MERCER CAPITAL

Understand the Value of Your Auto Dealership

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Brent A. McDade currently serves as a vice president of Mercer Capital. Mercer Capital is a premier business valuation and investment banking firm serving a national and international clientele.

Business valuation services are provided for a wide variety of needs, including but not limited to corporate valuation services, tax compliance, litigation support, financial statement reporting compliance, and employee stock ownership plans. Clients range from public to private, from smaller companies to large multi-nationals in a broad range of industries as well as numerous governmental agencies.

In addition, Mercer Capital provides investment banking and corporate advisory services including sell-side and buy-side merger & acquisition representation, fairness opinions, solvency opinions, business interest and securities valuation, and board presentations, among others.

Mr. McDade has experience providing valuation services related to fairness opinions, equity and fixed income securities valuations, and interests in tax-pass through entities. In addition, he is a lead member of Mercer Capital's Litigation Support Team. He provides analytical support in business damages, fair value opinions, lost profits analyses, securities fraud, shareholder disputes, and tax-related cases.

Mr. McDade has broad industry experience providing corporate valuation and investment banking services to hundreds of companies in an array of industries. Specific industry experience includes, but is not limited to, construction, general & specialty contracting, distribution companies, financial services companies, food processing, heavy equipment, insurance underwriters, manufacturing, oil & gas, professional service businesses, restaurants, retail, telecommunications, trucking & transportation, and wood processing.

Valuing Auto Dealerships

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WHY DO I WANT TO VALUE MY BUSINESS?

While death and taxes may be the only things that are truly certain, it is equally certain that the ownership of every business will eventually change hands. If we can agree that you will not own your business forever, then we should also be able to agree that it is important for you as a business owner to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved, whether you like it or not! Because your business will change hands, it is important for you to understand the key concepts of business value and how value is determined for your business.

Ownership transfers can be categorized as either voluntary or involuntary. Voluntary Transfers occur in a variety of ways. Consider the following:

» Gift of stock within the family

» Sale of stock to key employees

» Implementation of an Employee Stock Ownership Plan

» Sale of the entire company under favorable circumstances

» Pre-sale of stock through a Buy-Sell agreement

Involuntary transfers occur just as frequently and often under the most adverse circumstances

» Death is the ultimate involuntary transfer

» Divorce may result in retaining the business, but other assets are transferred on the basis of the value of the business

» Sale of the business when the owner is uninformed or required to sell due to financial or business conditions

» Forced sale pursuant to the terms of the franchise agreement

In most of these cases, these transactions are among the most important of the owner's business and personal life. An understanding of the value of your business is an important component in preparing yourself for any of these eventualities.

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Mercer Capital has developed the Business Transfer Matrix through which to view the different ownership transition scenarios. In the Matrix, partial sales typically represent transfer of a minority interest and total sales represent transfer of a controlling interest.

Ownership Transfer Matrix	Partial Sale/Transfer	Total Sale/Transfer
Things That You Make Happen (Voluntary, Legacy Path)	ESOP Outside Investor(s) Sales to Insiders/Relatives Combination Merger/Cash Out Going Public Gifting Programs Buy-Sell Agreements	Sale of Business Stock-for-Stock Exchange w/Public Company Stock Cash Sale to Public Co. Installment Sale to Relatives/Insiders ESOP Management/Buyout Buy-Sell Agreements
Things That Happen To You (Involuntary, Lifestyle Path)	Divorce Forced Restructuring Shareholder Disputes Buy-Sell Agreements	Death Divorce Forced Restructuring Bankruptcy Shareholder Disputes Buy-Sell Agreements

A PRIMER ON THE KEY CONCEPTS OF DETERMINING VALUE

It comes as a surprise to many business owners to learn that there is not single value for their business or a portion of the business. Numerous legal and contractual factors play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary). Therefore, be certain that any valuation of your business address each of the following:

Valuation Date

Every valuation has an "as of date" which simply means that it is the date around which the analysis is focused. The date may be set by legal requirements, such as death or divorce, by contract, such as by a Buy-Sell or franchise agreement, or it may be implicit, such as the closing date of a transaction.

Purpose

The purpose of the valuation is important. The value determined for one purpose is not necessarily transferable to another. There is no such thing as a one size fits all approach to valuation.

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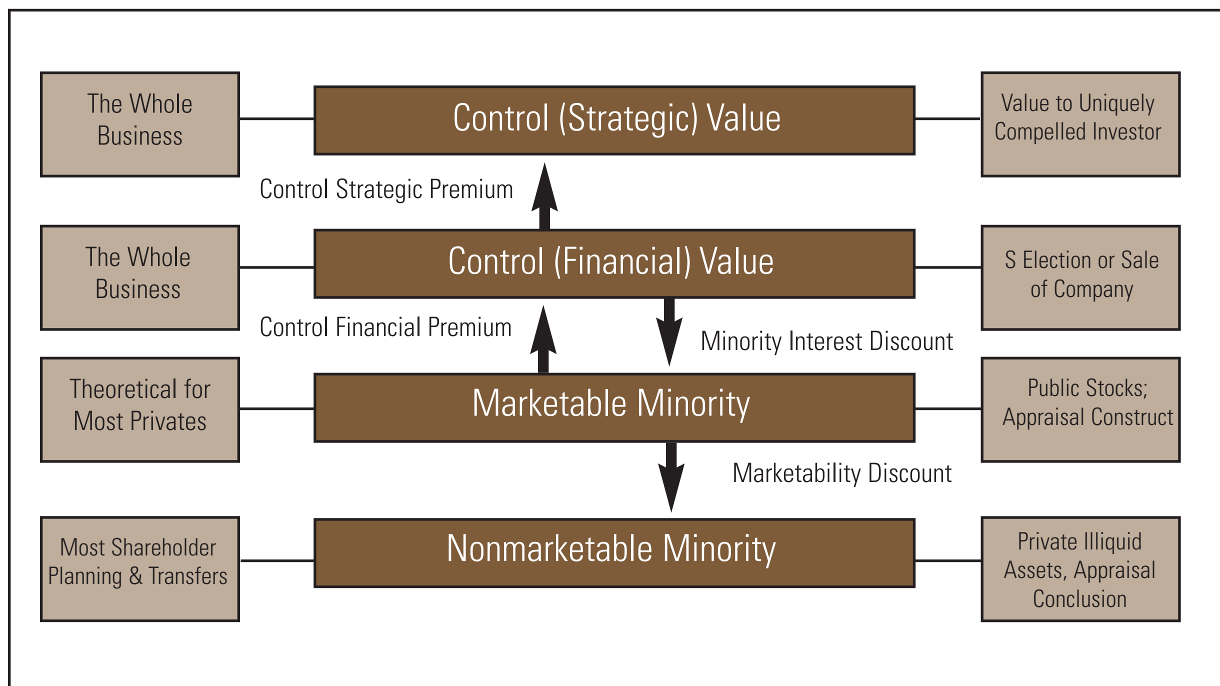
Standard of Value

The standard of value is an extremely important legal concept because it will help determine the rules of the game. There are many standards of value just as there are many types of ownership transfers. The standard of value will influence the selection of valuation methods and the level of value. The most familiar standard is fair market value, which is often used in tax matters. Other important standards are investment value (purchase and sale transactions), statutory fair value (corporate reorganizations), and intrinsic value (public securities analysis). Matching the standard of value to the valuation is crucial to obtaining a relevant determination of value.

Level (Premise) of Value

When business owners think about the value of their business, they are almost always implicitly thinking about the value of the business in its entirety. The value of a single share, for example, is the value of the whole divided by the number of shares. In the world of valuation, this just may not be true. The determination of whether the valuation should be on a controlling interest or minority interest basis can be a complex question, yet it will be of great importance. A minority interest value might include discounts for lack of control and marketability. Therefore it is quite possible that a share of stock valued as a minority interest will be worth far less than a share valued as part of a control block.

The chart below shows the relationship between the levels of value:



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At the top of the chart is the strategic control level of value, which is an investment value concept. It refers to the price that might be paid to acquire control of the business by a particular buyer who anticipates being able to make synergistic improvements to the operations and profitability of the business.

The financial control level of value refers to the price that might be paid by a typical investor for control of a business. The investor does not have the ability to derive synergistic benefits from the transaction but often expects to improve the operation of the business through better management. Typical negotiated transactions between individual dealer point owners generally take place at this level of value, since it is unlikely that this type of transfer results in significant synergy.

The other levels of value refer to the value of minority interests in the business. A minority interest does not have the ability to make critical business decisions, and therefore, a minority share is generally worth less than its pro rata share of the value of the entire business. The marketable minority interest level of value refers to the value of a minority share for which there exists a ready, liquid market. The closing prices quoted in the newspaper for the shares of the public dealerships are marketable minority interest prices.

The nonmarketable minority interest level of value refers to the value of minority shares for which there is no ready market. Holders of a minority interest can neither make important business decisions nor sell their shares in a ready market. As you might imagine, this is the lowest level of value.

NEW AUTOMOBILE DEALERSHIP INDUSTRY CONDITIONS

The National Automobile Dealers Association (NADA) publishes annual financial and other information about automobile dealers. Key summary data for NADA's "average" automobile dealership is as follows:

Average Dealership Profile

	2000	2001	2002	2003	2004	2005	% Change 2004-2005
Total Dealership Sales	$29,360,978	$31,670,046	$31,275,581	$32,296,859	$33,009,335	$32,318,461	-2.1%
Total Dealership Gross	$3,734,466	$4,154,469	$4,175,456	$4,315,654	$4,363,870	$4,307,479	-1.3%
As % of Total Sales	12.7%	13.1%	13.4%	13.4%	13.2%	13.3%	0.8%
Net Profit before Taxes	$455,924	$618,974	$615,673	$564,143	$559,686	$531,033	-5.1%
As % of Total Sales	1.6%	2.0%	1.9%	1.7%	1.7%	1.6%	-5.9%
New-Vehicle Dept. Sales	$17,638,914	$18,808,644	$18,651,091	$19,359,130	$20,116,264	$19,469,000	-3.2%
As % of Total Sales	60.1%	59.4%	59.6%	59.9%	60.9%	60.2%	-1.1%
Used-Vehicle Dept. Sales	$8,388,678	$9,187,234	$8,942,973	$9,142,647	$9,090,534	$9,067,128	-0.3%
As % of Total Sales	28.6%	29.0%	28.6%	28.3%	27.5%	28.1%	2.2%
Service and Parts Sales	$3,333,386	$3,674,168	$3,681,518	$3,795,081	$3,802,537	$3,782,334	-0.5%
As % of Total Sales	11.4%	11.6%	11.8%	11.8%	11.5%	11.7%	1.7%
New-Veh. Avg. Selling Price	$24,923	$25,797	$26,163	$27,565	$28,060	$28,381	1.1%
Used-Veh. Avg. Selling Price	$13,648	$13,930	$13,840	$13,473	$14,247	$14,923	4.7%
Average Net Worth	$1,876,231	$2,016,200	$2,230,699	$2,243,589	$2,613,063	$2,258,753	-13.6%
Net Profit as % of Net Worth	24.3%	30.7%	27.6%	25.1%	24.3%	23.5%	-3.3%

Source: National Automobile Dealers Association

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With the exception of 2002, the year 2005 marked the first decline in average dealership sales in at least 13 years, the time period for which dealership sales data was analyzed for this article. Dealership gross profit was 13.3% in 2005, near the high end of its 12.6% to 13.5% range over the previous 13 years. Despite the improvement in the gross margin, net profit before taxes fell in 2005 on both a dollar basis and as a percent of sales.

One of the key trends impacting new automobile dealers is the reduction in the number of dealers (owners of dealerships) and points (retail locations) in the industry. The number of dealerships has declined each year from 25,025 at January 1, 1988, to 21,495 at January 1, 2006, although the rate of the reduction appears to have slowed in recent years. This is quite probably due to fewer acquisitions by large dealer groups and reduced efforts by manufacturers to shrink the number of dealer points. However, in August, 2006 Ford announced plans to reduce its domestic-brand dealerships in 19 major markets.

The typical automobile dealership today is a significantly larger, more complex operation than the typical dealer of 20 years ago. In 1985, over 8,000 dealerships sold fewer than 150 new vehicles per year, and fewer than 4,000 dealerships sold more than 750 new vehicles per year. Now, that relationship has almost reversed, as less than 3,500 dealerships sell fewer than 150 new vehicles per year, and over 6,400 dealerships sell more than 750 new vehicles per year. Today's larger dealerships are more valuable in absolute terms than the dealers of yesteryear, and they require an increased level of management sophistication.

The new car market has changed over the years, as well. In 1994, General Motors and Ford had new vehicle market shares of 33.3% and 25.4%, respectively, while Toyota and Honda had market shares of 7.2% and 5.2%, respectively. During 2005, the market share of General Motors was 26.3%, and Ford's was 18.3%. Toyota and Honda, on the other hand, increased their respective market shares to 13.3% and 8.6%. In July, 2006, Toyota sold more vehicles than Ford for the first month ever, becoming for that month the second-largest-selling automobile brand in the United States.

These are important trends from a valuation perspective, as larger dealerships tend to be worth more per dollar of sales than smaller dealerships, higher margin dealerships tend to be worth more per dollar of sales than lower margin dealerships, and luxury import dealerships, because of the perception of enhanced short-term growth prospects, tend to be worth more than domestic dealerships. While these generalizations are true, it is important not to forget that the relative attractiveness of a brand can change significantly as well. For example a Nissan dealership is quite attractive at the present time, while just a few years ago the opposite was true. Saturn would be an example of dealer attractiveness moving in the opposite direction.

DEALERSHIP FINANCIAL STATEMENTS

The key financial statements for an automobile dealer are its balance sheet, which catalogs the assets and liabilities of the dealership at a point in time, and its income statement, which shows the total revenue and expenses of the dealership (and therefore its profitability) during a given period of time, typically one year.

The balance sheet of an automobile dealership is typically dominated by the inventory of new and used cars on the asset side and floor-plan financing on the liabilities side. The LIFO method of accounting is frequently used for inventory; therefore some type of adjustment in the carrying amount of inventory is needed. Operating assets include the depreciated book value of the dealership's fixed assets, operating cash, and accounts receivable. However, in our experience, many dealerships have significant non-operating assets on their balance sheets that often make transactions more difficult to compare.

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The key revenue drivers are new and used vehicle sales (the front end), and the service, parts, and body departments (the back end). During the early to mid 1990's, the typical new car department was essentially a breakeven operation. In the late 1990's, the strong economy allowed increasing new vehicle department net profit, but 2005 marked the third year in a row that new vehicle department net profit declined for the average dealership. In 2005, the new vehicle department contributed 60.2% of the average dealership's sales but only 14.5% of its operating profit. Used vehicles tend to be a higher margin product line for dealers. Used vehicles accounted for 28.1% of the average dealer's sales and 27% of operating profit. This leaves the back end, service and parts, which accounted for only 11.7% of total sales but a full 58% of operating profit. Clearly, a successful back end is an important component of a successful dealership.

AUTOMOBILE DEALERSHIP VALUATION

Valuation Methodology

There are three general approaches to valuing a business. These include the cost (or asset) approach, the income approach and the market approach. As a general rule every valuation should consider each of these approaches. While some may not be applicable to a particular valuation, each approach incorporates procedures that could enhance awareness about specific business attributes that may be relevant to determining the final value.

In each approach are specific ways to determine value that are commonly referred to as methods. Typically, analysts will use several methods to determine value. While many methods may be used, it would not be surprising to see the following:

Blue Sky Method

This is perhaps the most familiar method to many in the industry. It involves determining the market value of the operating assets of the business, deducting the market value of its liabilities, and then adding to this base an additional amount for the blue sky, or goodwill, associated with the business and the value of any non-operating assets. The sum is the value of the equity of the business on a controlling interest basis.

In the Blue Sky Method, an asset approach is used to determine the value of the business, but one of the assets, blue sky, is valued using an income approach.

The calculation of the appropriate net asset value presents some challenges. For example, most dealerships use accelerated depreciation methods, so the book value of the fixed assets could be low relative to the market value. This is a particular area of concern for dealerships that have aggressively expensed items that have relatively long useful lives. Adjusting inventories from LIFO to FIFO may create another significant adjustment to reported book value, and there is a chance that additional adjustments will be necessary related to potential F&I chargebacks.

Once the net value of the tangible assets is determined, it is necessary to calculate the amount of blue sky to be added. In general, it is determined as some measure of earnings times a multiple. There is generally more consensus in the industry concerning the multiple to be applied than the cash flow to which it is applied. In general, industry participants tend to expect multiples of 2x to 5x something, but that something tends to vary depending on the person to whom one talks. The cash flow multiplied by something between 2 and 5 might be after-tax earnings or pre-tax earnings, and those earnings might be from the most recent period or an average of several recent periods.

One area of agreement is that whatever earnings stream is used, adjustments are typically made for owner compensation and fringe benefits, unusual or nonrecurring items, rent, income statement debits or credits related to non-operating assets, and interest income on any cash and securities that will not transfer to the new owner. The net result of all this is that like most rules of thumb, almost all industry participants agree that the method should be used, but it results in vastly different conclusions depending on who is using it and how they believe it should be applied.

Capitalization of Earnings

Methods under the income approach are wide ranging. Quoting the Business Valuation Standards, the Income Approach is "a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount."

Common valuation methods under the income approach are the discounted cash flow and single period capitalization methods. Methods under the income approach are based on the idea that the value of a business today is equal to the present value of all the future benefits that the business can reasonably be expected to produce in the future. Income approaches require the analyst to determine the level of benefits (typically measured in terms of earnings or cash flow) expected to be generated by the business in future periods and an appropriate discount rate at which to determine the present value of those future benefits. The discount rate reflects both the time value of money and the risk associated with those future benefits.

The most common method used under the income approach is referred to as a single period capitalization of earnings. As opposed to a detailed projection of future earnings, the analyst determines a base level of annual earnings and then determines a multiplier (also known as a capitalization factor) appropriate to that earnings stream.

The capitalization factor is the amount by which the base level of earnings is multiplied in order to determine the value of the business, and it reflects the analyst's opinion concerning two key value drivers – risk and growth.

Holding everything else equal, the riskier the cash flows of the business are perceived to be, the lower the multiple that will be assigned. With regard to risk, established dealerships with established customer relationships (both for the purchase of new cars and in the service department) will command higher multiples than will dealerships with fewer repeat customers, since the generation of new customers is perceived as more risky than the retention of existing customers.

The greater the expectation for growth of cash flows going forward, the higher the multiple. In general, this means that dealerships in growing areas selling popular cars will typically bring a higher multiple than dealerships in areas of declining population or household income selling brands that are perceived as waning in popularity.

Guideline Company Method

The market approach is defined in the Business Valuation Standards as "a general way of determining a value indication of a business, business ownership interest, security, or intangible asset by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold."

Market methods include a variety of methods that compare the subject with transactions involving similar investments, including publicly traded guideline companies and sales involving controlling interests in public or private guideline companies. Consideration of prior transactions in interests of a valuation subject is also a method under the market approach.

The guideline company method compares the subject company to a group of one or more publicly traded companies that the analyst believes are similar to the subject company in investment characteristics. For auto dealers, this generally means comparing the subject companies to one or more of the following: America's Car-Mart, Asbury Automotive, AutoNation, Group 1 Automotive, Hometown Auto Retailers, Lithia Motors, Major Automotive, Sonic, and United Auto Group.

While these companies do provide information about the investing public's perception of the value of automobile dealerships, direct comparisons to these companies should be made with caution, as any particular dealership might not be directly comparable to the public companies. For example, while the NADA's average dealership had 2005 sales of about $32 million, the smallest of the public companies, America's Car-Mart, has annual sales on the order of $200 million, and the largest, AutoNation, has annual sales of almost $20 billion. Clearly, these operations are much larger than the typical automobile dealership. In general, they are also more geographically diverse, selling cars in multiple markets in multiple states, and they also sell cars from a variety of manufacturers. It is a rare dealership (and I use the term generously) that is truly comparable to companies of this size.

Public company data can be useful in assessing the reasonableness of a controlling interest valuation by looking at the ratio of total revenue to total capital. The "outside in" macro view of valuation can be interesting; however, keep in mind that the ratio will decline as the size of the subject dealership declines.

Other Valuation Methods

In relatively rare cases, other valuation methods will be applied. These might include methods that compare the subject dealerships to similar dealerships that have sold, although the private nature of most dealership transactions makes the accumulation of data regarding sales problematic. They also might include discounted cash flow methods that discount a forecast of expected future cash flows to the present. This method is generally seen with very new dealerships or dealerships where, for whatever reason, the financial future of the business is expected to be different from its past.

CONCLUSIONS

If you engage an appraiser to help you determine the value of your business, expect to see multiple valuation methods representative of each of the three general approaches to value. While the blue sky method is attractive because it is familiar to dealership owners and simultaneously reflects both an asset approach and an income approach, be aware that there is not universal agreement concerning how it should be applied. Also, keep in mind that many financial buyers of automobile dealerships think in terms of pricing a deal to get a specific return on investment, although they may negotiate in the blue sky language familiar to dealers. As you read an appraisal report that contains a capitalization of earnings, verify, using your own experience and judgment, the reasonableness of the base level of earnings and the growth rate assumed. Rely on your own judgment and your other financial advisors about whether the discussion of risk in the appraisal report seems to reasonably describe the risk associated with the subject business.

At the end of the day, the appraised value of the dealership has to fall within a range of reasonableness. A reasonable business owner would be unlikely to sell a dealership if the concluded value was too low, as it would be more attractive to continue to operate the business. Similarly, a reasonable buyer would never pay more for a dealership than an amount on which a reasonable return could be achieved based on reasonable expectations about future performance.

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