MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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VALUE FOCUS

Auto Dealer Industry

Mid-Year 2019

Mercer Capital is a national business valuation and financial advisory firm. Valuations of auto dealers require special knowledge of the industry, hybrid valuation methods, and understanding of industry terminology. This newsletter provides useful statistical metrics of the auto industry as well as content about the unique industry factors and value drivers of business valuations. We can assist you and your clients in valuation and consulting matters within the auto industry.

We hope you find the newsletter to be a resource and appreciate any feedback along with any suggested content topics or ideas that you'd like to see in future editions. You can send your feedback and ideas to Scott Womack at **womacks@mercercapital.com**.

Valuation Issues in Auto Dealer Litigation

In our family law and commercial litigation practice, we often serve as expert witnesses in auto dealership valuation disputes. We hope you never find yourself a party to a legal dispute; however, we offer the following words of wisdom based upon our experience working in these valuation-related disputes. The following topics, posed as questions, have been points of contention or common issues that have arisen in recent disputes. We present them here so that if you are ever party to a dispute, you will be a more informed user of valuation and expert witness services.

Should Your Expert Witness be a Valuation or Industry Expert?

Oftentimes, the financial and business valuation portion of a litigation is referred to as a "battle of the experts" because you have at least two valuation experts, one for the plaintiff and one for the defendant. In the auto dealer world, you are hopefully combining valuation expertise with a highly-specialized industry. It is critical to engage an expert who is both a valuation expert and an industry expert – one who holds valuation credentials and has deep valuation knowledge and also understands and employs accepted industry-specific valuation techniques. Look with caution upon valuation experts with minimal industry experience who utilize general valuation methodologies often reserved for other industries (for example, Discounted Cash Flow (DCF) or multiples of Earnings Before Interest, Taxes and Depreciation (EBITDA)) with no discussion of Blue Sky multiples.

Does the Appraisal Discuss Local Economic Conditions and Competition Adequately?

The auto industry, like most industries, is dependent on the climate of the national economy. Additionally, auto dealers can be dependent or affected by conditions that are unique to their local economy. The type of franchise relative to the local demographics can also have a direct impact on the success/profitability of a particular auto dealer. For example, a luxury or high-line franchise in a smaller or poorer market would not be expected to fare as well as one in a market that has a larger and wealthier demographic.

In those areas that are dependent on a local economy/industry, an understanding of that economy/industry becomes just as important as an understanding of the overall auto dealer industry and national economy. Common examples are local markets that are home to a military base, oil & gas markets in Western Texas or natural gas in Pennsylvania, or fishing industries in coastal areas. There's also a fine balance between understanding and acknowledging the impact of that local economy without overstating it. Often some of the risks of the local economy are already reflected in the historical operating results of the dealership.

[1] DCF methodology might have to be considered in the early stages of a Company's lifecycle where the presence of historical financials either does not exist or are limited.

Valuation Issues in Auto Dealer Litigation

(continued)

If There Are Governing Corporate Documents, What Do They Say About Value, and Should They Be Relied Upon?

Many of the corporate entities involved in litigation have sophisticated governance documents that include Operating Agreements, Buy-Sell Agreements, and the like. These documents often contain provisions to value the stock or entity through the use of a formula or process. Whether or not these agreements are to be relied upon in whole or in part in a litigated matter is not always clear. In litigated matters, focus will be placed on whether the value concluded from a governance document represents fair market value, fair value, or some other standard of value. However, the formulas contained in these agreements are not always specific to the industry and may not include accepted valuation methodology for auto dealers.

Two common questions that arise concerning these agreements are 1) has an indication of value ever been concluded using the governance document in the dealership's history (in other words, has the dealership been valued using the methodology set out in the document)?; and 2) have there been any transactions, buy-ins or redemptions utilizing the values concluded in a governance document? These are important questions to consider when determining the appropriate weight to place on a value indication from a governance document.

Some litigation matters (such as divorce) state that the non-business party to the litigation is not bound by the value indicated by the governance document since they were not a signed party to that particular agreement. It is always important to discuss this issue with your attorney.

Have There Been Prior Internal Transactions of Company Stock and at What Price?

Similar to governance documents, another possible data point(s) in valuing an auto dealership are internal transactions. A good appraiser will always ask if there have been prior transactions of company stock and, if so, how many have occurred, when did they occur, and at what terms did they occur? There is no magic number, but as with most statistics, more transactions closer to the date of valuation can often be considered as better indicators of value than fewer transactions further from the date of valuation.

An important consideration in internal transactions is the motivation of the buyer and seller. If there have been multiple internal transactions, appraisers have to determine the appropriateness of which transactions to possibly include and which to possibly exclude in their determination of value. Without an understanding of the motivation of the parties and of the specific facts of the transactions, it becomes trickier to include some, but exclude others. The more logical conclusion would be to include all of the transactions or exclude all of the transactions with a stated explanation.

Valuation Issues in Auto Dealer Litigation

(continued)

What Do the Owner's Personal Financial Statements Say and Are They Important?

Most owners of an auto dealership have to submit personal financial statements as part of the guarantee on the floor plan and other financing. The personal financial statement includes a listing of all of the dealer's assets and liabilities, typically including some value assigned to the value of the dealership. In litigated matters, these documents are important as another data point to valuation.

One view of the value placed on a dealership in an owner's personal financial statement is that no formal valuation process was used to determine that number; so, at best, it's a thumb in the air, blind estimate of value. The opposing view is the individual submitting the personal financial statement is attesting to the accuracy and reliability of the financial figures contained in document under penalty of perjury. Further, some would say that the value assigned to the dealership has merit because the business owner is the most informed person regarding the business, its future growth opportunities, competition, and the impact of economic and industry factors on the business.

For an appraiser, it's not a good situation to be surprised by the existence of these documents. A good business appraiser will always ask for them. The dealership value indicated in a personal financial statement should be viewed in light of value indications under other methodologies and sources of information. At a minimum, personal financial statements may require the expert to ask more questions or use other factors, such as the national and local economy, to explain any difference in values over time.

Does the Appraiser Understand the Industry and How to Use Comparable Industry Profitability Data?

The auto dealer industry is highly specialized and unique and should not be compared to general retail or manufacturing industries. As such, any sole comparison to general industry profitability data should be avoided.

If your appraiser solely uses the Annual Statement Studies provided by the Risk Management Association (RMA) as a source of comparison for the balance sheet and income statement of your dealership to the industry, this is problematic. RMA's studies are organized by the North American Industry Classification System (NAICS). Typical new and used retail auto dealers would fall under NAICS #441110 or #441120. This general data does not distinguish between different franchises.

Is there better or more specialized data availiable? Yes, the National Automobile Dealers Association (NADA) publishes monthly Dealership Financial Profiles broken down by Average Dealerships, which would be comparable to RMA data. However, NADA drills down further, segmenting the industry into the four following categories: Domestic Dealerships, Import Dealerships, Luxury Dealerships and Mass Market Dealerships. While no single comparison is perfect, an appraiser should know to consult more specific industry profitability data when available.

Valuation Issues in Auto Dealer Litigation

(continued)

Do You Understand Actual Profitability vs. Expected Profitability and Why It's Important?

Either through an income or Blue Sky approach, auto dealers are typically valued based upon expected profitability rather than the actual profitability of the business.

The difference between actual and expected profitability generally consists of normalization adjustments. Normalization adjustments are adjustments made for any unusual or non-recurring items that do not reflect normal business operations. During the due diligence interview with management, an appraiser should ask does the dealership have non-recurring or discretionary expenses and are personal expenses of the owner being paid by the business? Comparing the dealership to industry profitability data as discussed earlier can help the appraiser understand the degree to which the dealership may be underperforming.

An example of how normalizing adjustments work is helpful. If a dealership has historically reported 2% earnings before taxes (EBT) and the NADA data suggests 5%, the financial expert must analyze why there is a difference between these two data points and determine if there are normalizing adjustments to be applied. Let's use some numbers to illustrate this point. For a dealership with revenue of $25 million, historical profitability at 2% would suggest EBT of $500,000. At 5%, expected EBT would be $1,250,000, or an increase of $750,000. In this case, the financial expert should analyze the financial statements and the dealership to determine if normalization adjustments are appropriate which, when made, will reflect a more realistic figure of the expected profitability of the dealership without non-recurring or personal owner expenses. This is important because, hypothetically, a new owner could optimize the business and eliminate some of these expenses; therefore, even dealerships with a history of negative or lower earnings can receive higher Blue Sky multiples because a buyer believes they can improve the performance of the dealership. However, as noted earlier, the dealership may be affected by the local economy and other issues that cannot be fixed so the lower historical EBT may be justified.

For more information on normalizing adjustments, see our article **Automobile Dealership Valuation 101.**

Conclusion

The valuation of automobile dealerships can be complex. A deep understanding of the industry along with valuation expertise is the optimal combination for general valuation needs and certainly for valuation-related disputes. If you have a valuation issue, feel free to contact us to discuss it in confidence.

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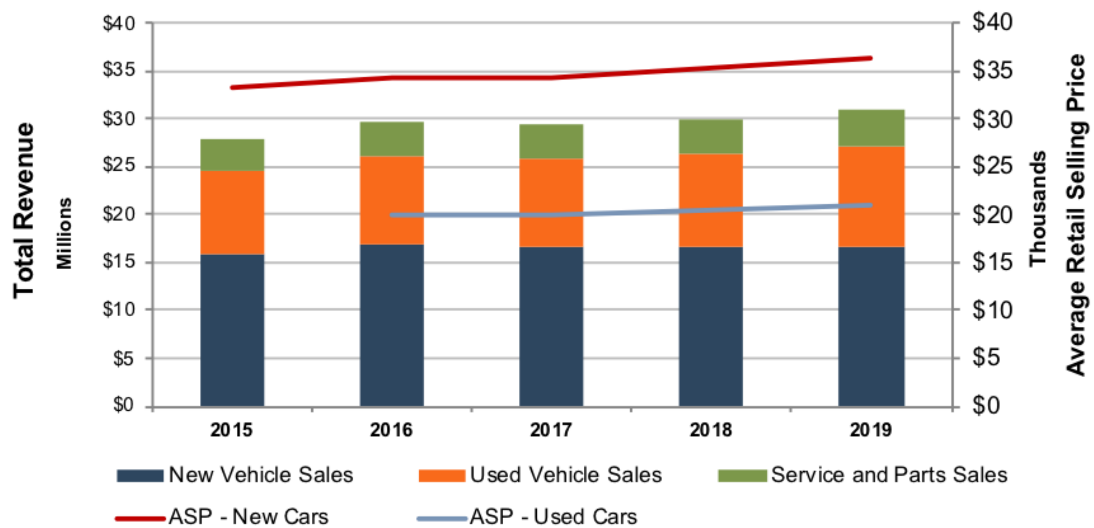
Average Annual Auto Dealer Profile

Average total sales per dealership increased 3.3% through mid-year 2019 (compared to mid-year 2018), driven primarily by service and parts departments (7.6%) and used vehicles (5.9%). Revenue from new vehicles increased just 0.6%, though it continues to make up more than half of dealership revenues at 54%. This follows the trend since 2015 as service and parts revenue has increased at a compound annual growth rate of 5.0% since 2015, compared to 4.1% for used vehicles, 1.2% for new vehicles, and 2.6% for total sales.

The average retail selling price of new cars and trucks increased 3.3% though the number of new vehicles sold decreased 2.3%. In the first half of 2019, used vehicle sales increased both in price (2.2%) and quantity (4.3%), though the gap in average selling price (ASP) between new and used cars increased modestly as new cars retail for an average of over $36 thousand while used cars on average sell for just under $21 thousand.

Total Sales and ASP for Average Light Vehicle Dealers



Source: NADA

Light Weight Vehicle Sales: Autos And Light Trucks (SAAR)

A Seasonally Adjusted Annual Rate (SAAR) is defined as a rate adjustment used for economic or business data, such as sales or employment figures, that attempts to remove seasonal variations in the data. In the automotive space, it is understood to mean the number of light weight vehicles sales (autos and light trucks) sold in a given month, adjusted for seasonal factors and scaled up to a year's worth of sales based on that month.

SAAR, an oft quoted figure for auto dealers, stood at 17.2 million in June 2019 after the BEA recently recalculated its seasonal adjustments. This was above the 16.9 observed in June 2018, though SAAR for the first six months of 2019 was down 1.2% compared to the first half of 2018. SAAR of around 17 million remains a positive sign for the industry and is not far off recent peaks of nearly 18 million in mid-2015 and 2017. Light trucks have represented a significant portion of sales, with cross overs and pickup trucks making up 39.4% and 17.0% of the market, respectively. Since the midpoint of the year, the Federal Reserve has cut the Fed Funds rate twice, which all else equal should decrease vehicle costs for consumers.

Total Gross Percentage Breakdown

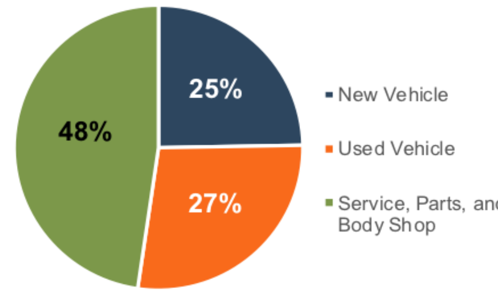
Source: St. Louis Fed

Domestic Dealerships

Gross Profit Trends

Gross profit increased 4.8% through the first half of 2019 for domestic dealerships, outpacing its compound annual growth of 2.4% since 2015. While achieving the highest level of gross profit ($3.1 million) in the past five years, domestic dealerships continue to earn the lowest gross profit compared to import, luxury, and mass market dealerships. Nearly half of gross profit in the first half of 2019 came from service and parts departments for domestic dealerships. The remainder was relatively evenly split with used vehicle gross profit edging new vehicle gross profit.

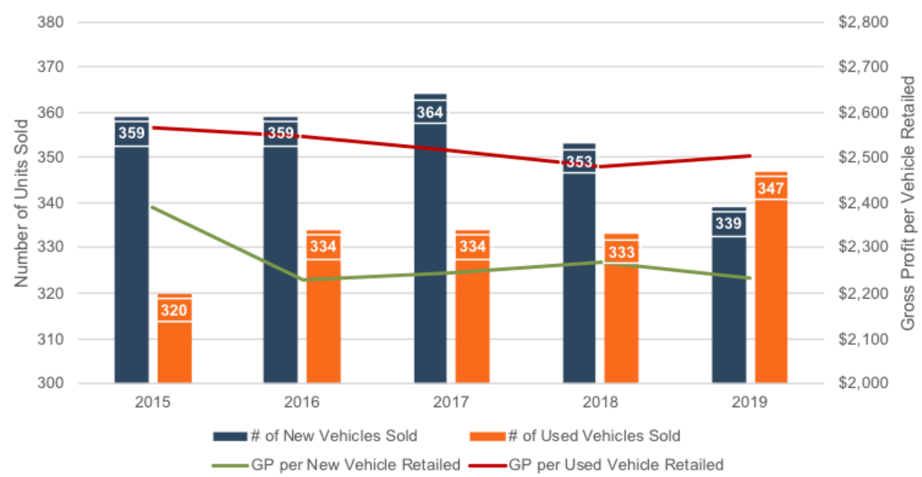
Gross Profit by Segment



Source: NADA

Gross profit trends have been on the decline for new car segments of domestic dealerships. The number of new cars sold dropped 4.0% in the first half of 2019, notably below the recent peak in 2017. Gross profit per new vehicle sold decreased 1.6% in 2019, ending two years of modest growth. While gross profit per used vehicle has generally declined since 2015, the first half of 2019 showed an uptick. Used vehicle sales also increased 4.2% for domestic dealerships. In total, domestic dealerships have generally seen margin compression (GP per unit) and consumers have increasingly opted for used vehicles over new ones.

New and Used Vehicles Sold and Gross Profit per Unit



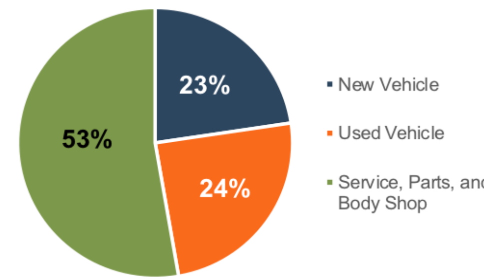
Source: NADA

Import Dealerships

Gross Profit Trends

Gross profit spiked 7.2% through the first half of 2019 for import dealerships, led by an 8.2% increase in service and parts departments. This was the highest level of gross profit ($4.1 million) in the past five years and the second time above the $4 million threshold. More than half of gross profit in the first half of 2019 came from service and parts departments for import dealerships. This is similar to the breakdown seen for domestic dealerships with used vehicles making up a bit more of gross profit than new vehicles. Service and parts departments have considerably higher margins, which allow them to make up a significant portion of gross profit without being a large portion of the dealership's revenue.

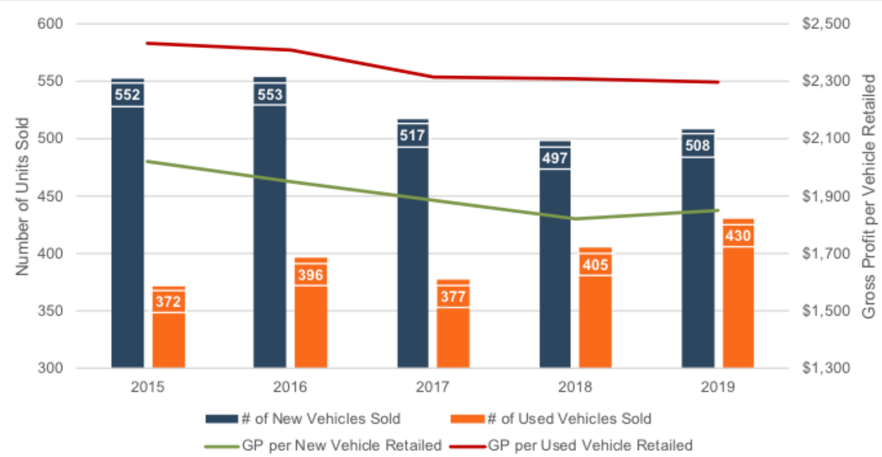
Gross Profit by Segment



Source: NADA

Import dealerships sold more new and used cars in the first half of 2019 than 2018. This represented a recent peak for used vehicles sold, which has increased 14% since mid-year 2017. However, this only represented a mild bounce back for new vehicles which have generally trended down in the past five years. This mirrors the margin trend for new vehicles as gross profit per new vehicle has decreased steadily since 2015, with a modest increase in the first half of 2019. Meanwhile gross profit per used vehicle has declined in each year since 2015, albeit at a slower compound annual growth rate (-1.4%) than new vehicles (-2.2%).

New and Used Vehicles Sold and Gross Profit per Unit



Source: NADA

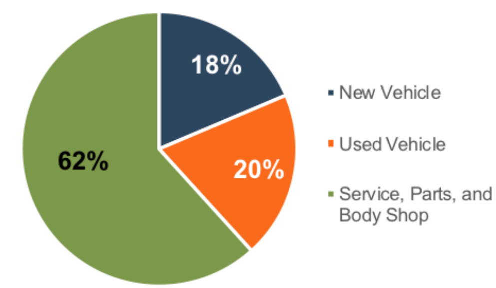
Luxury Dealerships

Gross Profit Trends

Gross profit increased 2.2% to just below $5 million through the first half of 2019 for luxury dealerships, though it remains below recent historical levels. However, luxury dealerships continue to achieve the highest levels of gross profit compared to other types of dealerships.

Luxury dealerships receive the highest percentage of their gross profit from service and parts departments as consumers are more likely to go to a dealership for servicing when they purchase a more expensive vehicle.

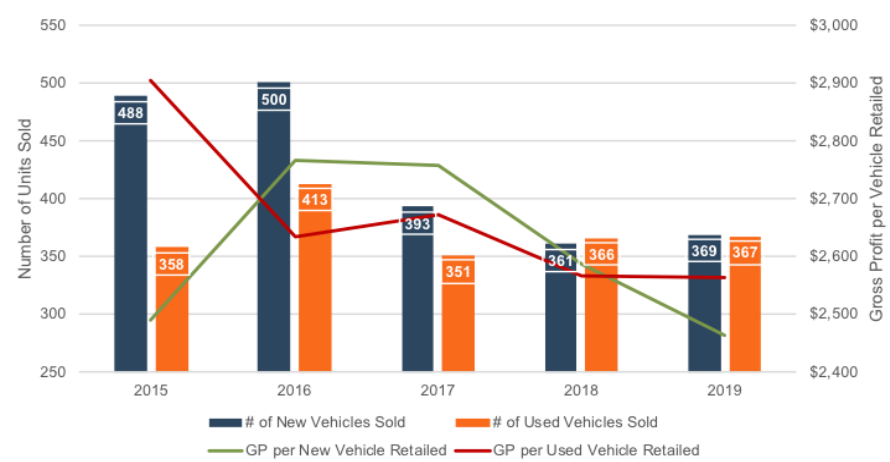
Gross Profit by Segment



Source: NADA

Service and parts departments are crucial to luxury dealerships as gross profit increased despite declines in new and used vehicle gross profit in the first six months of 2019. Both the number of new vehicles sold and gross profit per new vehicle peaked in the first half of 2016. The number of new cars and trucks sold dropped over 20% in mid-year 2017, with gross profit per new vehicle declining about 5% in each of the past two years. Used vehicle sales spiked 15.4% in 2016 to the detriment of margins as gross profit per used vehicle sold declined 9.4%; this trend reversed in mid-year 2017. Since then, used vehicle sales have increased to their highest point outside of 2016 while gross profit per vehicle sits at a recent low of about $2,560 per unit.

New and Used Vehicles Sold and Gross Profit per Unit



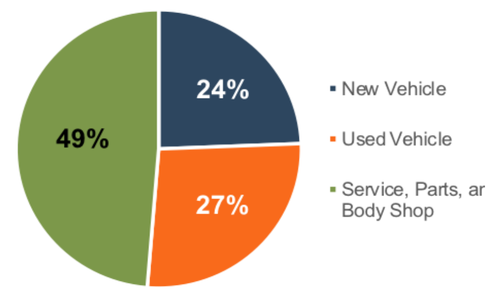
Source: NADA

Mass Market Dealerships

Gross Profit Trends

Gross profit increased 6.2% through the first half of 2019 for mass market dealerships, reaching a recent peak at just under $3.5 million. Like most other types of dealerships, approximately half of gross profit in the first half of 2019 came from service and parts departments, with the remainder relatively evenly split with used vehicle gross profit just above that for new vehicles. Mass market dealers were the only type to see a decline in first half sales in 2019, though gross profit increased 1.7%. This was carried by a 3.5% increase in service and parts gross as gross profit declined for both new and used vehicles.

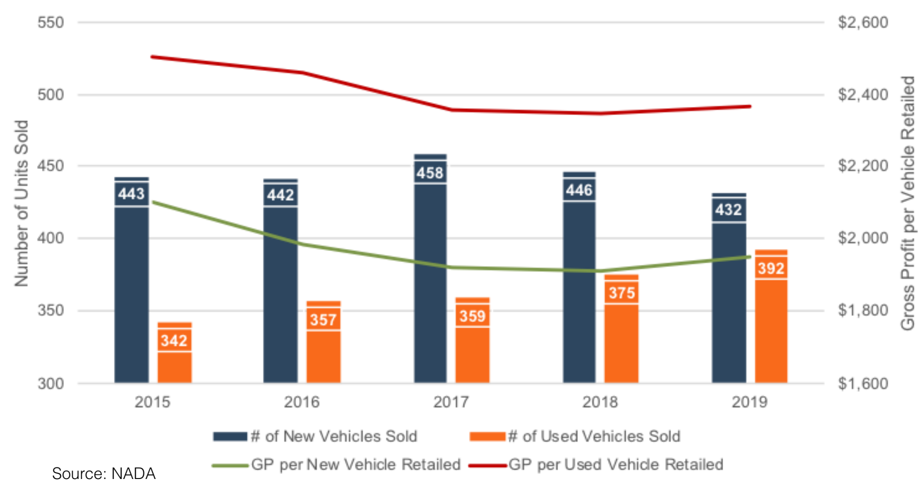
Gross Profit by Segment



Source: NADA

Like domestic dealers, mass market dealerships have seen declining new car sales as consumers increasingly choose used vehicles. While this generally leads to lower revenues, dealerships across all types tend to earn a higher gross profit per vehicle, so this shift in consumer preferences does not necessarily harm auto dealers. Still, mass market dealers sell more new cars and trucks than used. Gross profit per vehicle has followed the same general pattern for mass market dealerships with a general decline since 2015, buoyed by an increase in the first half of 2019.

New and Used Vehicles Sold and Gross Profit per Unit



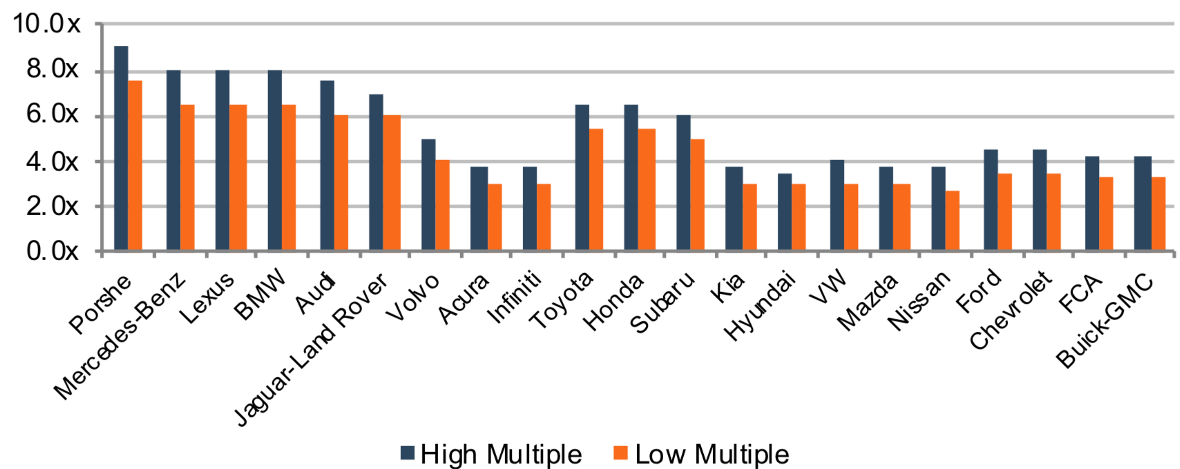
Source: NADA

Blue Sky Multiples

Blue sky multiples come from the Haig Report and are calculated as a multiple of adjusted pre-tax profits. The ranges are an expression of what buyers in a competitive situation will pay for the goodwill of dealerships. Dealerships that are underperforming or in desirable markets will have high multiples while those that are over-performing, are in less desirable markets, or have significant real-estate issues will have lower multiples. In some cases, only a franchise value range is reported, indicating underperforming brands that potentially have negative earnings for which a pre-tax multiple would be non-meaningful.

Blue Sky Multiples for Q2 2019 are largely unchanged from year-end figures, as is frequently the case. Declines tended to be on the domestic side while there were some reintroductions and bifurcating of brands on the luxury end.

Q2 2019 Blue Sky Multiples

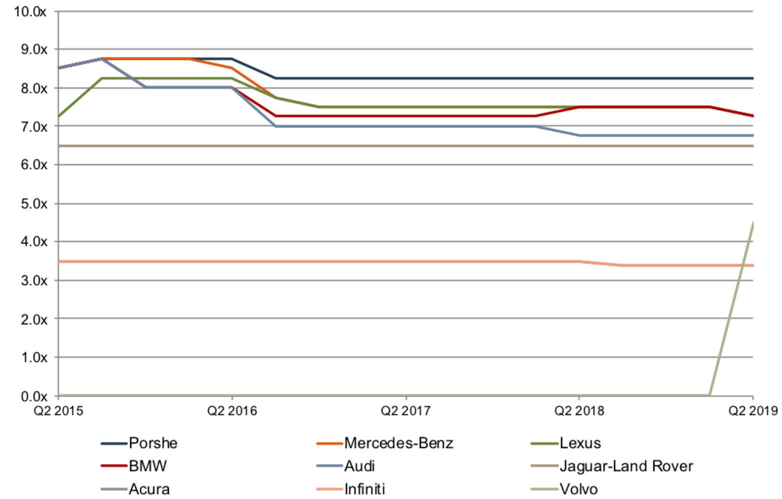


Source: Haig Report

Blue Sky Multiples History

Luxury Blue Sky History

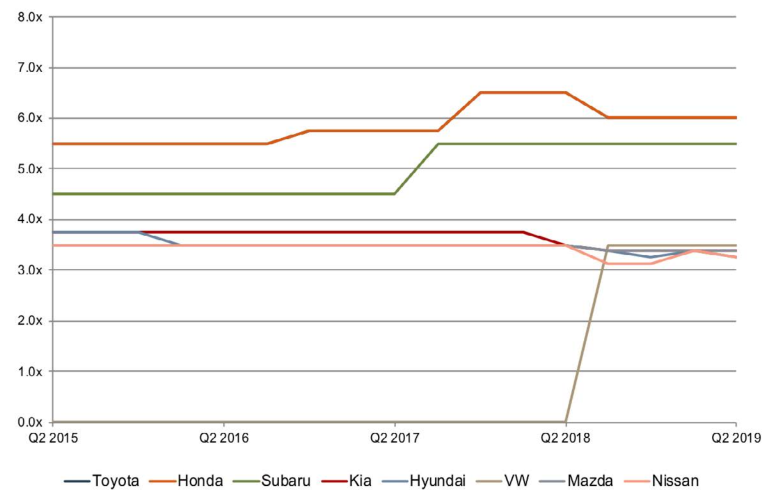
Luxury Blue Sky Multiples for Q2 2019 were largely unchanged from year-end figures. A multiple range of 4-5x was introduced for Volvo after years of only reporting a franchise value, leaving Cadillac as the only reported brand without a multiple. Haig Partners also continued its trend of reporting brands individually by reporting separate figures for Acura and Infiniti, though they continue to have the same multiple range.



Source: Haig Report

Mid-Line Import Blue Sky History

Mid-Line imports generally receive lower multiples than high line, though Toyota, Honda, and Subaru do outpace some of the less popular luxury brands. Nissan dealerships are seeing a higher top-end multiple in 2019, though still below Q2 2018. Otherwise, this segment has largely been steady.



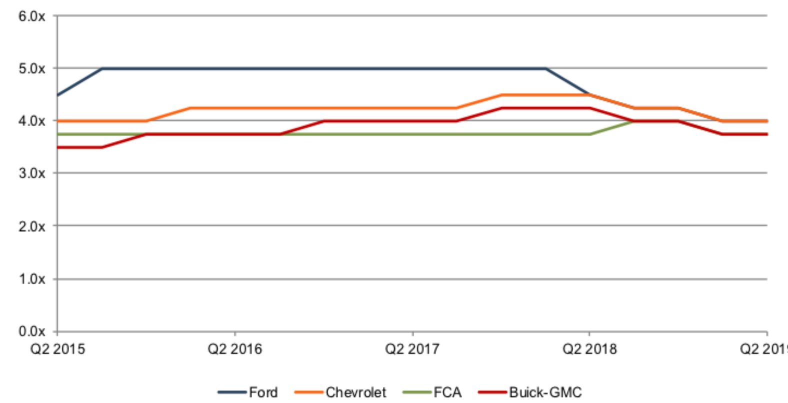
Source: Haig Report

Blue Sky Multiples History

(continued)

Domestic Blue Sky History

Unlike luxury and midline imports, domestic franchise Blue Sky multiples all modestly declined as Ford and Chevy dropped to 3.5x-4.5x and Buick-GMC and FCA each dropped to 3.25x-4.25x. Year-to-date sales were down for each of these franchises of dealerships.



Source: Haig Report

Mercer Capital

Auto Dealer Industry Services

Mercer Capital has expertise providing business valuation and financial advisory services to companies in the auto dealer industry.

Mercer Capital provides business valuation and financial advisory services to auto dealerships throughout the nation. We provide valuation services for tax purposes, buy-sell agreements, partner buyouts, and other corporate planning purposes. Mercer Capital also works with owners who are considering the sale of their dealership or the acquisition of other dealership(s).

Services Provided

- Valuation of auto dealer industry companies
- Transaction advisory for mergers, acquisitions and divestitures
- Valuations for purchase accounting and impairment testing
- Fairness and solvency opinions
- Litigation support for economic damages and valuation and shareholder disputes

Contact a Mercer Capital professional to discuss your needs in confidence.

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