners on style or design, in order to make our products fit for the long-term"

Service Provider E, which faced competition from freelancers said that trading on the quality of their service allowed them to increase their prices by 300%:

"We can guarantee and demonstrate better quality. We could have tried to compete with (freelancers) on price, but I think that would have been suicidal".

Investment in marketing is an option being taken by a number of businesses to attract and retain customers. Unable to reduce prices, both Manufacturer A and Service Provider H, have bolstered their marketing efforts and Service Provider J said that it was focusing its efforts on more targeted marketing.

As a result of increased cost pressures, businesses are also looking to improve their efficiency in order to save money and restore profit margins. By reviewing their internal processes, both Service Provider J, and Manufacturer C said that they were hoping to improve efficiency and make cost savings.

"(We're) monitoring lighting levels and machine levels – we're looking at cutting back wherever we can"  
(Manufacturer C)

Businesses are also investing money in order to improve efficiency. Company B said that due to the market it was in, its prices for standard products had remained the same eight to nine years. Unable to increase prices, it was buying new equipment to increase efficiency. To reduce the cost of fuel, Company I said that it is looking into buying a Hybrid Car that does 70 miles to the gallon.

# Recommendations | Alleviating the Pain of Cost Pressures.

As this report has established, cost pressures are a growing concern for businesses in Leeds, York and North Yorkshire. However, the report also identifies a number of innovative techniques that businesses are adopting to minimise the negative effect of inflation and other cost pressures

## 1. Identify your competitive edge

Rising cost pressures make it increasingly difficult for businesses to compete on price. However, focusing on the quality or the niche positioning of a product can offer businesses an alternative competitive edge. This can be achieved either through the re-positioning of existing products and services or through product development and diversification of your companies offering.

The delivery of a unique selling point provides businesses with the opportunity to increase their prices and therefore pass on cost pressures to customers, whilst also adding value. Identifying where and how value added to your products and service will inform pricing decisions and allow a business to focus marketing efforts on its most profitable customers.

For businesses without in-house marketing resources, external agencies and consultants can offer specialist advice and support. The chamber can assist you with finding appropriate providers

## 2. Invest in New Processes to Increase Productivity

Investment in equipment and people can help transform your business into a leaner organization and facilitate higher output through fewer resources. Acquisition of new tools, machinery and software can help in speeding up processes and production, minimize waste and reduce energy consumption, resulting in better working practices and efficiency savings. Investment in training can help improve productivity through the up-skilling and motivation of the workforce. The end result for businesses are lower costs and a gross value added return.

Improved productivity allows greater flexibility and leniency with profit margins, meaning that price increases don't impact other areas of the business (such as staffing levels) or price competitiveness.

There are several ways that businesses can improve efficiency and it is important that owner and managers undertake a full review of their internal processes, employee output levels and supply chain to see where savings can be made. Organizations, such as the Manufacturing Advisory Service ([www.mas.bis.gov.uk](http://www.mas.bis.gov.uk)), can offer advice on how to make your business leaner.

## 3. Renegotiate commercial terms with partners

Well managed and intelligent procurement decisions can optimize supply chains by reducing the costs associated with interface transactions and processes. Cost reduction consultants can work in partnership with businesses to identify and develop an effective purchase management strategy.

The chamber has special arrangements with a number of national and local providers and is able to bring you preferential rates on a wide range of business services.



Members of Leeds, York & North Yorkshire Chamber's Policy & Representation Team involved in the QES are Mark Goldstone, Head of Corporate Relations, and Hayley Johnson, Corporate Communications.

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