RISK INSIGHTS

Financial Forecasting in the Post-Pandemic World

BY PATRICK DIERCKS, JOSEPH MARCHESE & BRIAN ALLEN

Executives from PKF Clear Thinking provide key points that both lenders and their borrowers need to be mindful of when preparing and reviewing 2022 and beyond business plans.

At this point, it would be highly unlikely that any business, irrespective of size or industry, remains unaffected by the COVID-19 pandemic. Those impacts could be positive, negative, large or small, but it would be reasonable to assume that no business has operated 'normally' since March 2020. Given this lack of normalcy, and the common practice of using historical performance to guide future forecasting, a common question and theme that we are hearing from both lenders and borrowers is "How do we account for COVID impacts in 2022 and beyond?"

While there are some similarities in certain industries and lines of business, the specifics of how and when COVID impacted businesses is truly on a case-by-case basis. The first step in gaining an understanding of the "when" component is to develop a timeline that encompasses all impactful events throughout the pandemic. Some examples of macro events would be both the institution of and the subsequent remanding of governmental restrictions (national, state, local), stimulus infusions, and industry specific regulations/guidelines. On a more micro level, some items to be considered would be the type of business and or industry it is operating in, changes in business hours/days of operation, receipt of PPP funds and/or employee retention credits, layoffs, furloughs, and remote work. The second step is to line up this timeline with the financial results of 2020/2021 and determine whether or not these events did, in fact, have an impact (positive or negative) on the business's performance, and then measure that change in performance.

In going through the exercise of normalizing for the impacts of COVID, it is very important to not lose sight of one undeniable fact: the COVID-19 pandemic did occur. And because it did, we must recognize that it had effects and they are likely to continue at some level for the foreseeable future. Given that, normalization should not necessarily be viewed as an attempt to make a baseline for forecasting future periods, but viewed more as a tool to understand whether the effects of the pandemic possibly masked or exacerbated underlying business issues. Having a solid understanding of how the business performed prior to the pandemic and the trajectory it was on is critical in determining what normalization looks like. It will also serve as a guideline of determining what the future growth curve looks like.

The chart on the next page illustrates a real-world example of a recent retail client of ours that was positively impacted by the COVID-19 pandemic. As you can see based on pre-COVID data, the company was steadily growing at approximately 3.4% per annum and realized significant increases during 2020 and 2021 as would be expected. For 2022, the company is projecting a decrease in same-store sales based on the concept that the majority of increases they experienced above their historical growth rate were one time in nature. When we look at what the revenue would have looked like for 2022 had they just maintained the trend they were on for several years prior to

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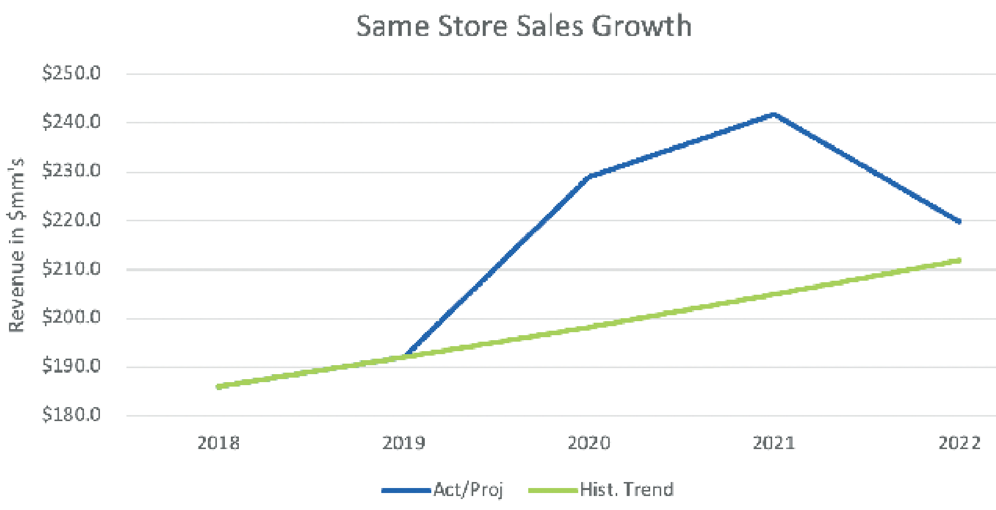


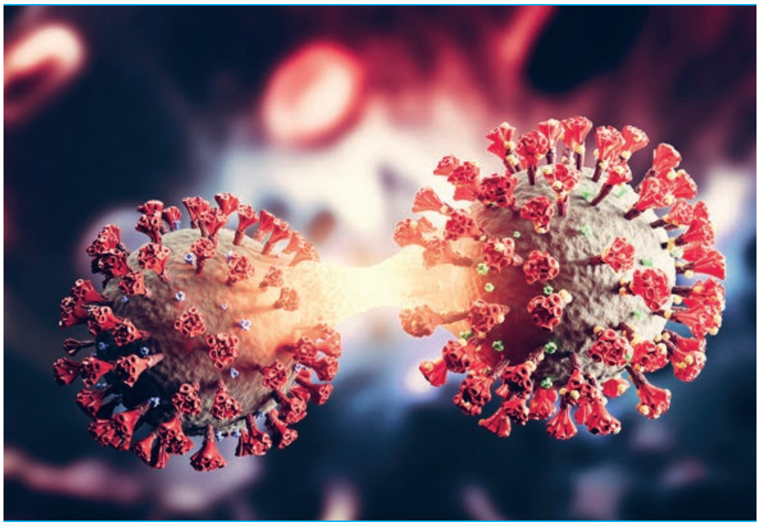
the pandemic, we see that they would likely be experiencing a similar level of projected revenue in 2022 even without the pandemic.

While this example serves to validate the 2022 revenue projections for this specific company, there are many other instances where businesses were experiencing downward trends pre-COVID and then saw increases purely because of COVID. It is these situations where one needs to be wary of how a company is projecting their post-COVID performance. Just because sales or profitability increased during COVID, does not necessarily mean that the business addressed and fixed the underlying issues that were causing decline in the first place.

There seems to be a fairly consistent practice of both lenders and borrowers relying upon 2019's results as the baseline for what the post-pandemic business should look like. In some instances, this can be a very good tool as 2019 was certainly the most recent full year with no impact from the pandemic. However, in our opinion, it should not be the sole source of comparison. As stated above, no one was immune to COVID impacts and, therefore, some of those effects need to be taken into consideration. One of these impacts will likely be a desire for most companies to continue operating more of a hybrid remote-working environment. In most cases, this change in the work environment has resulted in a cost impact such as increased IT expenses and reduced productivity. Also, future rental income for landlords will be greatly impacted should businesses start to shrink their physical space. Some additional possible impacts that will continue for some time include the continued reductions in travel expenses, cost and productivity impacts associated with "buy online/pickup-in-store" programs, staffing shortages, and wage increases. Obviously, every business is going to have its own circumstances, but understanding which pandemic effects will continue is key to projecting what future periods will look like.

It would be almost impossible to discuss this topic without mentioning the 1000-pound gorilla in the room: the uncertainty surrounding supply chain issues that are likely to continue well into 2022. The single biggest risk to any business plan for 2022 is likely to be supply-chain related. Whether it is the lack of container ships or truck drivers, freight cost increases, or log jams in the major U.S. ports, there will continue to be significant impacts at all levels related to getting any sort of product. Various iterations of sensitized plans for reductions in raw materials and finished goods availability should be a part of any forecasting process for 2022 to illustrate for all stakeholders where the "pain points" may lie, not to mention how increases in freight costs will impact margins and pricing. The negative impacts of supply chain issues will be amplified for those that were not planning, have fewer opportunities for access to capital, or are not able to pass along increases in costs to their customers. As with any sort of "market" environment, when there is limited supply, it usually goes to the highest/best bidder. In this instance, it will likely be less about who is willing to pay a highest/best price, but will most certainly favor those that have high levels of working capital that they can leverage to pay sooner. This is not to say that there aren't going to be increased costs across the board, especially as it relates to freight costs, which have increased exponentially. Ultimately, these supply chain issues are likely to manifest themselves at a much more macro level in the form of inflation, which, short of some sort of regulatory intervention, will continue to impact lenders and borrowers for the foreseeable future.

On the other side of the coin, there are many other COVID impacts that likely will not continue as we get to a post-pandemic environment or, at the very least, not to the level that they did in 2020-2021. Over the last year, we have seen many businesses posting record levels of profitability despite little to no revenue growth. When we dig into the numbers it is plain to see that the lion's share of this profitability can be attributed to better margins, drastic expense cuts, and PPP loan forgiveness. As inventories have been reduced due to supply chain issues and shifts in consumer spending habits, businesses have been forced to carry less inventory. Paired with the fact that the consumer was willing to pay full price, retailers did not need to discount to the same levels they did historically. This equated to increased margins, greater profitability, and reduced working capital needs as the gross margin return on inventory (GMROI) increased to levels not realized before. Additionally, while there have been some instances where businesses have realized that they were carrying too much expense burden and found a way to be successful without those expenses, there are many businesses that are planning to get closer to pre-pandemic spending levels because they simply cannot continue to operate productively with significant decreases to their resources. And while the PPP loan forgiveness is obviously somewhat more straightforward to identify when reviewing profitability, the PPP loans (whether forgiven or not) also need to be taken into account as it relates to projecting the working capital needs of the business.



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Some of the negative effects that many businesses faced included reduced revenues due to mandated closures and changes in consumer spending habits. Many of those have already started to revert themselves back to more of a pre-COVID state. Restaurants are open, people are going to movies, travelling more, working less from home, commuting, etc. The consumer is now spending money on eating out and less at the grocery store, taking a vacation versus remodeling their kitchen. Obviously, not all of these changes will go completely back to their pre-pandemic status, but for the most part, consumers have short-term memories, and are likely to return to something close to their pre-pandemic habits over the next few years.

There may not be a "one-size-fits-all" approach as it relates to forecasting in the post-COVID era, but certainly there are some key points that both lenders and their borrowers need to be mindful of when preparing and reviewing 2022 and beyond business plans. Understanding the different nuances of each business and how they specifically will address both the positive and negative effects of this unprecedented time will be key to making sure that they are able to continue to operate in a viable manner.

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