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CORPORATE FINANCE INSIGHTS

Spring 2022

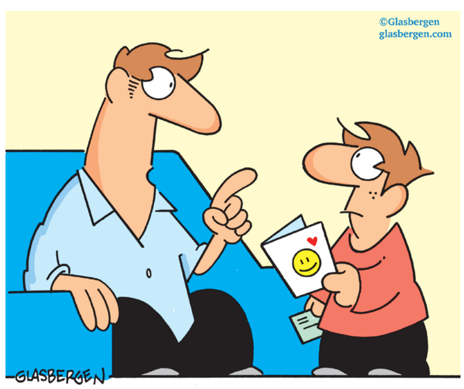
Inflation and Valuation

When I started my first “real job” in 1985, the US was just coming out of a period of heavy inflation. It took a little while for our policymakers to figure everything out, but by 1985 inflation was under control. Paul Volcker and the Federal Reserve Bank (the “Fed”) did such a good job with it that by the late 1980’s many analysts stopped building inflation complexity into their analyses.

Too Much Ice Cream

The US has had a manageable level of inflation since then, which is a big relief because inflation can make business decisions much more complicated. Inflation itself isn’t bad. It’s the level of inflation that economists worry about. From a central banker’s perspective inflation is like ice cream – a little bit is good but too much is bad for you. Central banks often point to 2% inflation being the minimum level needed to support healthy economic growth. Also, low and stable inflation makes it easier for businesses (and people) to make good financial decisions.

Our economy’s problem since 2008 is that our central bank, the Fed, has been concerned about deflation settling in. Deflation is less well understood than inflation, and its effects are much more dangerous. Deflation contributed significantly to the Great Depression. Importantly, efforts to fight-off deflation can lead to, or worsen, asset bubbles and/or cause policymakers to overshoot and create uncontrolled inflation, which it looks like we have now. The big question today is whether high inflation is temporary or something more long-lasting.



“Your grandmother sent you $5 for your birthday. Put it in the bank for a very long time and someday it will be worth $2.”

Foggy Binoculars

Inflation makes valuation challenging for a few important reasons. The first is that it makes forecasting financial results more difficult. As I mentioned in previous newsletters, valuation is a prophecy of the future, so difficulty predicting what the future will look like makes valuation work more complex.

It is hard to tell how things will play-out. Inflation doesn’t affect all businesses the same way. Some businesses do better in inflationary environments, others do worse. Similarly, even within a single business, some expenses may spike up while others may hold fairly constant. Sales to some customer segments may increase while other customers may pull back.

Also, management teams have a number of questions about how to approach price increases with their customers, who get a say in the matter after all. Is the company able to at least pass along cost increases? Is there room to improve profit margins? How will customers react? Can customers substitute other products for ours?

Financial models can become more detailed and scenario analysis becomes more important. It would make things simpler if we could trend some historical data and see how a company and its operations (revenue and expenses) performed in an inflationary environment previously. But we haven’t had high inflation in over 35 years! A company, industry and economy will change

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dramatically during such a lengthy time gap, and it is not common that anyone would keep records from that long ago anyway.

Another difficulty is that an inflationary environment creates instability in capital markets. For valuation analysts this is important, because we use public market data to estimate the value of privately held companies. We look at how public companies trade in the stock market to estimate market multiples for a market approach to valuation. We look at yields on US Treasury debt and corporate debt, and returns in the stock market to estimate the cost of capital for an income approach to valuation. When markets are unstable it can be more complex to work with public market data.

Be Cautious

Hopefully the Fed and other policymakers can guide our economy through all of this quickly. In the meantime, caution is the keyword. Make sure to do your analysis and carefully consider what may happen under different scenarios. Consult with your trusted friends and professionals (lawyer, CPA, investment advisor). Give yourself some time to consider decisions but be prepared to act with imperfect information. We will get through this, but it could take some time.

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Please contact Ronald DiMattia at Corporate Value Partners at (216) 741-1330 or ron@corporatevaluepartners.com with any questions or if you need help with a valuation or corporate finance matter.

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