Valuation Insight: Exploring the Impact of Inflation and Interest Rates on Business Valuations

Inflation and interest rates are two important economic indicators that can significantly affect business valuations. Inflation relates to the overall increase in prices of consumer goods and services, while interest rates are the rates at which borrowers can borrow money from lenders. These two factors can influence the financial performance of a business, as well as the value of its assets and liabilities. As such, it is essential for business owners, investors, and analysts to understand and assess the impact of inflation and interest rates on business valuations.

In this newsletter, we will first go through the general overview of current market conditions, then dive deeper into the relationship between the two economic indicators and how they affect the valuation of businesses, in addition to what actions businesses can take to navigate high inflationary and interest rate environments.

Where are we today?

A business cycle, which is the pattern of cyclical fluctuations in an economy, can influence asset returns over an intermediate-term horizon. In today's economical environment, most economies are experiencing mature business cycles due to continuing inflationary forces, slow down in industrial activity, and intensified monetary policies.

Figure 1 visualizes the current economic state of major economies indicating that the U.S. is positioned in the late-expansion phase with rising probability of entering a recession during 2023, while the Euro Area has likely already dropped into a recessionary phase. A recessionary phase can be characterized by negative economic activity, limited access to credit, declining sales and earnings, and lower inventories.

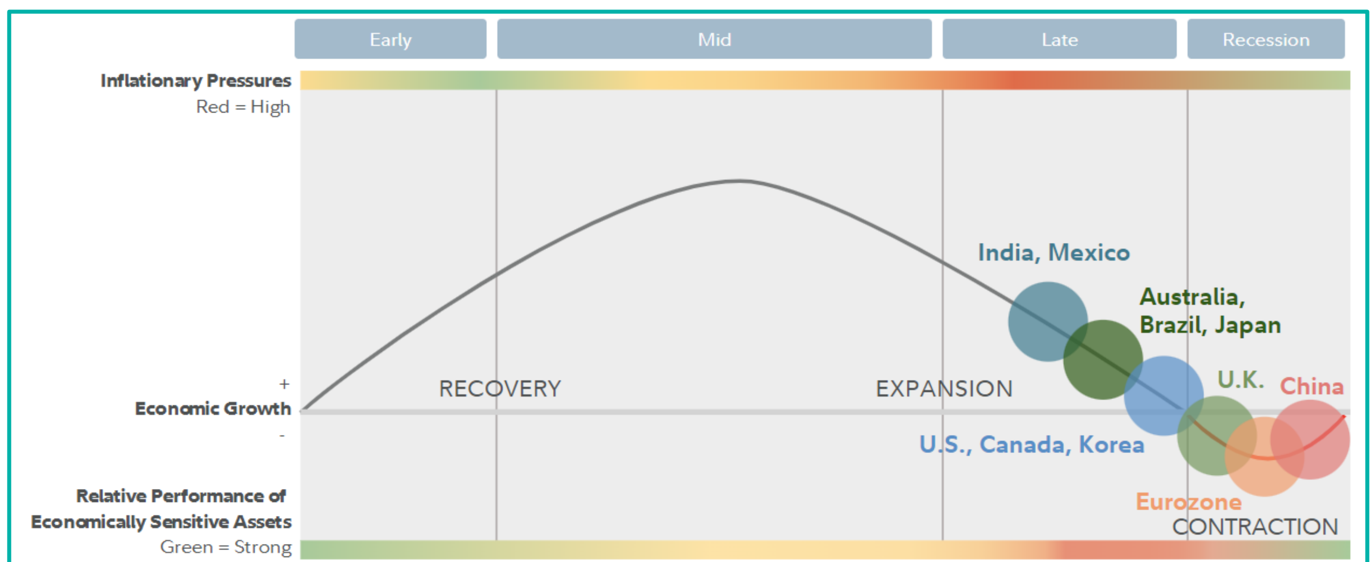

FIGURE 1: GLOBAL BUSINESS CYCLE
Source: Fidelity Investments

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How did we get to the current economic environment?

Following a decade of high growth economies and low interest rates, the 2020 global pandemic caused shockwaves worldwide forcing governments to implement lockdown restrictions in an attempt to limit the spread of the virus. This resulted in supply chain disruptions and shortages of goods and raw materials, leading to higher prices in consumer goods and services. As the global economy began to recover from the aftermaths of the restrictions in place, demand for goods and services surged putting further pressure on prices, particularly housing and food.

Adding to the pandemic's impact on the global economy, the Russian invasion of Ukraine took the world by surprise triggering unprecedented economic uncertainty and gas shortages causing energy prices to skyrocket. Compounded pressure on prices, caused by both the pandemic and the invasion, subsequently lead to the highest global inflation levels seen since the mid-1980's. As shown in Figure 2, inflation rates have surged to 8.50% in the U.S. and 6.40% in the Euro Area.

How did central banks respond?

Central banks across all economies adopted intense monetary policies including significant interest rate hikes to control the rapid inflation and slow down consumer demand. Figure 3 displays that the US Federal Reserve increased interest rates by 450 basis points over 14 months, while the European Central Bank lagged behind with a 300-basis point increase over the same period.

As a result, global economies were hit hard, as shown in Figure 4, growing only by 3.4% during 2022, down from 6.0% in 2021. Following higher than expected inflation rates recorded in March 2023, interest rates are anticipated to continue rising, tipping the global economy into further slowdown in 2023.

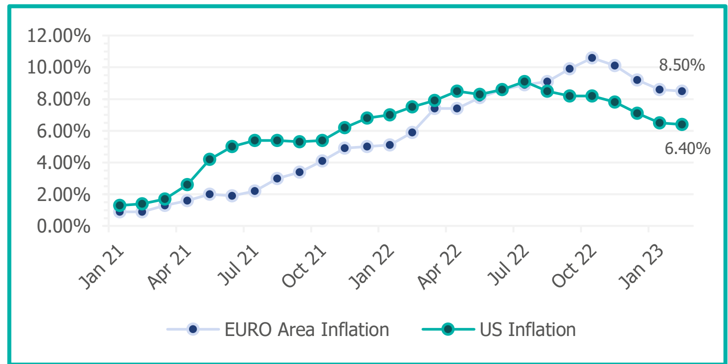

FIGURE 2: U.S. & EURO AREA INFLATION
Source: ECB Inflation Dashboard, Investing.com, Nexia Poyiadjis Limited

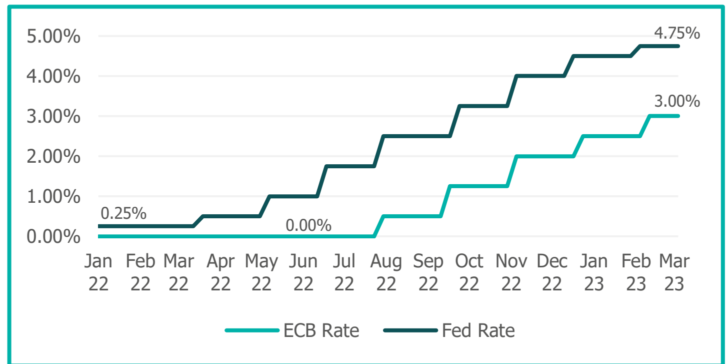

FIGURE 3: FED & ECB INTEREST RATES
Source: Federal Reserve Economic Data (FRED), Nexia Poyiadjis Limited

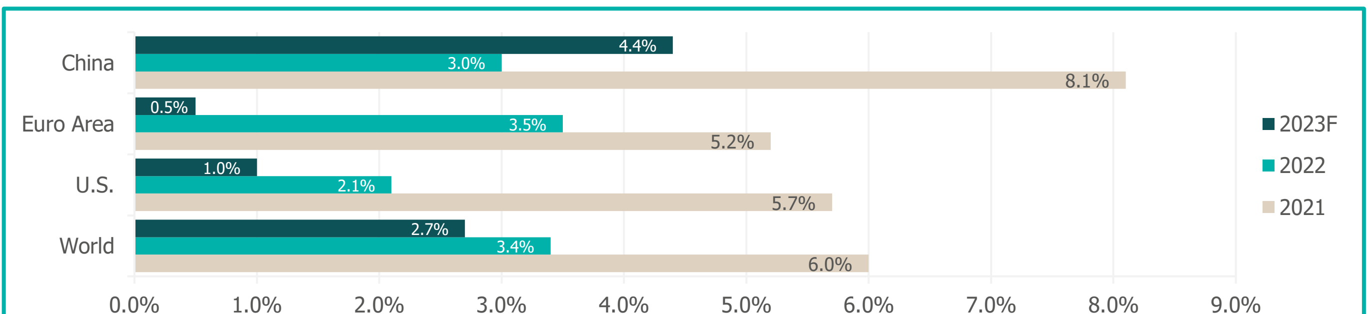

FIGURE 4: ECONOMIC GROWTH 2021-2023
Source:: IMF, The Washington Post, Eurostat, The Associated Press

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How do interest rates and inflations impact valuations?

Interest Rates

Interest rates play a vital role in the valuation of businesses, particularly those that rely on debt financing. As interest rates rise, the cost of borrowing money increases, which can lead to a decrease in the value of businesses that have high levels of debt. This is because the higher cost of borrowing reduces a company's cash flow and profitability, making it less attractive to investors.

Additionally, higher interest rates can also increase the discount rate used in the discounted cash flow (DCF) valuation method. The DCF valuation method is a commonly used method for valuing businesses, which estimates the present value of a company's future cash flows. As interest rates and uncertainty rise, investors demand a higher return for the same level of cashflow which will lead to a lower valuation for the business, if all else remains equal.

Moreover, when interest rates rise, investors may shift their money from equities to fixed income assets, which can lead to a decline in equity prices. A decline in stock prices can lead to a decrease in the market value of a company, which can ultimately reduce its overall valuation.

Inflation Rates

Inflation is another factor that can have a significant impact on business valuations. Inflation refers to the general increase in the price of goods and services over time. As inflation rises, the cost of goods and services also increases, which can lead to a decrease in a company's profit margins.

Inflation can also impact a company's growth prospects. As the cost of goods and services increases, companies may have to spend more money on production, marketing, and other business expenses, which can reduce their ability to invest in growth opportunities. This can ultimately lead to a lower valuation for the company.

In Figure 5 we can quantify the drop in company valuations as inflation rises. Valuations multiples such as the Price-Earnings Ratio fell from an average of 34x down to 8x as inflation increased.

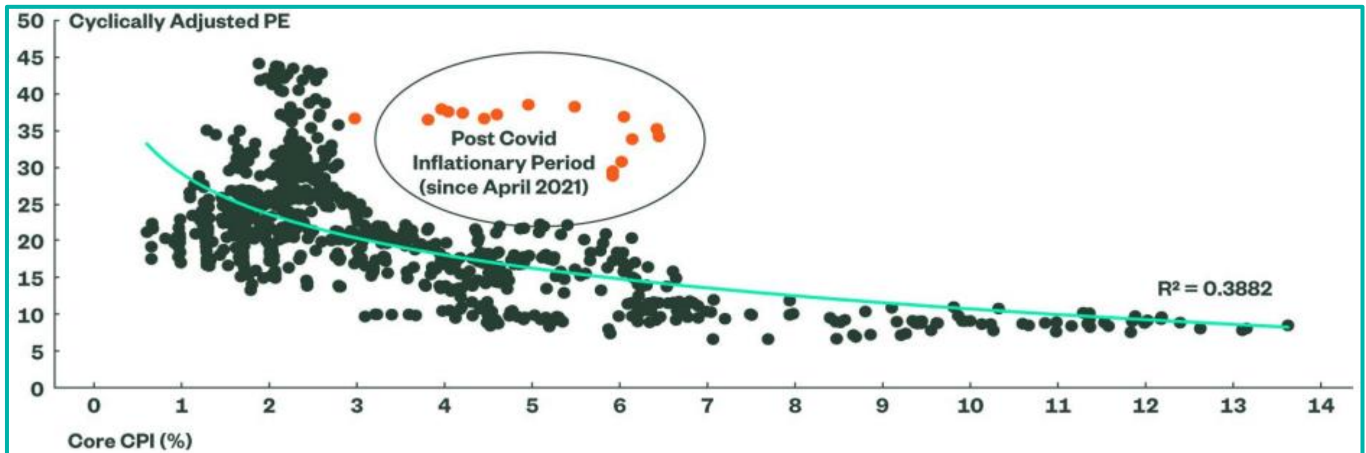

FIGURE 5: INFLATION CORRELATION WITH LOWER VALUATION MULTIPLES
Source: State Street Global Advisors

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Conclusion

Rising interest rates and inflation can have material impact on the valuation of businesses. Higher interest rates increase the cost of borrowing and reduce the present value of future cash flows, which results in a lower valuation for the business. Inflation increases operating costs, reduces growth prospects, and also reduces the present value of future cash flows, which results in a lower valuation for the business.

Therefore, it is crucial for businesses to monitor these economic indicators and adjust their strategies accordingly to mitigate the impact on their valuation.

What actions can businesses follow to navigate current market conditions?

1. Cashflow Maintenance & Generation Strategies

- Prepare a clear debtor policy (clearly defined payment terms, communicate consistently with customers, and consider offering discounts to encourage payment)
- Manage inventory levels (match current demand with appropriate stock needs, identify slow moving or excess stocks and monitor performance)
- Focus on your suppliers (monitor changes in prices, diversify to reduce risk, increase creditor days)
- Sell non-core assets & reduce non-core capital expenditures
- Review long-term borrowing terms and consider renegotiating interest rates & payments terms
- Consider raising new equity as a buffer to cater for any urgent obligation that may arise

2. Optimize Profitability

- Review short term budget and projections
- Focus on costs (reduce unnecessary costs, tighten the cost approval process, and reduce R&D costs
- Sell / Discontinue loss making operations

3. Eliminate / Mitigate Risks

- Focus on your customers and how they are affected by any changes in the industry
- Consider diversification for both suppliers and customers
- Keep employees engaged and onboard with your strategy through open communication

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