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Jacks of All Trades
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The Impact of Inflation on the Value of Your Business and What You Can Do About It

Dealmakers need to consider a simplified model of marketing, operating and financial characteristics.

Chuck Faunce
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VALUING A BUSINESS requires analyzing the complex interactions between a company and the environment in which it operates. One area of the business environment that hadn't presented much complexity until recently was low and stable inflation, as it represents the optimal condition for economic decision making.

However, inflation is currently at the highest rate in decades, and it can impact the value of a business through its effects on both cash flows and the cost of capital. While the effect of inflation on the cost of capital is straightforward in direction if not magnitude, the effect of inflation on a business's cash flows is potentially more complex and could be positive or negative. Getting a handle on its effect is important in either case.

One way dealmakers can try to understand the risk inflation poses to cash flows to portfolio or target businesses is to consider a simplified model of a business's marketing, operating and financial characteristics. In addition to highlighting potential risks, this model can be used to identify potential mitigation opportunities over relevant planning horizons based on expected future inflation behavior.

Marketing characteristics include potential and targeted market segments, and positioning in terms of each product's or service's features, pricing, promotion and distribution. The effect of inflation on a business's revenue will vary to the extent demand for the business's products and services is elastic. Demand elasticity is affected by the availability of substitutes and level of competition and depends on issues such as the extent to which customers consider a product or service to be either a commodity or differentiated, and also either discretionary or non-discretionary.

The scope of a business's market may provide opportunities to change its focus to less elastic segments if it can leverage its customer relationships and industry reputation. The effects of inflation may also manifest in the costs associated with a business's marketing mix. Holding costs, for instance, increase both directly through higher interest rates and indirectly through a reduced ability to obtain additional financing as may be required to expand working capital.

Operating characteristics include product and service development and delivery, staff attraction, retention and development, capacity management and quality control. The effect of inflation will vary depending on the life cycle stages of a business's products and services. High inflation may simplify price skimming strategies and complicate price penetration strategies in the introduction stage and may have the least effect in the growth stage. In contrast, it may have the greatest effect in the maturity and decline stages, even to the point of decreasing the length of those stages.

Using the BCG Matrix, a business can manage existing products and services to emphasize cash cows, selectively prioritize stars and question marks, and trim dogs. Other useful product portfolio management frameworks include the Ansoff Matrix, the GE McKinsey Matrix and the Innovation Ambition Matrix. In this context, one of the goals of each of these frameworks is to identify the extent of a business's pricing power.

The uncertainty introduced by inflation is smallest for improvements to existing products or services than can be sold to existing customers ("core" elements of the portfolio) because the impact of a yield improvement, waste reduction, or substitution is amplified in an inflationary market, and they can be implemented sooner than new products for existing customers or existing products to new customers ("adjacent" elements). The uncertainty introduced by inflation is largest for new products for new customers ("transformational" elements). In addition to its effect on product and service development and delivery decisions, this uncertainty also affects the cost of capital.

Inflation can affect both cash flows and the cost of capital, and its impact on cash flows can be complex.

One way to think of retention practices is the combination of pay, opportunity and recognition. Good retention practices pay off in an inflationary environment by reducing the costs and inefficiencies associated with the need to attract new staff. In contrast, cost savings associated with temporarily decelerating staff development have to be weighed against longer-term effects on employee morale and business effectiveness and efficiency. The effect of reducing unused capacity can be weighed against the resulting longer term capacity constraints.

Conversely, outsourcing or extending equipment service life to reduce stress on overused capacity can be weighed against the purchase and financing costs of new equipment. Finally, inflation introduces relatively little uncertainty to well-understood and relatively near-term inspection and prevention costs, direct and indirect internal failure costs and direct external failure costs. However, because they may only be realized over a longer term due and so would benefit from the additional compounding effect inflation has on present values, inflation could actually incentivize and thereby amplify nominal indirect external failure costs.

Financial characteristics include measurements of profit, asset and risk management that inform the analysis of marketing and operating characteristics in addition to purely financial considerations such as cash and capital management decisions. For example, the cost of holding cash can be compared to increasing use of a line of credit, and opportunities to shrink receivables and extend payables must be weighed against the effects it could potentially have on customer and supplier relationships. Finally, the higher interest rates that result from inflation will lower coverage ratios, so in addition to reducing profitability, inflation is likely to make it harder to get additional debt financing.

Understanding the impact of inflation on a business is crucial when valuing a company. Inflation can affect both cash flows and the cost of capital, and its impact on cash flows can be complex. In addition to the extent to which inflation is elevated, the expected duration of the period of elevated inflation may affect the relative significance of the characteristics.

However, by considering a simplified model of a business's marketing, operating and financial characteristics, dealmakers can better understand the risks posed by inflation to portfolio or target businesses and identify opportunities for mitigation over relevant planning horizons. Once the simplified model has been considered, areas identified as particularly sensitive may be considered in more detail. **M&A**

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