Rising Interest Rate Effect

We invited James Taylor, Managing Director for The Presidio Group, to submit this article. James addressed our group, the National Alliance of Auto Dealer Advisors (NAADA) at a recent meeting. If you have any questions regarding this article and would like to speak with James, please let us introduce you to him.

Much has been said in recent years about high dealership valuations. To illustrate the fleetingness of these historic times, we walk through the negative effect on dealership valuations in rising interest rate environments. The key drivers in decreased dealership valuations in an increasing rate environment are:

1. higher financing cost and
2. higher ROIC demanded by investors.

In this example, we use the U.S. Treasury Note's 10-year yield (www.treasury.gov), which has averaged approximately 2.30% since May 1, 2015, and representative ROIC hurdles we have experienced by public and private strategic buyers.

First, we apply the 10-year risk-free return to a simplified dealership valuation. Then, we assume that the dealership generates $10 million in annual pre-tax profits.

Next, buyers would require a 20% annual return in today's interest rate environment. We have assumed that this would result in a $100 million valuation to produce this 20% return.

We next analyze the effect of 2% and 5% increases in the 10-year Treasury yield to 4.30% and 7.30%. In the +2% scenario, a $100 million dollar investment would need to generate an additional $2 million in cash flow to compensate for the 2% risk-free rate increase.

As a result, the valuation for our business decreases 22% to $78 million from a 2% increase in interest rates. Similarly, a +5% scenario would drive the value of our dealership down by 42% to $58 million.

To further complicate the scenario, we all know that profits generally decrease in arising interest rate environment with pressures from tighter consumer credit and increased borrowing costs. We simply decreased profits to $9 million in a +2% interest rate environment and to $8 mil-lion in a +5% environment but realize that the pressure on profits could be more substantial.

We have enjoyed historic low rates since 2008, which hit a near 34-year low in January 2015. However, a 10-year Treasury of 4.30% was normal from 2004 to 2007 following the Dot.com bubble burst recovery and 7.30% was normal from 1994 to 1999. With the unemployment rate near 5% and in-creased inflation concerns, an increase in interest rates from the Federal Reserve is anticipated in the near-term.

This valuation analysis should not necessarily be viewed as a caution to acquisition. The most valuable dealerships are generally run by sophisticated owners who understand market timing and the business cycle as it relates to interest rates. As a result, premium dealerships are usually only sold in top markets with the highest valuations. Dealers that sell in lower valuation environments are often smaller and are forced to sell from overleverage or poor performance. In rising interest rate environments, sophisticated dealers that are larger and better capitalized use these down markets to opportunistically acquire and grow their businesses.

If you would like to discuss the interest rates discussed in this article, contact one of our professionals today.

	TODAY	**2%INCREASE INYIELD**	**5%INCREASE INYIELD**
10-Year Treasury Yield	**2.30%**	**4.30%**	**7.30%**
Pre-tax Profits	**$10 MM**	**$9 MM**	**$8 MM**
InvestorRequiredReturn	**20%**	**22%**	**25%**
EstimatedDealership Valuation	**$100 MM**	**$78 MM**	**$58 MM**