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Inflation and Its Impact on Business Valuation in the US Economy

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Introduction

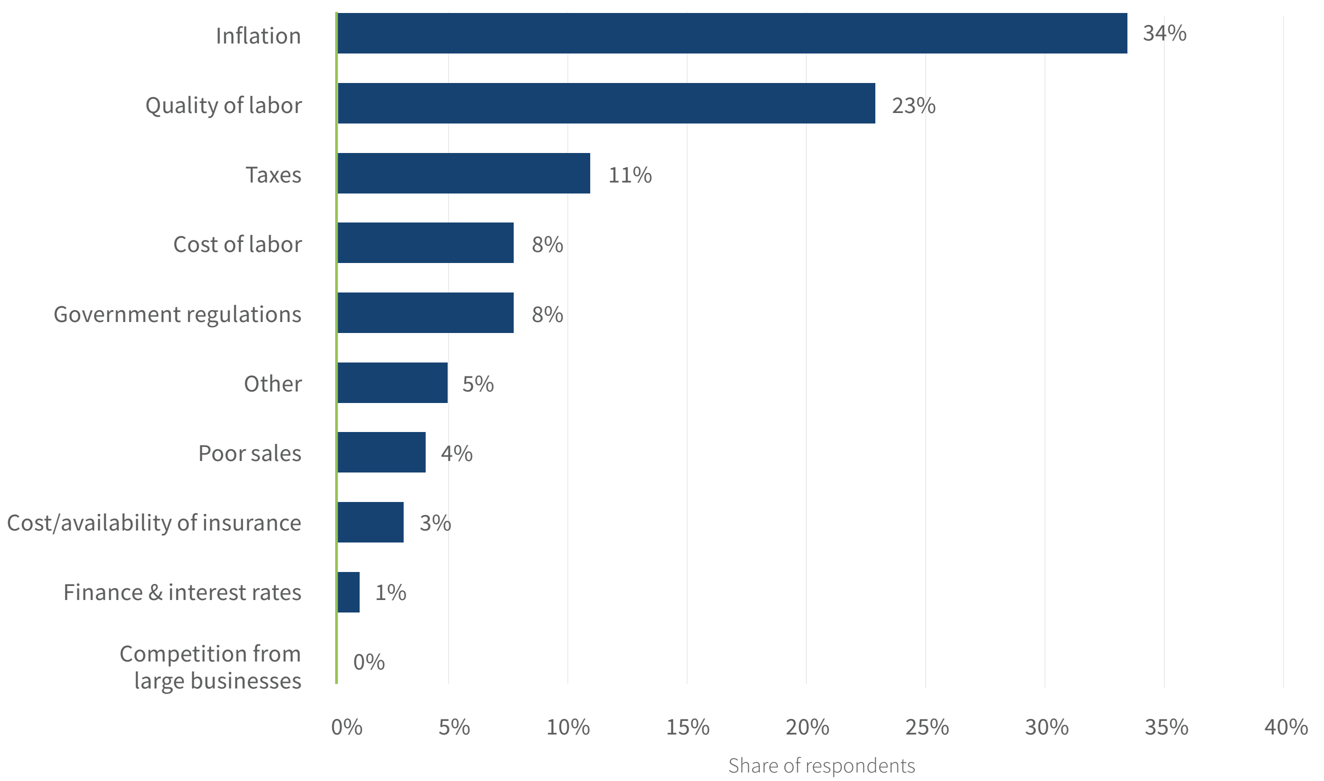
At the time of publishing, the US inflation rate stands at 8.52% (down slightly from June's rate of 9.06% earlier this summer). In economics, inflation is a general increase in the prices of goods and services in an economy. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation corresponds to a reduction in the purchasing power of money.

As consumers, we have all experienced the impact of inflation and have likely discussed the day-to-day challenges it has presented for us- whether it be commuting costs, price of groceries, rent and other living expenses- the list goes on.

Yet what is not as actively talked about, is the impact the current inflationary period is having on small business owners and their businesses- And if you work with business owner clients, it's likely they've come to you with questions about how to mitigate the impact of our current environment on their businesses.

When researchers asked more than 1,500 small business owners about their single most important problem, a clear majority said that inflation is their biggest problem. A total of 34% chose inflation, compared to 23% who said labor quality and 11% who said taxes.

Top Concerns of Small Business Owners

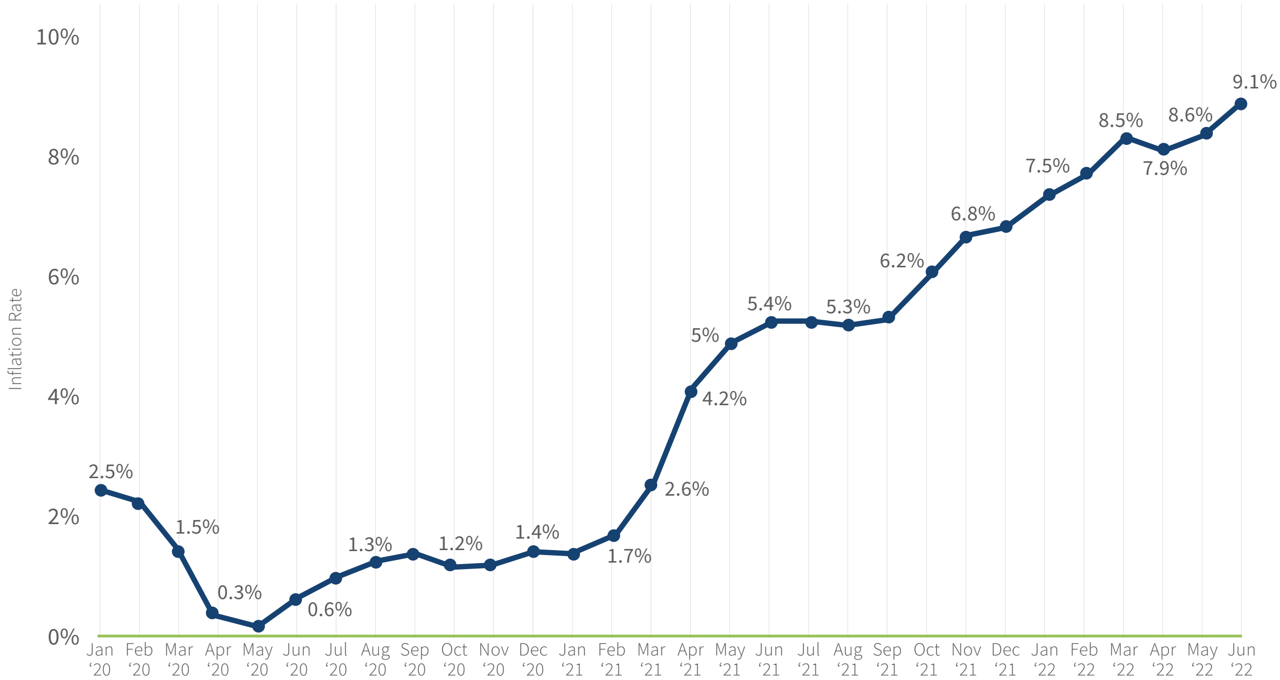


Addressing your client's concerns around inflation and what is to come in the coming months may seem daunting. However, it's important to remember this is not the first time we have experienced inflation to this degree. What makes the current inflationary period unique is not just the overseas war in Ukraine, but the additional recovery from a pandemic and the stop-start of COVID-containment policies in China's manufacturing hubs.

What is inflation now?

In addition to two consecutive quarters of negative GDP growth, during the month of June alone, the Consumer Price Index (CPI) for all items rose 1.3%. Over the 12-month period ending in June 2022, consumer prices are up 9.1% (the largest annual increase in 40 years). This increase varies for certain goods; for example, select fuel and oils are up 70.4% over the last 12 months.

Inflation Rates Over the Past 30 Months



Today's inflation is multi-faceted, i.e. we have both "supply side" and "demand side" forces combining to create the worst inflation in four decades.

Supply Side = Cost Push Inflation, e.g. reduced oil supply, higher oil and gas prices, leads to higher prices across the board (groceries/household items, etc.)

Inflation can start with scarcity of certain goods or raw materials such as energy or computer chips for vehicles or fertilizers for crops, etc.. That rings true in 2022, when we've seen massive disruptions in normal business due to COVID-19 and ongoing disruptions to the supply chains we depend on to deliver raw materials and finished goods.

Demand Side = Demand Pull Inflation, e.g. too many dollars (facilitated by the Fed who accommodates record level deficit spending through direct government security purchases) chasing too few goods leads to higher prices

Worst Case Scenario – when inflationary expectations become entrenched as an economy is shrinking. Due to inflation, workers demand higher wages – then the higher wages lead to higher prices and more inflation, etc., etc.

Generally speaking, inflation is not good for business. The primary effects of inflation on a business are that you're likely to sell less, see lower profits, and pay higher costs.

While some mega-corporations and sellers of high-priced, luxury goods with more established pricing power may not feel the impact on their bottom line, the majority of smaller, privately-owned businesses are likely to raise the price of their goods and services, and in turn sell less or lose customers. These same companies are also under pressure from employees to raise wages to keep up with a higher cost of living.

Speaking with Business Owner Clients on the Topic of Inflation

Every business is unique in how they are affected by the combination of 40 years of high inflation. However, there are common pain points all businesses are facing.

Challenges your small business owner clients are likely experiencing:

- Goods and materials become harder to find
- Dollars buy less and materials cost more
- Consumers redirect spending
- Labor costs increase
- Rising interest rates lead to shifts in investment portfolios

With inflation, BOTH revenues and operating expenses may rise with the relative change of each determining the impact on total profits.

Big picture, there are three major factors you and your clients should focus on:

What is their industry, or more specifically, their NAICS code?

The price of raw materials and production, and the amount of money customers have to spend. When it costs more to buy the eggs and flour or get the lumber or nails you need, profits will go down. Raw materials often become difficult to find as well as more expensive to have delivered.

Consider customers' purchasing power. If they're paying more for groceries and electricity and other necessities, they have less money left over to spend on other more discretionary items.

The ultimate impact of this current bout of inflation on the US economy is still uncertain, with the following key questions likely to determine future developments:

- How long will supply chain disruptions last?
- How do inflation expectations affect wage negotiations?
- How do consumer spending habits evolve?
- What is the nature of monetary policy?
- How will the 2022 election affect future policy-making in Congress?

Other questions advisors should prepare themselves for:

How do the current economic forces impact the profitability of the company in the next few years?

Can price increases on raw materials be passed on to customers? (i.e. is it "bad business" to increase prices because overhead costs are an increasing expense?)

When the government spending stops/slows and security prices drop, will there be a drop in demand for goods/services?

The Valuation Focus Evolution

As we have moved from the COVID era into the post-COVID era, valuation focus for many industries has shifted from historical metrics to expected metrics; that is, the next 12 months, as supported by actual recent developments.

Financial results from 2020 and 2021 are not relevant for many industries, such as hospitality, restaurants, etc. In many cases, data from 2019 may be most reflective of current expected conditions, but each situation is different.

From a valuation perspective, experts should be analyzing businesses based in large part on forecasted data (the next 12 months primarily) and thoroughly examining the levers of their model that are tied to economic conditions.

The Impact of Higher Interest Rates on Discount Rates

Whereas the pandemic has elevated risk for many businesses across industries, the arrival of inflation has led to higher interest rates and a universal rise in discount rates (the cost of capital/required rates of return). Higher discount rates are synonymous with lower capitalization rates and lower valuation multiples.

The M&A markets are already reflecting these developments as recent record high multiples have mostly edged downward as we move into the second half of 2022.

We saw the real-world impact of inflation on interest rates at the beginning of August, when the SBA raised the maximum variable interest rate to Prime +3 for loans over $350,000.

Variable Maximum Interest Rates for SBA 7(a) Loans

Loan Amount	Rate
$50,000 and Less	Prime + 6.5
$50,001 to $250,000	Prime + 6.0
$250,001 to $350,000 to $350,000	Prime +4.5
Over $350,000	Prime + 3.0

Maintaining Value During Periods of Rapid Inflation

Inflation reduces real profits, as each dollar of profits will purchase a smaller bundle of goods and services. For example, $1 million in "profits" today will not purchase the same resources as $1M in profits two years ago (inflation is a hidden tax).

The key to maintaining the value of the business during periods of rapid inflation is profit protection – and expansion (if possible).

Businesses are valued based on their ability to generate cash flows, and a business is sold based on the expectation that it will generate future profits. The more cash flow a business can generate and secure, the more it will be worth.

Creating a detailed accurate forecast that accounts for expected price and cost inflation in future cash flow projections is essential. Accounting for the inflation component is imperative to identifying the appropriate levers the company can control. Having conversations early with customers and suppliers about increasing prices can allow a company to make quick decisions and put them in the best position to succeed.

Essential vs. Non-Essential Businesses and the Impact of Inflation

For many businesses, sustained inflation may cause a rise in direct costs, as well as broad business costs. Oftentimes, essential businesses can maintain their profits by passing these cost increases onto customers. But for non-essential businesses, a devastating effect of inflation is lower customer demand for discretionary goods and services, leading to lower profits.

In addition, companies may see a rise in overhead expenses, such as long-term lease agreements that contain escalation clauses tied to inflationary measures. Vendors and professional service providers to your business may also increase their prices during times of inflation. Furthermore, wage increase demands can create upward internal pressure to retain skilled labor in an extremely tight labor market. The rising cost of living for lower wage employees could result in turnover for more expensive employee alternatives.

Inflation, Profitability and Value

If inflation is impacting the profitability of a company and the business is unable to pass its increased costs to customers, the business is going to be worth less.

For a business to maintain or increase its value, it must be growing. When inflation slows the business's growth, it negatively affects the projected growth rate applied to the business (the projected growth rate is one of the most sensitive attributes of any valuation model). Additionally, a valuation expert may utilize a higher discount rate (apply a lower valuation multiple) on a company that is more sensitive to inflation.

External industry and macroeconomic factors can also impact a company's valuation. Key factors include the rising cost of capital (both the cost of equity and the cost of debt tends to rise), labor scarcity, input costs, and supply chain bottlenecks. If a company's profitability can be greatly impacted by economic factors over which the company has no control, the risk profile and discount or capitalization rate are likely to increase—resulting in a lower valuation.

The Effect of Pricing Power

Companies with pricing power – that is, inelastic demand where a given price increase has little impact on demand – will fare better than those without. The inverse is elastic demand, whereby a small price increase leads to an even greater drop in demand.

As inflation rises, all companies will have more freedom to raise prices, but companies with pricing power, coming from stronger competitive positions, will be able to do so more easily than companies without that pricing power, operating in businesses where customers are resistant to price increases. Consequently, when inflation rises, the former will be able to raise prices more than the inflation rate, while price rises will lag inflation for the latter group.

If revenues and costs both rise at the inflation rate, margins should be unaffected by changes in inflation, but this is a rare outcome. For companies that have costs that are sensitive to higher inflation and revenues that are less so, margins will decrease as inflation rises. Conversely, for companies with costs slow to adjust to inflation, but revenues that can do so quickly, margins will increase as inflation rises.

How does the current rise in inflation affect the value of companies?

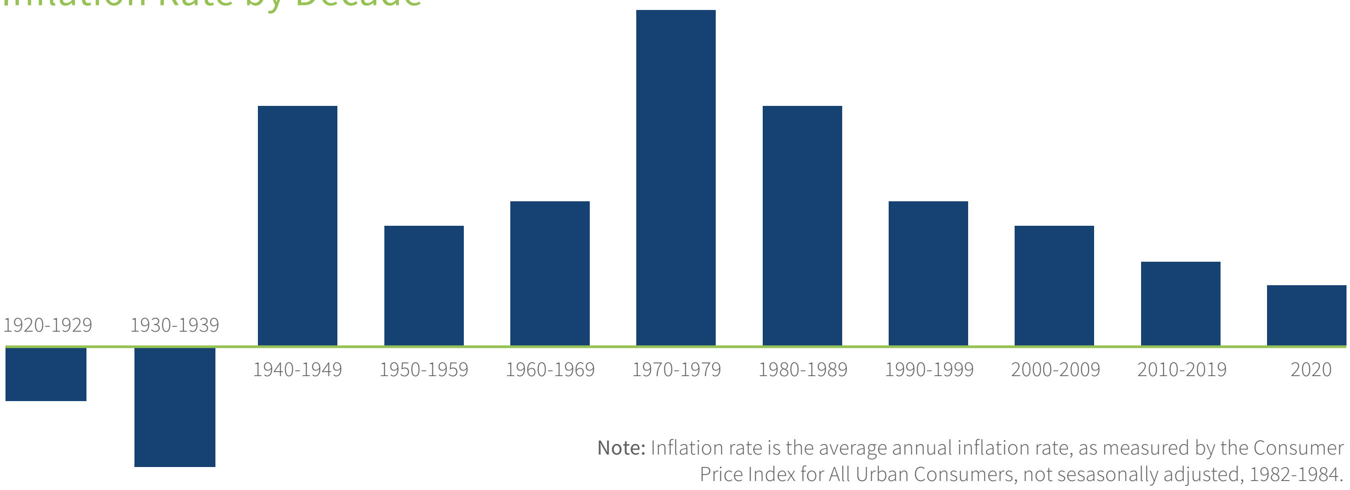
First and foremost, the value of companies is driven by profits. The higher the profits, the higher the valuation. This means that valuations in general are higher in a high-growth environment as experienced during the strong rebound in the economy during 2021.

Historical experiences with inflation suggest that company growth rates tend to slow during an inflationary period for a variety of reasons. The inability to pass on cost increases to customers will curtail company profits. Those companies and industries most impacted by inflation may be seen as "riskier", thereby reducing perceived value.

The problem is that we believe that the governments around the world have overdone it with money supply expansion because of COVID-19, and the demand for goods and services is artificial to a large extent. Whatever role low interest rates and high government spending may have played in helping economies to stabilize during the recent global recession, these same policies are forcing companies, investors, and policy makers alike to be aware of the potentially negative effects of inflation – including the costs of eradicating inflationary expectations.

Some economists are already warning of a return to the levels of the 1970s, when inflation in the developed countries of Europe and North America hovered at around 10 percent. The following table highlights the historical effectiveness of US policymakers in curtailing inflation during the 40 years since the last major bout of rising prices and wages:

Inflation Rate by Decade



Note: Inflation rate is the average annual inflation rate, as measured by the Consumer Price Index for All Urban Consumers, not sesasonally adjusted, 1982-1984.
Source: Morningstar Direct

Generally, sustained inflation requires a constant and enduring rise in broad business costs. Since labor comprises as much as 70% of total US business costs, sustained consumer price inflation typically requires sustained wage inflation. Although wage levels are rising in many industries, overall wages and labor costs remain moderate. Optimists believe that as the US government's economic stimulus dissipates and the Federal Reserve continues to raise interest rates, wage cost pressures will also decline.

Inflation Creates Winners and Losers

Just as individual companies will respond differently to the arrival of inflationary forces, the impact will also differ from one industry to the next. Inflation will impact industries and companies in varying ways with some benefiting and others searching for ways to navigate this challenging economic landscape.

Below is a general overview of industries and sectors that have typically benefited/weakened during periods of inflation. It is important to note that these are general statements, and the actual impact of inflation is predicated on many factors including industry, specific company factors, company management, etc.

Potential Winners

Real Estate As building slowed and the demand for home buying soared, the price of housing has also increased. Many potential homebuyers have parked their money on the sidelines and have opted for renting as they await a more optimal entry point into the market. Rental rates have seen dramatic increases, helping property owners. However, it is important to note that rising interest rates may lower real estate value in the future.

Energy (Oil and Gas) Energy and more specifically, oil and gas, are likely to see success during this period of inflation. Sanctions imposed during the conflict in Ukraine, among other political measures, have been factors in limited supply sources. Short term demand for these products remains relatively unchanged even at higher prices. Rising interest rates will slow economic growth, which will cause oil prices to fall in the future.

Bonds Treasury Inflation-Protected Securities (TIPS) are bonds which are indexed to inflation. As inflation increases, so does the principal value of the bond. This allows investors to mitigate inflation and the purchasing power of their money.

Commodities Items such as gold and silver have long been dubbed as hedges against inflation. Demand, and thus prices, for commodities increases during period of inflations. Producers and sellers of these have better odds against inflation.

Food Production Food producers may be able to benefit during inflation due to their ability to pass on rising prices. The Russia/Ukraine conflict has limited the output of wheat production with a corresponding increase in price. While some food producers could see negative impacts, producers of staple foods will find it much less challenging to traverse inflation.

Potential Losers

Transportation This industry is primarily impacted by rising fuel costs; however, there is also added pressure through increased expenses related to tires, oil and labor. New and Used vehicle inventory remains low which may have a greater impact on smaller businesses looking to replace their fleet. Businesses can expect to see higher maintenance costs to keep their current fleet operational.

Construction As inflation creeps up so does the cost of the underlying drivers in construction; materials and skilled labor. Steel, aluminum, lumber and other materials have seen steep price increases over the past year, leading to large expense increases for companies in the construction industry. Rising fuel costs and the cost of machinery continue to exacerbate the issue. Businesses which are unable to pass costs are left to absorb the increase cutting into slim profit margins.

Hospitality After a tough year from COVID-19, the hospitality industry is likely to see further disruption from inflation through rising food costs, increased labor costs and reduced demand discretionary spending. With purchasing power declining, consumers are mindful of their purchases and are indulging less. In regard to lodging, economy and budget hotels are in a position to see more benefit as travelers seek more affordable accommodations.

Overall, inflation poses a significant problem to small businesses who are forced to pass costs along to customers or take a hit to their bottom line. According to a report posted by the National Federation of Independent Business (NFIB) , the majority of small business owners indicate inflation as having a substantial impact on their operations. Fuel, Labor, Rent and utilities were reported as the major contributors to higher expenses; thus owners should take time to examine their own respective expense structure to identify areas for potential improvement.

The analysis of inflation and its impact on business valuation will conclude here with a list of other specific steps which may be taken to “inflation proof” your business.

- Consider adjusting current pricing model to absorb increased expenses
- Review expense structure for any redundant/unnecessary
- Consider cross-functional workflow to offset labor shortages
- Consider hybrid/remote work to offset which also provide a labor friendly convenience
- Consider leveraging automation
- Consider capacity/reasonableness of prolonging capital outlays

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