

Critical Issues in Business Valuations and Family Transitions for Auto Dealers

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Scott A. Womack, Senior Vice President, is active in family law litigation (traditional litigated divorce and collaborative divorce) and corporate valuation and leads Mercer Capital's Auto Dealer Industry team.

Scott assists estate planning attorneys in federal and state valuation matters, family law attorneys in divorce matters (including business valuation, forensic accounting, division of marital estate, etc.), and small business owners involving the potential sale of their businesses. Scott has testified in several jurisdictions involving family law matters. In addition, he has testified in Tax Court.

As the leader of Mercer Capital's Auto Dealership Industry team, Scott provides valuation services to dealerships throughout the U.S. related to corporate planning and reorganization, transactions, employee stock ownership plans, and tax issues as well as valuations of intangible assets, and assets subject to specific contractual restrictions. Scott and his team also consult with auto dealer clients in the process of selling or buying.

Scott's overall valuation concentration includes gift, estate, and income tax planning and reporting (valuation of businesses and business interests); financial Reporting under FASB ASC 350 (goodwill impairment testing- formerly FAS 142), FASB 718 (valuation of stock-based compensation including stock options, restricted stock, stock appreciation rights, etc.- formerly FAS 123R); and holding company valuations (real estate/marketable securities) and fractional interests in real estate.

Scott is a featured speaker for auto dealer industry groups, family law associations, attorneys, accountants, business appraisers, and business professionals on various valuation and financial advisory topics.

What We'll Cover Today

- Typical Normalization Adjustments for Business Valuations
- Value Drivers of Store Valuation
- Buy-Sell Agreement Issues
- Common Family Transition Issues

SECTION 1

Normalization Adjustments in Valuation

What's the Point?

- Develop a “public equivalent” for comparability purposes
- Identify significant non-recurring or unusual expenses (or potentially sources of income)
- Determine a reasonable earning power of the Company

Management Motivations for Adjustments



Adjustments provide investors and creditors with better insight into company's "true" earnings



Adjustments that present a favorably biased view of company's performance



Managers incentivized to achieve desired outcome and/or fraud

Where Do We Find Potential Adjustments

Reviewing trends in the Dealer Financial Statements

- Material fluctuations (\$ and %)

Notes to the financial statements

Management interviews and site visits

- It's interesting what may come up during a conversation
 - “As a matter of fact, we did hire a one-time consultant for general business consulting. It was \$100,000. Never again!”

Asking the question: “Any non-recurring, extraordinary, unusual expense(s)?”

Types of Earnings Adjustments

	Description	Examples
Type 1: Non-recurring, unusual items	One-time gains or losses, unusual or non-recurring items, discontinued operations, run-rate adjustments, etc...	<ul style="list-style-type: none"> • Sell a building; remove gain on sale • Settle a lawsuit; remove settlement expense • Adjust ongoing revenue and expenses for a mid-year acquisition
Type 2: Discretionary items	Normalizing officer/owner compensation and discretionary expenses that would not exist in a well-run, publicly traded company	<ul style="list-style-type: none"> • Owner takes distributions in lieu of comp or takes all profit in form of salary; normalize comp • Treat owner's condo as non-operating asset; remove related expenses

See Integrated Theory, 2nd Ed. (pp. 110-114)

Common Adjustments

Balance Sheet

- Inventory valuation method (LIFO v. FIFO)
- Depreciation method (accelerated v. straight line)
- Fixed Assets/Leasehold Improvements
- Goodwill/Other Intangible Assets
- Non-Operating Assets
- Working Capital
- Owner A/R

Common Adjustments

Income Statement

- Inventory valuation method (LIFO v. FIFO)
- Depreciation method (accelerated v. straight line)
- Excess compensation for key people (salary, bonus, dividends)
- Fringe benefits (excess)
- Rent
- Other Income Items
- Discretionary/Non-Recurring/Personal Expenses
- Expected Industry Profitability vs. Actual Profitability

Fixed Assets

If Dealership doesn't own real estate:

Remove (net of depreciation):

- Buildings
- Leasehold Improvements
- Land

22	NON	CARS	0080	53	60	0000	1330	0024	739317	AVERAGE MONTH TOTAL EXPENSES	397556	NET CASH	
23	U	TRUCKS	0001	66	DAYS	0002	1330		598	NET CASH OVER (UNDER)	141370		
24	S	CARS	0110							MORTGAGES PAYABLE	2500	0225	
25	E	TRUCKS	0111							OFFICERS AND OWNERS	2510	0226	
26	D	CARS	0100	NEW	1470	0101			1480	FORD	2515	0227	
27	D	RE-MARKETED VEHICLES		VE					1480	OTHER	2520	0228	
28		PARTS							1500	USED VEHICLES	2530	0229	
29	ALL	TOTAL CURRENT ASSETS										85633	0230
30	O	TOTAL CURRENT LIABILITIES										6503	0231
31	L	LEASED VEH. - NET	0102		0103				1810	SESSION PURCHASE LOSS	2600	0232	
32		RENTAL VEHICLES - NET							1850		2605	0233	
33									1851		2610	0234	
34		NET WORTH										240000	0235
35		LAND AND IMPROVEMENTS - NET							1700	STOCK PAR VALUE	2615	0236	
36									1705		2620	0237	
37		BUILDINGS		COST					1710	ION (NON US)	2625	0238	
38				DEPRECIATION					1715		2630	0239	
39		EQUIPMENT		COST					1720		2635	0240	
40				DEPRECIATION					1725		2640	0241	
41		LEASEHOLDS		COST					1730		2645	0242	
42				AMORTIZED					1735		2650	0243	
43		FINANCE RECEIVABLES DEFERRED - NET										1800	0244
44		RECEIVABLES - OFFICERS & EMPLOYEES							1810	YTD	2655	0245	
45		CASH VALUE - LIFE INSURANCE							1820		2660	0246	
46		CASH							1830		2665	0247	
47		OTHER ASSETS - NET							1837		2670	0248	
48		TOTAL ASSETS										9	0249
49		FROZEN CAPITAL								USED VEHICLE INVENTORY	2831219	0250	
50										USED MINIMUM OR GUIDE	2215001	0251	
51										PARTS INVENTORY	616218	0252	
52										ACCOUNTS RECEIVABLE AGING		0253	
53		OPERATING ANALYSIS		MONTH	YTD	MONTH	YTD	VEHICLE ACCTS	0000	CURRENT	31 - 60	61 - 90	91 +
54		SALES		3583040	36973462	% TOTAL SALES		PARTS ACCTS	0001	46649	0507	0514	0521

Goodwill/Intangible Assets

22	NON CARS	0000	53	60	0000	1330	0024	739317	AVERAGE MONTH TOTAL EXPENSES	397556	NET CASH
23	UPO TRUCKS	0001	66	DAYS	0002	1340	0025	1039598	NET CASH OVER (UNDER)	141370	
24	S CPO CARS	0110									
25	E (Franchise Only) TRUCKS	0111									
26	D RE-MARKETED CARS										
27	MARKETED VEHICLES										
28	PARTS IN EQUIPMENT										
29	ALLO'										
30	OT										
31	V LEASEHOLDS										
32	3										
44	FINANCE RECEIVABLES DEFERRED - NET					1800	0014				
45	RECEIVABLES - OFFICERS & EMPLOYEES					1810	0015	241605			
46	CASH VALUE - LIFE INSURANCE					1820	0016				
47	OTHER ASSETS - NET					1830	0017	5515			
48	TOTAL ASSETS						0018	9492851			
49	FROZEN CAPITAL						0254	3227326			
430	(Negative amount = no frozen capital for dealership)						0205	20915			
44	PSB RECEIVABLES							2108			
45	RE										
46	CAS										
47	OTHER										
48	TOTAL ASSETS										
49	FROZEN CAPITAL										
50	SALES					3583040		36973462			
51	PSB					364946		486307			
52	OPERATING ANALYSIS					371871		47			
53	OPERATING ANALYSIS										
54	SALES					3583040		36973462			

Remove:

- Goodwill
- Intangible Assets

Goal: To conclude a Net Asset or Tangible Value of Dealership

Working Capital

Goal: To assess if Dealership has excess or deficient amount of working Capital

Actual Working Capital

Less: Required Working Capital

Excess(Deficient) W/C

22	NON CARS	0080	53	60	0090	1330	0024	73931	330940	NET CASH
23	U CPO TRUCKS	0001	66	DAYS	0002	1380	0025	10	397556	
24	S CPO CARS	0110				1370			141370	
25	E (Franchise Only) TRUCKS	0111								
26	D RE- CARS	0003	14	60	0005					
27	MARKETED VEHICLES TRUCKS	0004	43	DAYS	0000					
28	PARTS INV.	0007	209155		1400	0008				528001
29	ALLOWANCE - PARTS INVENTORY ADJUST									
30	OTHER INVENTORIES	MEMO WORK IN PRO								
31	LIFO INVENTORY	0100	49782	1470	0100					
32	RESERVE	PARTS								
33	PREPAID EXPENSES									
34	TOTAL CURRENT ASSETS									
35	LEASED VEH. - NET	0102								
36	RENTAL VEHICLES - NET	UNITS CAR								
37	LAND AND IMPROVEMENTS - NET									
38	BUILDINGS	COST								
39		DEPRECIATION								
40	EQUIPMENT	COST								
41		DEPRECIATION								
42	LEASEHOLDS	COST								
43		AMORTIZED								
44	FINANCE RECEIVABLES DEFERRED - NET									
45	RECEIVABLES - OFFICERS & EMPLOYEES	VEHICLE ACCTS								
46	CASH VALUE - LIFE INSURANCE									
47	OTHER ASSETS - NET									
48	TOTAL ASSETS									
49	FROZEN CAPITAL	USED VEHICLE INVENTORY								
50		PARTS INVENTORY								
51		PSB RECEIVABLES								
52										
53	OPERATING ANALYSIS	MONTH	YTD	MONTH	YTD	VEHICLE ACCTS				

ACCOUNTS RECEIVABLE AGING			
	CURRENT	31 - 60	61 - 90
VEHICLE ACCTS	46649		
OTHER ACCTS	33721	7346	
TOTAL	80370	7346	

Owner Accounts Receivable

6	NOTES RECEIVABLE	0050	1100	0006	OTHER - SHORT TERM	2030	0205
7	Discounted Notes Receivable (NON US)	0051	1105	0007	LONG TERM - CURRENT PORTION	2040	0206
8	ACCOUNTS RECEIVABLE	0052	05765	0008	VEHICLE	2055	0208
9					PARTS BODY SERVICE	2100	0209
10					OTHER	2105	0210
11					INCOME TAX REFUND	2200	0211
12	W & P CLAIMS		12 2017		ADD	2205	0212
13	VEHICLE HOLDBACK		DEC 31 2017		CITY STATE	2300	0213
14	INCENTIVES					2310	0214
15	FINANCE CONTRACTS - NEW					2400	0215
16	CONTRACTS - USED					2402	0216
17	MARKETABLE SECURITIES					2410	0217
18						2415	0218
19						2480	0219
20						2420	0220
21						2423	0221
22						2480	0222
23						2485	0223
24						2485	0224
25						2485	0225
26						2485	0226
27						2485	0227
28						2485	0228
29						2485	0229
30						2485	0230
31						2485	0231
32						2485	0232
33						2485	0233
34						2485	0234
35						2485	0235
36						2485	0236
37						2485	0237
38						2485	0238
39						2485	0239
40						2485	0240
41						2485	0241
42						2485	0242
43						2485	0243

Tip: Sometimes items are misplaced or disguised on dealer financial statement to overstate Working Capital

Tip: Ask questions of owner/controller during management interview

SECTION 2

Valuation Assumptions Influence Valuation Conclusions

Formula for Build-Up Discount Rate

Risk Free Rate
+ Equity Risk Premium X Beta
+ Small Stock Premium
+ Specific Company Risk
Estimated Discount Rate
-Long-term Growth Rate of Earnings
Estimated Capitalization Rate

P/E Example – Use of Build-Up or ACAPM

RFR	Risk Free Rate
P/E	Price to Earnings Multiples
ERP	Equity Risk Premium
SSP	Small Stock Premium
SCR	Specific Company Risk
G	Growth

Valuation Assumptions

DISCOUNT RATE SENSITIVITY Discount Rate Components		DISCOUNT RATES (R) / PRICE/EARNINGS MULTIPLES		
		Low/High	Mid-Range	High/Low
Risk-Free Rate	RFR	3.0%	3.0%	3.0%
Equity Risk Premium	ERP*	4.0%	5.0%	6.0%
Beta	β^*	0.9	1.0	1.1
Beta-Adjusted Large Stock Premium		3.6%	5.0%	6.6%
Small Stock Premium	SSP*	2.0%	3.0%	4.0%
Specific Company Risk	SCR*	1.0%	2.0%	3.0%
Estimated Discount Rate	R	9.6%	13.0%	16.6%
less: Estimated Core Earnings Growth	G_e	3.0%	3.0%	3.0%
Estimated Capitalization Rate		6.6%	10.0%	13.6%
Estimated Capitalization Factor	P/E	15.2	10.0	7.4

* Seemingly small differences in key assumptions can lead to significant differences in valuation multiples and conclusions

Valuation Assumptions

1. Growth Rates

- Avoid high or low
- Sustainability in long-term
- Analysis of other factors such as start-up, early stage, or mature company

2. Annualization

- Avoid annualizing a small sample and less than a year
- Ask for Trailing Twelve Month P&L (“TTM”) from company

Valuation Assumptions

3. Forecasts

- Ask about underlying assumptions
- Compare/contrast to historical trends and industry performance
- Ask for prior year's forecasts/budgets to assess level of success

4. Divorce Recession

- Doom and gloom in latest year
- Compare to historical trends, future outlook, condition of industry and economy

Valuation Assumptions

5. Industry Conditions

- Review and include narrative of industry conditions (IBIS World, First Research, etc.)
- How do industry factors affect the company

6. Risk Factors

- Avoid really high or really low assumptions
- Appraiser should provide general basis for conclusion

Valuation Assumptions

7. Multiples

- How applicable are comparable companies?
- Sample size
- Explanation for multiple selected and its position on low, middle, high end of range relative to company's performance

8. Time Periods

- Typically review five years of historical financial statements
- Be cautious of small sample size reviewed
- Explanation of time period selected for ongoing earnings assumption

SECTION 3

Value Drivers in a Store Valuation

Franchise

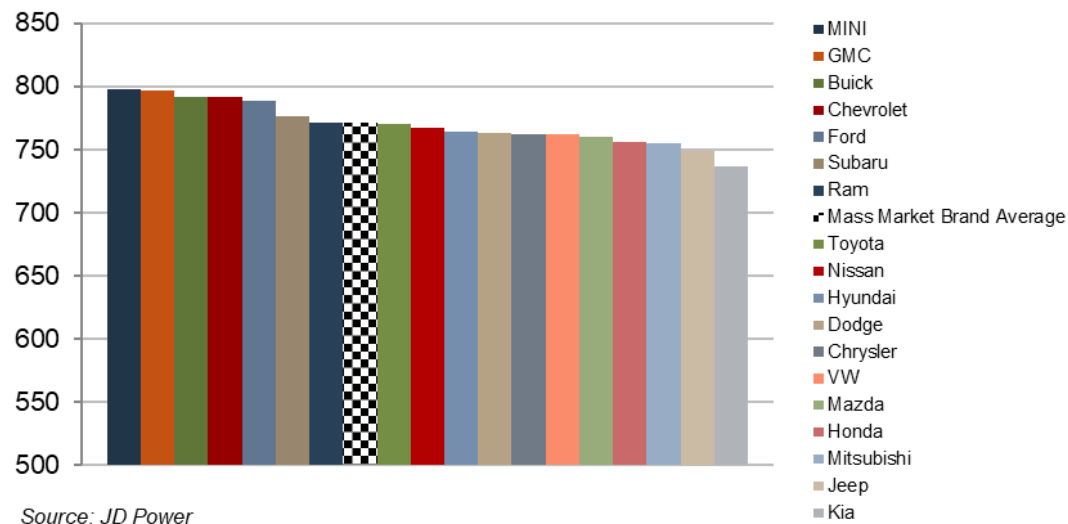


Real Estate

- Owned?
- Leased? From related or unrelated entity?
- Quality of Real Estate
- Signage/Brand Image Programs

Management/Employees

- Sales Satisfaction Index (SSI)

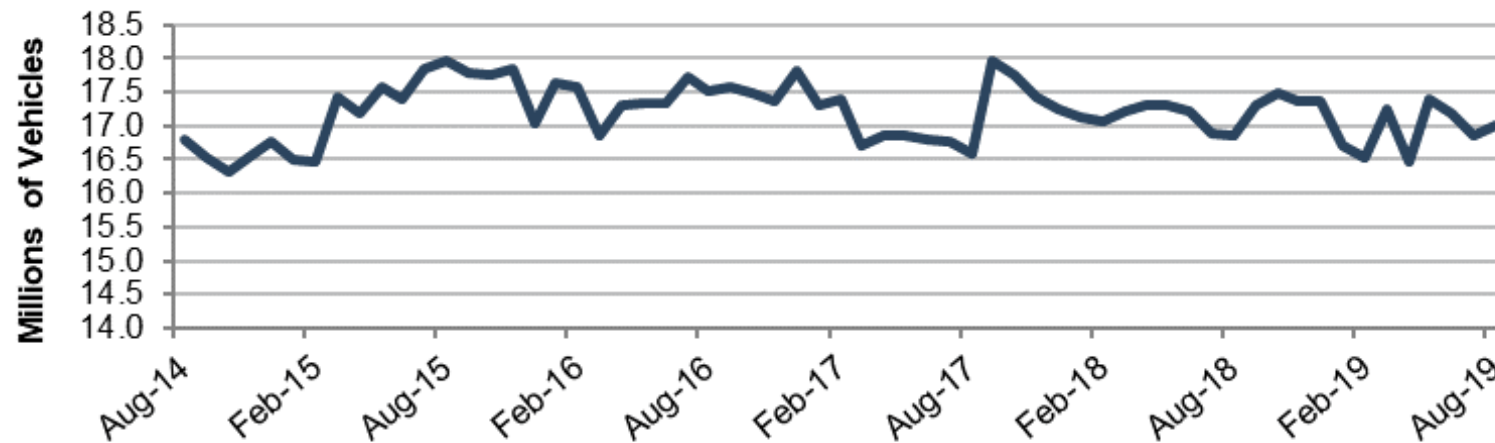


- Customer Service Index (CSI)

Sales CSI		Service CSI	
Dealership	District	Dealership	District
96.9	95.6	94.6	92.5
85.2	79.5	72.6	73.5
84.6	80.2	72.8	72.6
94.5	97.1	94.0	94.0
86.5	86.2	78.0	79.6
94.0	95.0	93.0	92.0
95.8	96.0	93.6	94.6
89.8	91.5	89.3	89.8

Recent Economic Performance

Seasonally Adjusted Annual Rate (SAAR)



Source: FRED

- Local Economic Conditions

Other Factors

- Buyer Demand
- Location/Market
- Single Point vs. Over-Franchised Market

SECTION 4

Buy-Sell Agreements

What Is a Buy-Sell Agreement?

Agreements by and between the shareholders (or equity partners of whatever legal description) of a privately owned business and, perhaps, the business itself that establish the mechanism for the purchase of stock following the death (or other adverse changes) of one of the owners. In the case of corporate joint ventures, they also **establish the value for break-ups or for circumstances calling for one corporate venture partner to buy out the other partner.**

Require agreement **at a point in time**

Define the conditions that **“trigger”** the buy-sell provisions

Relate to transactions that will or may occur **at future points in time**

Determine the **price(s)** at which specified future transactions will occur

Four Take-Aways

1. Virtually every buy-sell agreement “out there” will not work to provide reasonable resolutions in the event of trigger events
2. The **definition of value** in virtually every valuation process buy-sell agreement is **flawed** and will generate valuation problems
3. Most buy-sell agreements **will not work** as effective estate planning tools as result
4. The **solution** for most agreements is to change the pricing mechanisms to either:
 - a. *Single Appraiser, Select Now and Value Now (and Annually Thereafter)*
 - b. *Choose the Third Appraiser First (this is new!)*

Potential “Trigger Events”

- » Q Quits
- » F is Fired
- » R Retires
- » D Disabled
- » D Death
- » D Divorce
- » B Bankruptcy
- » D The D’s of Buy-Sell Agreements

Questions to Ask Yourself / Your Clients

Do your clients have a buy-sell agreement?

If so, what type of agreement is it?

Do they know what the buy-sell agreement says?

There are six defining elements that must be in every process agreement if the valuation process and, therefore, the agreement, will work

Do you/they know the estate planning and ownership implications if someone dies or there is another trigger event?

How is the buy-sell agreement funded?

How life insurance proceeds are treated can make a big difference in the valuation of the company

How Do Buy-Sell Agreements Come Into Existence?

POTENTIAL OPPOSING SHAREHOLDER CHARACTERISTICS THAT MAKE DISCUSSING BUY-SELL AGREEMENTS DIFFICULT

Characteristic	Shareholder 1	Shareholder 2
Age	Younger	Older
Ownership	Noncontrolling	Controlling
Involvement	Active	Inactive
Personal Outlook	Optimistic	Pessimistic
Investment Type	Sweat Equity	Real Money
Investment Amount	Smaller	Larger to Much Larger
Personal Guaranties	None	Substantial

No one wants to talk about uncomfortable things like dying or firing

Get Agreement. Now.

Just Do It.

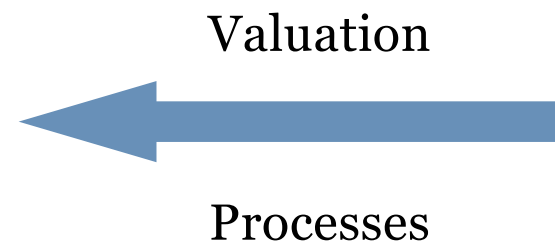
Types of Buy-Sell Agreements



Types of Buy-Sell Agreements

Based on how price is determined

- Fixed-price agreements
- Formula agreements
- **Process agreements**



Fixed-Price Agreements

Description

The owners agreed on a price.

That price is likely years out of date.

There are three possibilities regarding the price set:

- The value today is lower, perhaps far lower, than the realistic value.
- The value today is higher, perhaps far higher, than the realistic value.
- The value is the same as it was back then.

The owners haven't agreed on a way to update the price.

Realities seldom discussed

If the value is unrealistically low, each owner is betting that the other guy will die first and they will get to buy at the low price. Remember Wayne.

If the value is unrealistically high, each owner is betting that they will be the one to leave the business so he/she and their family can benefit. Remember Austin.

The other owner(s) are making just the opposite bets.

Why should the owners take a chance that they'll be on the wrong end of that bet?

Fixed-Price Agreements

Advantages

- » Easy to understand, easy to negotiate – the first time only!
- » Inexpensive
 - Easy for attorneys to draft
 - Easy for owners to understand
 - No appraisers required (not good!)

Disadvantages

- » Fixed prices are **seldom updated**, even over periods of many years. Inequities are almost certainly a result of out-of-date fixed-price agreements
- » Easy to set an initial price, but may be **difficult to reset as time passes** and interests diverge
- » The longer period of time between updates to fixed-price agreements, the greater the **potential for a divergence of the interests** of the various parties
- » Failure to update price can be **disastrous to estate plans** of owners

How to “fix” an out-of-date Fixed-Price Agreement

- » Update it annually – so simple but rarely ever done – so ineffective solution
- » Solutions to be

Formula Agreements

Description

The owners established a formula to calculate price.

Chances are, no one has calculated it lately.

Chances are, it can give an unreasonable result now.

Combined with changes in the company and the industry:

- The formula price may be higher than a realistic value today.
- The formula price may be lower than a realistic value today.
- The formula price is realistic today.

The owners haven't agreed on ways to make necessary/appropriate adjustments.

Realities seldom discussed

If the value is unrealistically low, each owner is betting that the other guy will die first and they will get to buy at the low price.

If the value is unrealistically high, each owner is betting that they will be the one to leave the business so he/she and their family can benefit.

The other owner(s) are making just the opposite bets.

Why should the owners take a chance that they'll be on the wrong end of that bet?

Formula Agreements

- » State a single formula to be applied to balance sheet and/or income statement metrics

Example

- » Multiple of Blue Sky – (3-5X)
 - What franchise? Source of Multiple
 - Multiple of EBT? Less Debt?
- » Book Value
 - NAV or Tangible Net Value

How to “fix” a Formula Agreement

- » Every year, calculate the price based upon the formula
- » What to do if the formula provides result that does not make sense?
- » Solutions to be discussed

Valuation Process Buy-Sell Agreements

Description

The owners agreed to let business appraisers set the price for the agreement if and when it is triggered. No one has the foggiest idea what will happen or what the price will be.

No one knows what “kind of value” the appraiser will provide:

- It **could be** the value of an illiquid interest.
- It **could be** the value of the entire enterprise pro rata to ownership.
- It **could be** reasonable and what each owner thought they agreed to.
- It **might not** (probably) be what anyone or everyone expects

No one will know until the end of a lengthy & uncertain process what the outcome will be.

Realities seldom discussed

Each owner is betting that the ultimate price will be favorable (or at least reasonable) for them. The company is betting that the process will work and that the price set will be affordable.

Everyone is betting and someone will lose.

Good estate planning?

Process Buy-Sell Agreements

A buy-sell agreement provides a valuation process employing one or more appraisers

Value is determined by the appraisers in a manner defined in the buy-sell agreement

Two types of process buy-sell agreements:

MULTIPLE APPRAISER

SINGLE APPRAISER

Valuation Process Buy-Sell Agreements

The valuation mechanism of every buy-sell agreement should be

UNDERSTANDABLE

PREDICTABLE

**LIKELY TO ACHIEVE REASONABLE
RESOLUTIONS**

**HELPFUL IN THE WEALTH MANAGEMENT
and ESTATE PLANNING PROCESSES**

SECTION 5

Family Transition Issues

Unique Auto Dealer Issues

- Factory-Approved Dealer Principal
- Second and Third Generation Owners
 - Decision to pass on to next generation or sell
- Active vs. Non-Active Children in Business
 - How to “Equitably” transfer value
 - Operating Entity vs. Real Estate Holding Entity

Questions

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