



## SMARTER PERSPECTIVE: ENTERPRISE VALUATION

# The Impact of the Economic Outlook on Valuation

By Seth Hersom

### Introduction

As observed and practiced in the valuation of privately-held companies and securities over the past several years, the impact of the economic outlook on valuation can be profound. The impact of the economic outlook affects valuation in any number of direct and indirect ways. Certain effects of the economic outlook addressed in this writing are as follows:

- Background
- Subject company cash flow forecasts
- Comparable company transactions multiples
- Development of discount rates
- Comparable public companies multiples
- Supporting the conclusion of value

### Background

A written appraisal or valuation report usually contains a section focusing on the economic outlook. The economic outlook section is normally contained within the narrative section of a valuation report and should include a review of each of the most important leading economic indicators, including any more



pertinent to the subject company and its business. That is, careful consideration should also be applied to indicators which affect customers, suppliers, or other business partners. One typical indicator discussed is economic growth that may be measured on a national, state or local level. Other economic trends may include inflation, housing starts, consumer confidence and spending, business investment, interest rates, fiscal policy, among others. There are numerous sources for finding economic measures on the national and other levels. Certainly, the internet has become a preferred method of accessing information with sources available free of charge as well as by subscription. Regardless of the source for historical

and forecasted economic data, the source should be clearly identified.

### Subject Company Cash Flow Forecasts

Forecasts used in a discounted cash flow model are typically five years, unless a shorter or longer period is justified. Growth beyond the discrete projection period is usually stable and set to match expected long-term inflation levels. The economic outlook in many cases could and should have a direct effect on the subject company's cash flow forecasts. For example, in the post-COVID era, it is common to observe many mature companies forecasting organic revenue growth upwards of 10 to 15 percent per year for several years. While such

aggressive growth forecasts from interested parties such as management must always be scrutinized, this level of growth may be more easily justified if the economy is emerging from or recovering from a disruptive event like a pandemic, or if there has been a recent shift in industry trends in which the company operates. A company that had experienced declines in revenue for several years and, like the economy, is in recovery mode will have an easier time achieving sales growth of 10 to 15 percent as that growth level would essentially be almost in sync with revenue lost during the pandemic. In essence, the seemingly high growth forecast in many cases only brings the company back to pre-pandemic levels achieving only modest growth relative to pre-pandemic levels. In any case, the subject company forecast should make sense relative to economic forces as well as the recent financial performance.

We recently worked as rebuttal experts on a case where post-pandemic tourism statistics were erroneously being used to bolster future sales projections. [This example includes the following table:](#)

YEAR	VISITORS	GROWTH
2014	41,126,512	-
2015	42,312,216	2.9%
2016	42,936,100	1.5%
2017	42,214,200	(1.7%)
2018	42,116,800	(0.2%)
2019	42,523,700	1.0%
2020	19,031,100	(55.2%)
2021	32,230,600	69.4%
2022	38,829,300	20.5%
2023	40,829,900	5.2%
<b>CAGR (2014 - 2023)</b>		<b>(0.1%)</b>
<b>CAGR (2019 - 2023)</b>		<b>(1.0%)</b>



The report we reviewed stated, "Management's growth forecasts are supported by tourism data, showing the city continues to recover and grow..." While we agreed that recent post-pandemic recovery trends were favorable, even impressive with 20.5% growth in 2022, we also recognized that measuring the CAGR from 2014 to 2023, as well as from 2019 to 2023, both showed nearly flat or even slightly negative longer-term growth trends. In other words, well after the pandemic, for 2023, visitors had yet to exceed pre-pandemic levels going back as far as 2014!

Of course, exceptions always exist. For example, the economic outlook may be dire, while for any number of reasons the subject company is forecasting growth. Perhaps the subject company gains a competitive advantage during hard times? Or maybe the subject company has stockpiled cash and plans to take advantage of the good (or bad) economy through acquisitions. On the other hand, the economic outlook may be grand while the subject company is expected to experience a decline in sales. Such a decline could be an example of a counter-cyclical business or a company -being caught in a downward spiral where a new product or competition is

eroding sales, perhaps even taxes or legislation could be to blame. When the company's outlook is different than the overall economic outlook, the most important question becomes why, and the valuation expert should be able to explain the discrepancies.

### Comparable Company Transaction Multiples

In June 2007, the American Institute of Certified Public Accounts (AICPA) issued the Statement on Standards for Valuation Services No. 1 (SSVS No. 1) that defines the guideline company transactions method as one within the market approach whereby market multiples are derived from the acquisition of majority stakes or entire companies engaged in the same or similar lines of business. This method is also referred to as deal comps, precedent transaction analysis, merger and acquisition (M&A) method, comparable M&A transactions, among others. The transactions method uses multiples of the target companies as a guideline for the estimate of reasonable multiples for the subject company. Guideline transactions typically result in higher business valuations due to potential synergies for the acquirer, as well as a control premium. Investment bankers often use precedent transactions



in corporate finance as well as mergers and acquisitions, but rarely in equity research. One reason for the lack of popularity is the equity research analysts' perception that this approach tends to be backward looking in nature, instead of a forward-looking method.

Strategic buyers, such as competing companies, have historically been both willing and able to pay higher purchase prices due to the perceived ability to realize synergies from the combined entity. When the public markets supply inexpensive debt with favorable terms, financial buyers like private equity firms offer competition to the strategic buyers over purchase prices. As debt financing becomes scarcer and more expensive, the advantage shifts back to the strongest and most creditworthy strategic buyers that are able to source acquisition financing.

Seller motivations can influence purchase price, especially when in urgent need of cash. Instead of a value maximization strategy, the seller may accept a lower valuation in exchange for speed of execution and certainty of completion. This may be especially pronounced during periods of grim economic outlook. This, theoretically, would have a downward effect on transaction

multiples and the valuation of private companies. In summary with regard to transactions and the economic outlook:

- Even during periods of uncertain economic outlook, the guideline company transaction method can be useful.
- Just as a larger sample size produces greater statistical significance, the utilization of additional valuation methods may lead to a more accurate business valuation. The various results can then be portrayed in a valuation football field chart.
- It is important to understand the nature of the purchase prices and market capitalizations when finalizing the universe of comparable acquisitions, including the deal dynamics (motivation, terms, etc.). The highest valuation is usually observed in all-cash transactions with strategic buyers through an auction process or hostile takeover situation.

Irrespective of economic outlook, the comparable company transaction method has other limitations that should be considered. Some of these limitations include:

- Availability of information such as limited comparable transactions

or private transactions with little information;

- Lack of comparability such as different size and scale, difference in maturity, varying profitability and outlook on future performance, or fundamentality different operations;
- Other limitations which may require consideration include transaction timing, market conditions at the time of the observed transactions, financial vs. strategic buyer, geographical differences, regulatory environment, accounting adjustments, and more.

Adjustments can often be made to account for some or all of the limitations discussed.

### **Development of Discount Rates**

The economic outlook can have a variety of effects on discount rates. Some of the "building blocks" for both equity and debt rates of return commanded by the marketplace will ultimately be affected by government and private sector borrowing rates. For example, U.S. Treasury rates and publicly available market debt rates are commonly used when developing discount rates. Long-term inflationary expectations may also have an effect. Certainly, the alpha, which represents the unsystematic risk



for a particular investment in a company, may be swayed by the impact of the economic outlook as it relates such investment in a specific company.

### **Comparable Public Company Multiples**

Guideline public companies, also known as public comps or comparable companies, sometimes include both equity research analyst estimates and the more optimistic management projections. For publicly traded companies, the 52 week high and low as well as current stock price can be included as a representation of how the public markets valued the company. The consensus estimate of equity research analysts is a useful point of reference. Multiples derived from public stock prices and those companies' performance measures or anticipated companies' performance measures are applied to the subject company performance to derive indication of value. Similar to the comparable company transaction method, adjustments may need to be considered when comparing the subject company to the identified public comps.

The stock market and the economy are intricately and intimately related. This article will not address in detail the implications of the economic outlook on the multiples derived from historical and forward looking performance measures of public companies, however, it is meant to serve as a reminder to look beyond the forward (or historical) multiples to

some of the underlying assumptions including the economic outlook. Also to question why the multiples are as they appear. How does the past and future economy translate in terms of multiples? Are the appropriate companies chosen and why? Is the performance of the companies selected subject to the same or similar economic conditions as the subject company?

### **Supporting the Conclusion of Value**

A valuation opinion should be self-supporting and stand on its own merit. The overall conclusion should be supported through a series of analyses consisting of schedules and a narrative report. The Economic Outlook research and analyses are usually contained within the narrative section of a valuation report. Beware of economic sections with no connection made as to how the outlook affects the subject company. This economic section of a written valuation report often paints a general economic picture and also proceeds to address issues more pertinent to the subject company's business and ultimate value. When presented as a whole, the end result should be a congruent work with most if not all indications pointing to the same generally supported conclusion of value for the subject company/interest. The economic outlook is one of many influencing factors to be considered in reaching such a "supported conclusion." This article was meant to add fuel for thought in using, reviewing and preparing opinions about valuation.

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