

Should Lower Rates Mean Higher Values?

With interest rates at historic lows, an obvious question is whether this low cost of capital has or should affect business valuations. If it costs less to borrow the money to buy a business, does that mean businesses should be worth more?

After all, low rates have affected prices in other areas. Low interest rates clearly have driven up housing prices. As home buyers have been able to afford to pay more for housing because of low rates, the price of houses has gone up.

Businesses, however, are not houses. A house "performs" the same no matter the price or economic climate. A four-bedroom home in a desirable area will still be a four-bedroom home in a desirable area if rates are high or low. Therefore, as lower rates make that house more affordable, a compensating increase in price is natural. Home buyers tend to look at the monthly payments as much as at the price of the property.

Effect of Low Interest Rates

With businesses, however, one has to remember that it has been a prolonged economic slump (including a slump in the performance of many businesses) that has created the economic environment in which such low interest rates are possible. In other words, while a house may perform the same in any economic climate, a business often does not.

This climate of low interest rates has also been a climate of low profits for most businesses. And low profits are no reason to boost valuation results.

Different Considerations

A valuation is based on a transaction between a willing buyer and a willing seller. In the housing example, our willing buyer will pay more at lower rates because he or she will get the same house for a lower overall cost. In our business example, the fact that it will cost the buyer less to finance the purchase does not offset the fact that the business being purchased is also worth less because of poor performance.

Also, while rates are down, credit is tighter. Business lending and mortgage lending are different markets.

Finally, in valuation circles, the build-up rate is based on a combination of the risk-free cost of capital (for interest, rates on 20-year Treasury notes) and the equity risk premium. While the equity risk premium has been low the last three years resulting from poor performance in financial markets, the rate is based on results traced all the way back to 1926.

Short-term changes do not have an immediate, dramatic effect. And a decrease in the risk-free cost of capital often means an increase in the equity risk premium, and vice versa.

In short, interest rates do need to be considered in valuations. Valuation professionals will consider the weighted average costs of capital and a business's debt-to-equity ratios. Interest rates do not, however, have nearly as significant an effect on business values as they do in other areas.

