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Focus on Forecasting in an Inflationary Environment

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If you have been forecasting for the last couple of years, you've probably asked yourself, "Why go through this exercise?" With such uncertainty and changes to supply and demand, forecasting has not been an easy or 'typical' exercise. Yet, the holders of shares in any company—including those that are partially or completely owned by an Employee Stock Ownership Plan ("ESOP")—are very interested in the performance of the business and its ability to create future value. COVID-19's disruption to the economy, as well as the supply chain and workforce of companies throughout the world, increased the level of attention paid by shareholders to the bottom line.

Now, in 2022, as the annual rate of inflation has persistently risen and interest rates—along with wages—are also growing, businesses continue to attempt to make a reasonable calculation of their company's worth. In general, inflation can have numerous potential impacts on the value of a business. For instance, for some, it can lead to increased overhead and inventory costs, the rising cost of debt and decreased consumer purchasing. Meanwhile, companies offering non-discretionary goods and services may be able to pass rising costs on to their customers, as a result of which they may be better protected from the impact of inflation.

In any case, these volatile conditions may lead business owners to regard the process of forecasting future performance similar to that of reading a crystal ball. Still, forecasting remains an important part of business planning since investors, including ESOP trustees, generally look to projected cash flows to determine the company's current value. Therefore, even if the company does not have a history of preparing forecasts, now is a good time to start.

When initially preparing a forecast, the company's management team should start with the basics. For example, depending on the type of business, management may want to review factors such as the organization's weekly, monthly or annual sales goals; whether regional sales goals are being met; if the sales team has minimum goals which need to be achieved in order for commission to be awarded; whether customer agreements require maintaining minimum inventory levels; the impact of supplier contracts—or the lack thereof—on the business; and whether there are industry benchmarks the company is trying to achieve.

Other planning tools include "top-down" and "bottom-up" forecasting. Generally speaking, top-down forecasts tend to be broad-based or "big picture" reviews. They start with general information about the overall market in which the company operates and then work down to determine the company's potential revenue based on market share. Conversely, "bottom-up" forecasting focuses on specifics within an organization and tends to have a sales- or production-based focus. In a "bottom-up" forecast, individual departments create their own outlooks which are then built into an overall company forecast. Oftentimes, companies use a hybrid approach when planning since a combination of the two methods can serve as a system of checks and balances to help determine whether the company's forecast is realistic and achievable based not only on the marketplace but also on feedback from key staff members such as sales leaders and/or the production team at a manufacturing firm.

Notably, when preparing a forecast that will be used as part of a valuation for ESOP purposes, it is also important to consider the U.S. Department of Labor's ("DOL") perspective on valuation. Projections, the validity of the projection assumptions and their impact on a company's valuation have been a central focus of the DOL's enforcement efforts. In Prairie's view, the DOL considers it important for both the valuation firm and the ESOP trustee to conduct a critical analysis of the management team's projections before incorporating them into the fair market value analysis. Some of the key issues the DOL suggests should be analyzed relate to the consistency of performance comparison, achievability of the forecast and the overall sensitivity of assumptions. While these are important questions to ask any time a forecast is being prepared—whether for an internal corporate purpose, planning for an acquisition or in the context of an ESOP—the DOL also looks to the rigor with which this analysis is conducted by the valuation firm and the ESOP trustee as well as the documentation that is available to support the forecast.

Additionally, shareholders, as well as valuation firms and ESOP trustees, should look to see whether the management team's forecast addresses the unique challenges of the current economic environment. For instance, when a company experiences a sharp decline in revenue and profit, such as during a period of significant inflation, the forecast should make rational assumptions about how the company will work through a recovery from the inflationary period—including the possibility that a recession will result. Since the inflationary environment is still in place as of this writing, the path to recovery remains somewhat unclear. Therefore, management teams must do their best to consider a wide range of factors when preparing forecasts under the current conditions. The forecast should project out to a time period which the management team anticipates will be a period of "normal" growth or when margins will stabilize at a targeted level; depending on the specific company under review, this may be three to five years away, or more.

In any case, there are several issues to consider when preparing a forecast during an economic environment characterized by rising interest rates and eroding consumer spending, including the following:

- *Implied Growth Rates* – In the period following the onset of COVID-19, the company may have experienced some "growth" rates that are not the "normal" level. In reality, the company may not have been growing to a new level but recovering from declines. Therefore, what comes after 2022 in the forecast may not be indicative of recent past performance or even industry performance. Although it may be a challenge in terms of year-over-year performance comparison, when preparing a one- to five-year forecast, think about whether the company will return to "regular" growth, recover back to 2021, 2022 or even pre-pandemic levels, or transition to a "new normal." While this starts with analyzing topline revenue, consider the impact on trends in earnings and cash flow as you work through the forecasting process. When forecasting, future dollars should be nominal, meaning they should reflect the real dollar and the impact of inflation. Before trying to capture the impact of inflation, it may be easier to start with real

dollars or "today's dollars." After analyzing sales volumes and trends, the impact of anticipated and targeted price increases can be added to future years' revenue projections.

- *Customers and Suppliers* – It may be helpful to look at the impact of individual customers or suppliers on your forecast. For example, is all or a portion of the customer base expected to change in light of shifts related to the inflationary environment? Such a determination can highlight changing demand volumes. With suppliers, analyzing real purchasing levels may be a good place to start, but an assessment of future potential price increases should also be considered. Depending on your suppliers, you may want to consider tracking a published purchasing or commodity index for insight into pricing levels. While future pricing may seem impossible to predict in light of numerous prior increases, it is essential to understand potential risk to margins and the need for additional pricing strategies. This analysis can be carried out for customers and suppliers, highlighting areas of risk and opportunity within the business.

- *Fixed and Variable Costs* – The impact of fixed and variable costs will have a significant effect on the forecast during the next few years. Fixed costs are those that remain the same regardless of production volume or output. Fixed costs may include facility-related costs such as rent or lease costs, insurance expense and salaries paid to employees. While the name implies the cost level is 'fixed,' keep in mind price increases and rising costs likely still need to be factored into the forecast. In comparison, variable costs may change based on the amount of output; this may include items such as commissions and the cost of raw materials. For many businesses, labor costs for hourly workers are the largest variable cost of doing business. Therefore, if the size of the workforce changes significantly or the rate paid to the workforce increases or decreases substantially, there may be a meaningful impact on costs. Shipping is another variable cost. For instance, during 2021, there were double-digit increases in the cost of shipping some goods via truck across the U.S. Additionally, if offices were closed or facilities operated at reduced capacity, the cost may have been generally the same fixed cost which lowers margins significantly. During the recovery, however, the company may experience significant margin expansion as revenue returns to help cover the cost. This will impact costs, potentially throughout the entirety of the forecast, depending on what the burden rate looks like not just in year one, but in years two, three, four and five of the forecast.

- *Compensation* – Another area on which to focus is compensation, which can be impacted by workforce continuity. In 2021 and 2022, many industries faced significant competition for qualified employees, which led to an increase in the amount of compensation companies were forced to pay new-hires, as well as existing employees. In some cases, employees quickly left their jobs, leveraging rising pay rates to their benefit and forcing the original employer to invest ever-increasing sums in additional recruiting and training costs. As a result, the company may have a labor force, or burden rate, that does not correlate with the level of sales or production that the company is experiencing. Therefore, it may be helpful to think about the company's cost profile and how it will work out in future years.

- *Capital Expenditures* – With regard to capital expenditures—which is when an organization spends money or takes on debt to acquire, upgrade or maintain physical assets such as property, plants, technology or equipment—some companies may choose to defer investments during the next year or two, or more, in order to preserve cash. Conversely, a company may decide to continue with capital investment despite inflation. Consider the impact of potential cost savings through automation and the ability to repay the investment in future dollars. Such an investment may give the company an advantage in a tight labor economy with persistent inflation. These types of plans should be reflected in the forecast.

- *Working Capital* – Working capital is the difference between a company's current assets (i.e. cash, accounts receivable and inventories) and its current liabilities (i.e. accounts payable). As part of the forecast, it is important to thoroughly analyze what the company's bigger balance sheet items—such as accounts receivable ("AR") and inventory turnover—will be and if they will be impacted once this period of supply chain disruption and rapid inflation subsides. For instance, on the inventory side, is the company subject to any minimum purchase agreements? Or, is the company taking in or holding a level of inventory that is not reflective of expected sales? In that regard, many companies have experienced supply chain disruptions during the past several years; as a result, they may be holding more inventory than normal simply, so they do not run into shortages in key components and materials. Therefore, on their forecast, the first-year assumption of inventory turnover may imply lower turnover since the company is holding higher inventory. Going forward, once the supply chain disruption has passed, the company may move back to a more normal targeted level of inventory. Meanwhile, another key consideration is AR. Often, during periods of distress, customers take longer to remit payment for their invoices. As a result, normal assumptions for AR days will not be sufficient, which may result in less working capital being freed up during a portion of the forecast period; this is important, as it impacts cash flow planning and is a key valuation assumption.
- *Historical Context* – Looking back to understand how a company performed during an economic or industry inflection can be helpful. If the company was in existence during the Great Recession and subsequent recovery, it can be helpful for the management team to look at how the company performed, how long it took to recover and what the company's projections were at the time. That said, the U.S. has enjoyed several decades of low inflation and many managers and business leaders have therefore not managed through periods of high or persistent inflation. While past recovery trends can be helpful, beware of how different inflation trends can persist. For instance, the recent onset of inflation was sudden and widespread, so the strategy of improving operational efficiencies in order to control cost is not going to be sufficient to overpower increased expenditures related to inflation. The ability to timely pass on inflationary cost should be a focal point of any strategic plan that is addressing inflation.
- *Other Data Sources* – It is also helpful to review trade publications, industry studies and economic studies, as they can be a great source of information to help with a forecast. It is important to ensure that each data source is reliable so that it can be used as a way to substantiate the forecast. However, be sure to remain cognizant of confirmation bias when considering other data sources. Confirmation bias is the tendency to search for, interpret or favor information in a way that confirms or supports the projection assumptions. Be careful to weight data sources based on their source, relevancy and timeliness.

While this framework includes numerous factors to consider when preparing a forecast, the specific factors which should be included in a forecast for your company may vary depending on the specific market and industry in which that company participates. Remember, any forecast includes inherent risk, and this is especially true in the uncertain times in which we are operating. In any case, it is important to keep in mind that all investors are interested in future performance. Therefore, when preparing a forecast, the management team should be cognizant of any new information which may impact the company's outlook.

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