VALUE FOCUS

Auto Dealer Industry

Year-End 2018

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**.

Measuring Up: Sorting Through the Puzzle of Dealership Metrics and Performance Statistics

In the first two issues of this newsletter, we discussed general valuation methodology and value drivers behind store valuations. This issue explains dealership metrics and performance statistics–what they mean, how to evaluate them, and where a particular store stacks up.

As always, performance measures are relative. We are relying upon averages provided by NADA as well as our experience working with auto dealers.[1]

A few key terms help frame our discussion:

- **Variable operations** refers to new vehicle department, used vehicle department, finance & insurance department, excluding warranty sales
- **Fixed operations** refers to service department (including warranty), parts department, and body shop where applicable
- **Front-end gross margin** refers to the gross profit margin realized on the sale of new and used vehicles; front-end margin typically varies in amounts between new and used vehicles depending on the franchise and types of cars being sold
- **Domestic dealerships as defined by NADA** typically consist of Ford, General Motors, and Chrysler/Dodge/Jeep/Ram/Fiat (FCA)
- **Luxury dealerships as defined by NADA** typically consist of Acura, Audi, BMW, Infiniti, Jaguar/Land Rover, Lexus, Mercedes Benz, Porsche, and Volvo
- **Import dealerships** typically consist of Acura, Audi, BMW, Hyundai, Infiniti, Jaguar/Land Rover, Kia, Lexus, Mazda, Mercedes Benz, Mitsubishi, Nissan, Porsche, Subaru, Toyota, Volkswagen, and Volvo
- **Mass market dealerships as defined by NADA** typically consist of Chrysler/Dodge/Jeep/Ram/Fiat (FCA), Ford, General Motors, Honda, Hyundai, Kia, Mitsubishi, Mazda, Subaru, Toyota and Volkswagen
- **High-line or ultra high-line dealerships** may consist of Lamborghini, Rolls Royce, Bentley, Aston Martin, Lotus, McLaren, Maserati, etc.

[1]The data and discussion are based generally on average dealership profiles and do not pertain specifically to domestic dealerships, import dealerships, ultra high-line dealerships, etc. Specific types of dealerships and their regional location could have different performance metrics and criteria.

Measuring Up: Sorting Through the Puzzle of Dealership Metrics and Performance Statistics

(continued)

Specifically, we are relying upon information from the average dealership profile for 2017 and 2018 from NADA.[2]

New Vehicle Department

For the average dealership profile, our experience has been that this department comprises between 50% - 60% (58% for 2017-2018 per NADA) of total gross sales. The front-end gross margin on new vehicles can vary over time and is somewhat controlled by the manufacturer. Typically, dealerships track and measure front-end gross margin on a per unit basis and can evaluate the overall performance of that figure by comparing it to prior years. Most domestic, import, or luxury dealerships experience a lower front-end gross margin on new vehicles than on used vehicles. Conversely, most high-line dealerships experience a higher front-end gross margin on new vehicles than on used vehicles.

New vehicles generally have a higher average retail selling price, lower front-end gross margins, and sell fewer units than used vehicles. These factors result in new vehicles comprising approximately 25% of total overall gross profits for an average dealership.

Used Vehicle Department

For the average dealership profile, our experience has been that this department comprises between 25% - 40% of total gross sales. These percentages can vary depending on franchise/dealership type and regional location. Like new vehicles, dealerships also track front-end gross profits on used vehicles on a per unit basis. Most domestic, import, or luxury dealerships experience a higher front-end gross margin on used vehicles than on new vehicles.

The sale of used vehicles should not be overlooked when assessing the value of a dealership. More often than not front-end gross margins on used vehicles will be higher than new vehicles. Additionally, the sale of both new and used vehicles put more cars in service and help drive profitability to fixed operations (to be discussed in next section). Based on our experience valuing new car dealerships, the range of used retail vehicles sold to new retail vehicles sold is 1.00 to 1.25. This figure can vary by dealership and can also be quite cyclical throughout the year. Further, our experience shows this ratio can climb to 1.5 to 1.6 when considering dealerships with successful wholesale used vehicle sales.

Used vehicles generally have a lower average retail selling price, higher front-end gross margins, and sell more units than new vehicles. These factors result in used vehicles comprising approximately 25% of total overall gross profits for an average dealership, or about even with the total overall gross profit contribution from new vehicles.

[2] It's important to note that other national sources of Blue Sky multiple data (Haig Partners and Kerrigan Advisors) classify the categories of dealerships slightly different from NADA, so all comparisons and discussion should be done in general terms.

Measuring Up: Sorting Through the Puzzle of Dealership Metrics and Performance Statistics

(continued)

Fixed Operations

The long-term success of a dealership's fixed operations is often tied to their effectiveness in selling new and used vehicles over time. These activities help to build brand in a market. Another critical factor in the success and level of profitability in the fixed operations is the auto industry cycle. In our last issue, we discussed the cyclicality of the industry not only in terms of certain months during the year, but also year-over-year.

Two such indicators of the auto industry life cycle are the SAAR and the average age of car. **As shown on page 14**, the monthly SAAR began to level off in late 2018 and into the first few months of 2019 (despite a slight spike in March 2019) evidencing slower new light vehicle sales. Additionally, **per our previous newsletter,** the average age of cars in service was approximately ten years.

Both factors foreshadow that fixed operations of successful dealerships should experience an uptick in the short-term and mitigate the moderate/sluggish new vehicle sales. When customers hold onto their cars longer, they are less likely to spend money on a new or used vehicle, but their maintenance needs on their current vehicle will likely increase.

For the average dealership profile, our experience suggests that the service department comprises between 10% - 15% of total gross sales. However, this department is typically the most profitable in terms of a percentage of sales. The combination of much higher margins on lower sales results in the service department averaging 45% - 50% of total gross profits, or a much higher contribution level than new or used vehicles.

Conclusion

All dealerships are not created equally. This article is a general discussion on various dealership metrics and performance statistics. Each statistic is relative and not to be viewed in a vacuum. Hopefully, we have provided a better understanding of the various departments, including fixed vs. variable operations and their contribution to overall profitability and eventual value of a store. A graphic display of historical profitability and other metrics are discussed later in the newsletter.

For an understanding of how your dealership is performing along with an indication of what your store is worth, contact us. We are happy to discuss your needs in confidence.

Scott A. Womack, ASA, MAFF
womacks@mercercapital.com | 615.345.0234

NADC Spring Conference Recap

I recently attended the 2019 Spring Conference of the **National Auto Dealers Counsel** (NADC) in Dana Point, California. This article provides a couple of key takeaways from the day and a half sessions on the current conditions in the industry.

Vehicle Subscription Services

Car subscription services are becoming a popular alternative to leasing. Each service varies in structure and is operated by dealers, manufacturers, and third parties.

Some offer reasonable traditional leases or allow customers to make monthly payments, but allow more flexibility/frequency in swapping vehicles for changing preferences and needs.

Some manufacturers are only initially offering subscription services regionally, or in specific markets (BMW and Mercedes-Benz are offering vehicle subscription services in the Nashville market).

Effect of Tariffs on New Vehicle Cost Differences

There has been a lot of talk in the news recently about impending tariffs in the auto dealer industry. Many unknowns and questions remain—Will President Trump enact tariffs? How will they affect the auto industry?

The Center for Automotive Research Report has compiled statistics to show the likely effects of tariffs on new/used vehicle pricing, estimated losses for dealers, and projected employment and GDP loss (as seen below). With so much at stake, the auto dealer industry will keep a close eye on monitoring any new developments.

Average Price Increase / All Vehicles	Average Price Increase / Imported Vehicles	Average Price Increase / Domestic Vehicles	Sales Loss (in Units)	Dealership Revenue Loss	Dealership Employment Loss	Total U.S. Employment Loss	GDP Loss
$2,750	$3,700	$1,900	1,319,700	$43.62B	77,000	366,900	$30.4B

Source: Center for Automotive Research Report

NADC Spring Conference Recap

(continued)

Tax Reform Act – Pass Through Entities vs. C Corporations

Amid the many changes that have resulted from the recent tax reform (the Tax Cuts and Jobs Act (TCJA)), here are a few directly impacting the auto dealer industry:

» **Interest Expense Deduction** – Auto dealers are allowed to deduct total interest expense (including floor plan interest) up to 30% of their adjusted taxable income ("ATI") and still recognize bonus depreciation on their qualified tangible property. If total interest expense is less than 30% of ATI, then the full amount is deductible along with bonus deprecation. If total interest expense is greater than 30% of ATI, auto dealers can deduct the full amount of interest expense, but lose the recognition of the bonus depreciation.

» **Sale/Dissolution Planning** – During the year of a potential sale, auto dealers should understand the ramifications of closing the sale earlier in the year versus later in the year. An earlier sale in the year could limit the wages for that year's tax return that could offset a large ordinary income event from LIFO and depreciation recapture and other ordinary income. Whenever possible, contact your accountant or tax planning consultants to discuss the timing of a proposed sale.

» **Pass Through Entities vs. C Corporations** – While there are many other legal considerations for choosing your entity structure, the TCJA has had an impact on the valuation of C Corporations. Specifically, the value of C Corporations has increased by approximately 15%, all other factors, due to the decline in the corporate tax rates. To learn more about the impact of the changing corporate tax rates on C Corporation valuations, **read this recent article.**

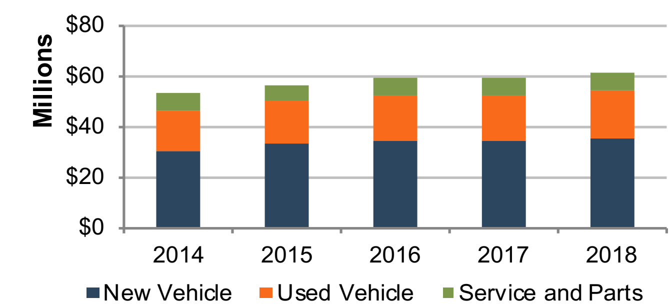
Scott A. Womack, ASA, MAFF
womacks@mercercapital.com | 615.345.0234

Average Annual Auto Dealer Profile

Average total sales per dealership increased 2.6% in 2018, driven by new vehicles, which make up approximately 58% of total sales. Used vehicles experienced 4.7% revenue growth while service and parts grew just 1.8%. The used-to-new ratio of average retail per dealership is up to 79.8% at the end of 2018, higher than previous years, but lower than the 85.9% figure seen midway through the year. However, it should be noted this figure has been higher during June than December in each of the last three years, demonstrating a seasonal impact at play.

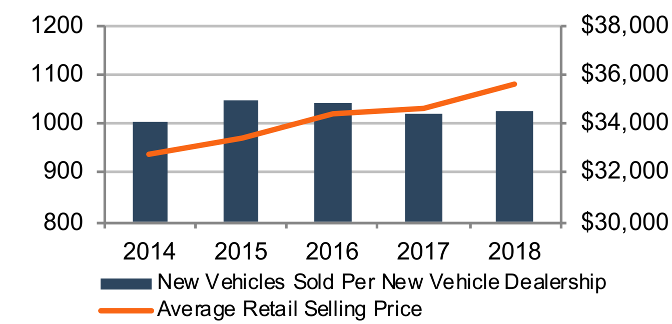
The number of new vehicles sold per new vehicle dealership edged up in 2018, but remains below levels seen in 2015 and 2016. Growth in average retail selling price for new cars has continued its upward trend, increasing 2.7% in 2018 to $35,608. Over the past five years, the average retail selling price for new cars increased at an average annual rate of 2.1%. Average retail selling price for used cars was $20,586, or approximately 58% of the price for a new car.

Total Sales of Average Light Vehicle Dealer



Source: NADA

New Vehicles Sold Per New Dealership



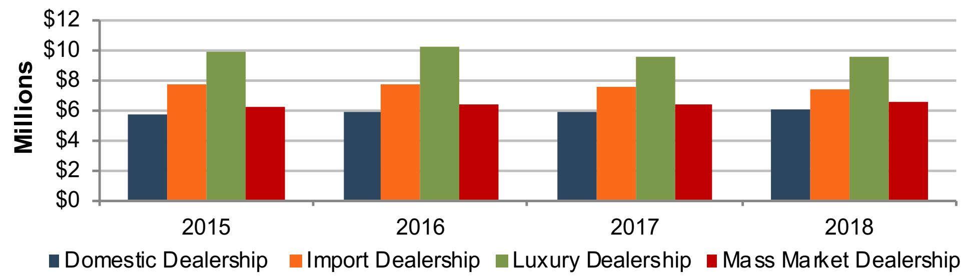
Source: NADA

Domestic, Import, Luxury, Mass Market Dealerships

Gross profits were mixed in 2018, with increases for domestic (+3.3%) and mass market (+1.5%) dealerships and slight declines from import (-0.2%) and luxury (-0.2%) dealerships. As expected, luxury dealerships continue to have the highest average gross profit, followed by imports.

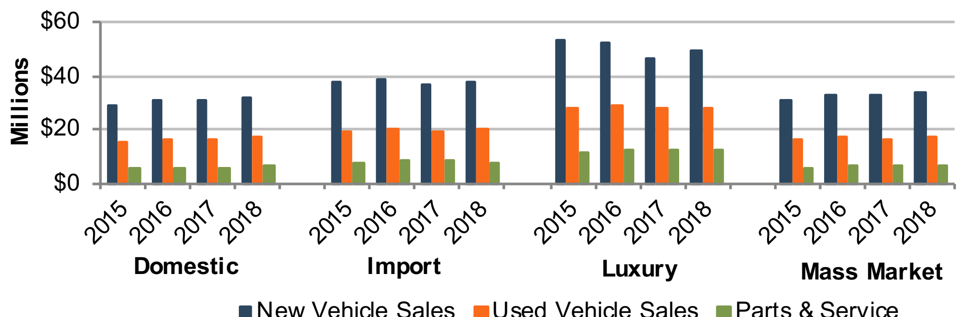
Average new and used car sales are up across all categories, with new car sales increasing the most for luxury dealers (5.4%) and the least for mass market (2.0%). This flips for used cars as mass market dealers increased the most (5.3%) and luxury the least (2.1%). Similar to the trend seen with gross profit, average service revenues were up for domestic (7.7%) and mass market (2.4%) dealers, but down for import (-1.8%) and luxury dealerships (-0.7%).

Gross Profit



Source: NADA

Vehicle Sales by Segment



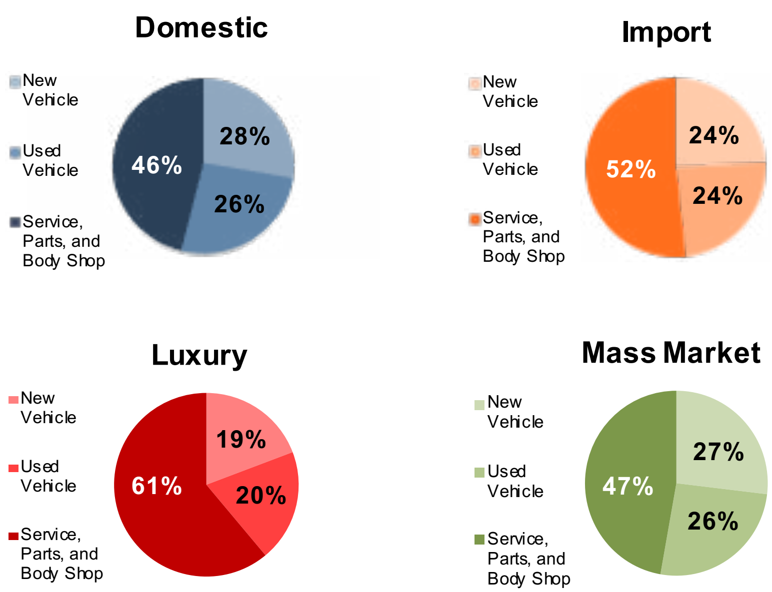
Source: NADA

Domestic, Import, Luxury, Mass Market Dealerships

(continued)

Segmentation of gross profit for year-end 2018 was relatively consistent with 2017. The largest change across all categories was domestic service and parts increasing from 44% to 46% as new and used each declined as a percentage of gross. New vehicles declined as a percentage of gross across all categories while used vehicles edged up for imports and luxury. Luxury continues to get the largest percentage of its gross from services outside of vehicle sales as the inverse relationship between vehicle retail cost and percentage of gross from vehicle sales has continued across all types of dealerships.

Total Gross Percentage Breakdown



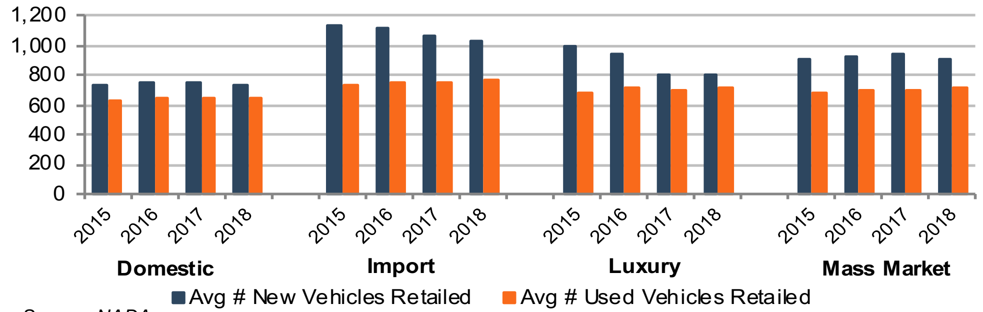
Domestic, Import, Luxury, Mass Market Dealerships

(continued)

The average number of used vehicles retailed increased across all categories as new vehicles all declined. With a higher mix of sales tilting towards new, the average number of vehicles sold declined for all but luxury dealerships, which had the lowest percentage of vehicles being new (52.6%). Imports had the largest decline in new cars retailed, yet it maintained the highest percentage of new vehicles sold in average selling prices.

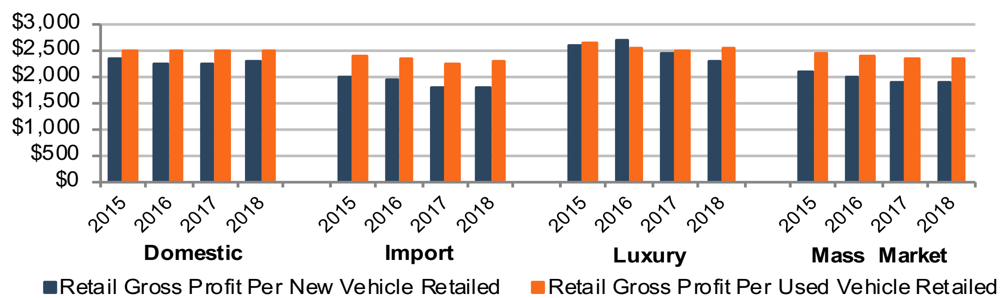
Average retail gross profit per vehicle sold continues to be higher for used cars than new, and this trend looks likely to continue as gross profit per vehicle increased more for used than new except for domestic dealerships. Retail gross profit has been trending down in recent years despite increases in average selling prices indicating tighter margins for dealerships.

Average Number of New and Used Vehicles Retailed



Source: NADA

Average Retail Gross Profit per Vehicle Retailed



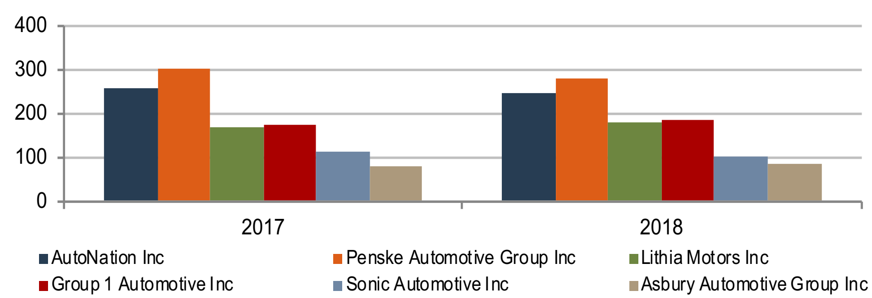
Source: NADA

Public Auto Dealers

After years of increases in the number of new car dealerships in the U.S. (albeit at a slower pace), 2018 saw a slight decrease to 16,794. Smaller operations continue to dominate the landscape, with 93.9% of owners owning between 1-5 dealerships. However, this figure has steadily trended downward, from 96.7% in 2009 as the industry's ownership has consolidated somewhat. In this time, owners with 11-25 dealerships have doubled their share from 0.8% to 1.6% and 6-10 have increased from 2.4% to 4.1%.

On the other end of the spectrum, public auto dealers are some of the largest in terms of number of dealerships, ranging from Penske Automotive Group Inc. with 280 to Asbury Automotive Group with 83. The only private company with this many is Hendrick Automotive Group with 96. Despite having the most dealerships, Penske actually decreased its number by 6.7% from last year's figure of 300. The largest percentage decline, however, came from Sonic Automotive Inc. whose 8 dealership decline represented a drop of 7.1%. AutoNation Inc. was the only other large public auto dealer to decrease its number of dealerships, though it still had by far the most new retailed units at nearly 311 thousand. The largest increase in number of dealerships came from Lithia Motors Inc., which narrowed the gap in dealership count with Group 1 Automotive Inc., but surpassed it in terms of new units retailed.

Total Number of Dealerships



Source: AutoNews

Public Auto Dealers

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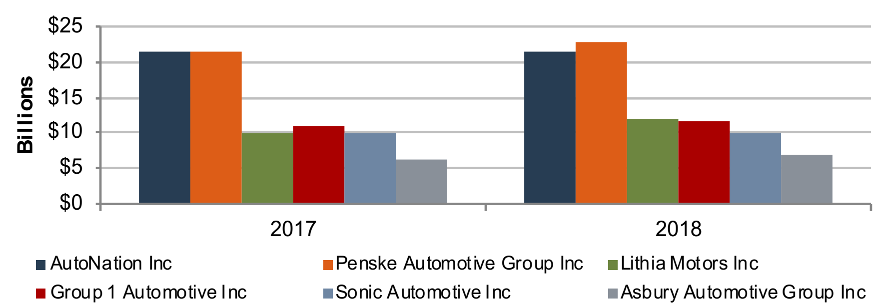
AutoNation was the only large public auto dealer to have negative revenue growth with a decline of 0.6%. Revenue growth of 6.5% for Penske was enough to see it surpass AutoNation for the top spot with $22.8 billion in sales. Lithia Motors saw the largest percentage increase in revenue at 17.2%, though its $11.8 billion in sales is just over half that of Penske. Sonic had the slowest revenue increase at 0.9% likely due to its declining number of dealerships as previously noted. Group 1 Automotive and Asbury Automotive Group each saw steady increases with Group 1 having stronger dealership growth but Asbury having a higher revenue increase.

Public Auto Dealer Revenues



Source: AutoNews

Public Auto Manufacturers

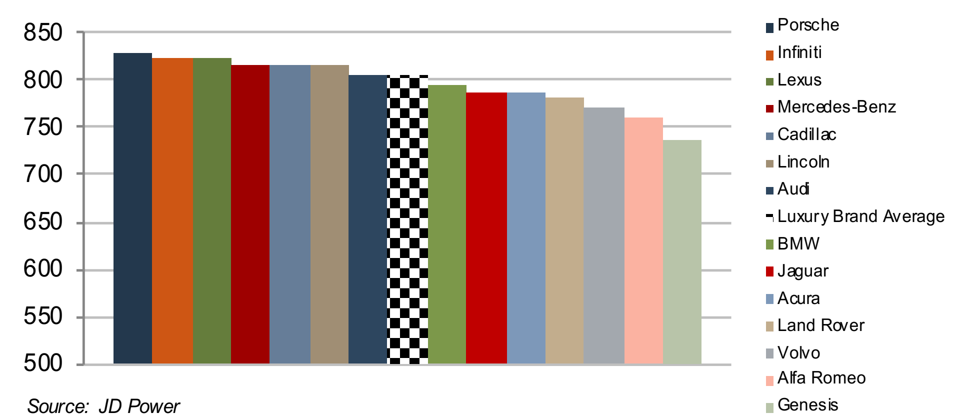
JD Power Sales Satisfaction Index (SSI)

Every year, JD Power releases the Sales Satisfaction Index Study, measuring satisfaction with the sales experience among new-vehicle buyers and rejecters (defined as those who shop a dealership and purchase elsewhere). Buyer satisfaction is based on six measures: dealer personnel (28%), delivery process (21%), "working out the deal" (18%), paperwork completion (16%), dealership facility (13%), and dealership website (4%). Rejecter satisfaction is based on five measures: salesperson (40%); fairness of price (15%); experience negotiating (15%); variety of inventory (15%); and dealership facility (14%). Scoring is based on a 1000 point scale and is based on a survey of 25,748 participants.

For luxury vehicles, Porsche and Audi were the highest gainers, edging up 10 points, putting Porsche at the top with 828, and bringing Audi in line with the 804 average. After being tied at the summit in 2017 with 830, both Mercedes-Benz and Lincoln plummeted, dropping to 815 and 814, respectively. Overall, the luxury brand average declined slightly in 2018 from 806 to 804. Genesis continues to be at the bottom, dropping a further 7 points to 736.

For mass market vehicles, MINI had the highest SSI at 798, which was below the average score for luxury vehicles. MINI received the top spot despite a decline from 2017 because Buick fell much further, from 808 to 792. This was not the largest decline, however, as Mitsubishi dropped 17 points to a score of 755. Still, this was higher than Kia who brought up the rear for the second straight year. Ford, Ram, Chrysler, and Jeep all had double digit increases, likely playing a role in the mass market average increasing from 766 to 771.

Sales Satisfaction Index (SSI) - Luxury

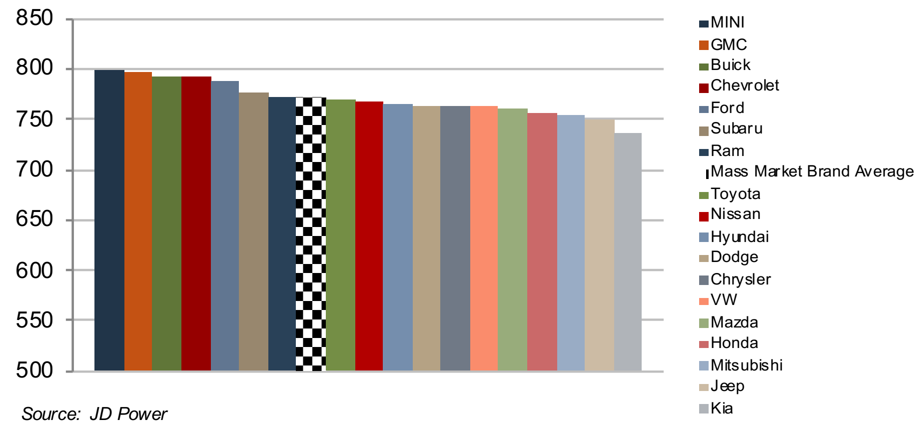


Source: JD Power

Public Auto Manufacturers

JD Power Sales Satisfaction Index (SSI)

Sales Satisfaction Index (SSI) - Mass Market

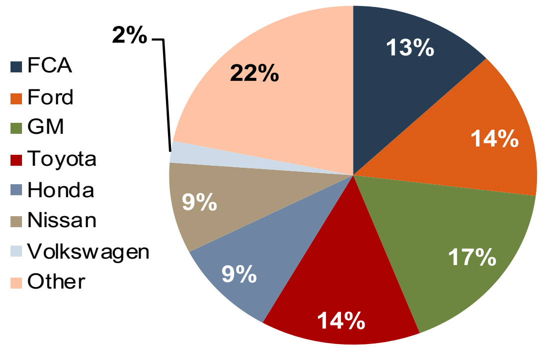


Source: JD Power

Market Share

Market share has remained relatively static in 2018. Volkswagen declined from 4% of the market in 2017 to 2% at the end of 2018, which was absorbed by the "other" category which continues to have the highest sales, followed by GM and Ford.

New Light Vehicle Market Share



Lightweight Vehicle Sales

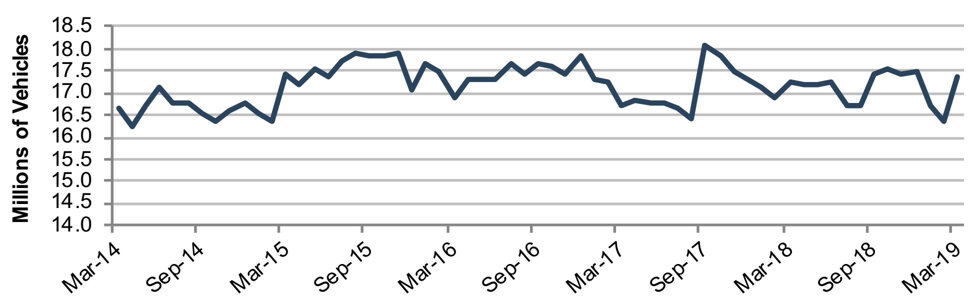
Auto and Light Trucks (SAAR)

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.

Despite numerous forecasts of SAAR dropping below 17 million in 2018, this did not come to fruition as it only dropped below 17 million in three of the twelve months in 2018. The total number of vehicles sold throughout the year was 17.2 million, up 0.5% from 2017. Consumers benefitted from the tax reform and a tight labor market throughout the course of the year. Declines in the stock market and gasoline prices had opposite effects in the fourth quarter, as the former lowered consumer wealth while the latter increased discretionary income. Gas prices are a gauge of the amount of money consumers have to spend in general, though it is even more closely tied to the automotive industry as lower gas prices make larger purchases on cars and trucks more palatable.

Since the beginning of 2019, both the stock market and gas prices have stabilized. The Fed's recent indication that there would be fewer rate hikes than initially expected in 2019 will likely aid sales going forward. The year got off to a slow start due in part to the government shutdown and poor weather conditions. In March, however, SAAR posted a strong 17.48 million units due in large part to gains in light truck segments. This brought the first quarter SAAR up to 16.94 million, though NADA still expects sales to decline to 16.8 million for the year.

Lightweight Vehicle Sales: Autos and Light Trucks, Seasonally Adjusted Annual Rate



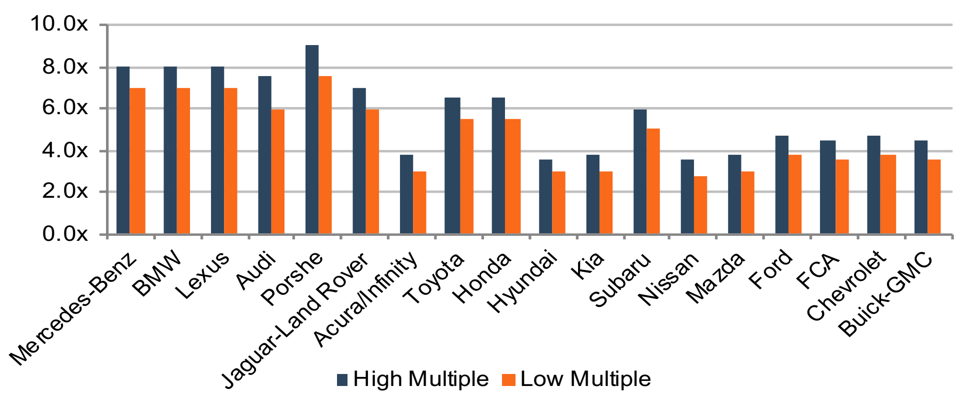
Source: FRED

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.*

Blue Sky Multiples for Q4 2018 are largely unchanged from mid-year figures, particularly for luxury vehicles, where only Acura/Infinity saw a slight decline on its top-end multiple. Porsche continues to lead the way in the 7.5x-9.0x range, while Acura/Infinity is around 3.0x-3.75x.

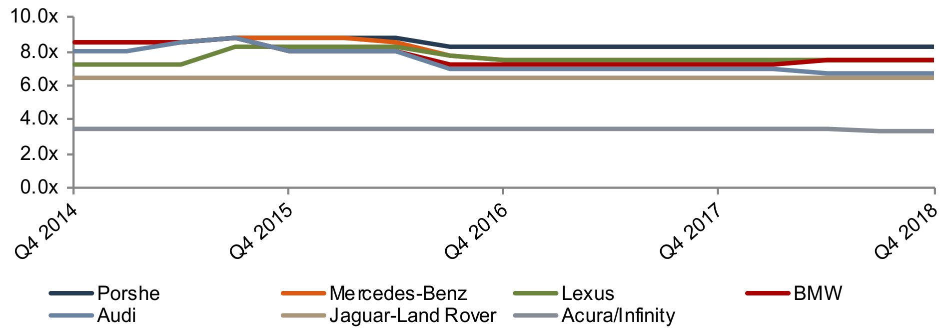
Q4 2018 Blue Sky Multiples



Source: Haig Report

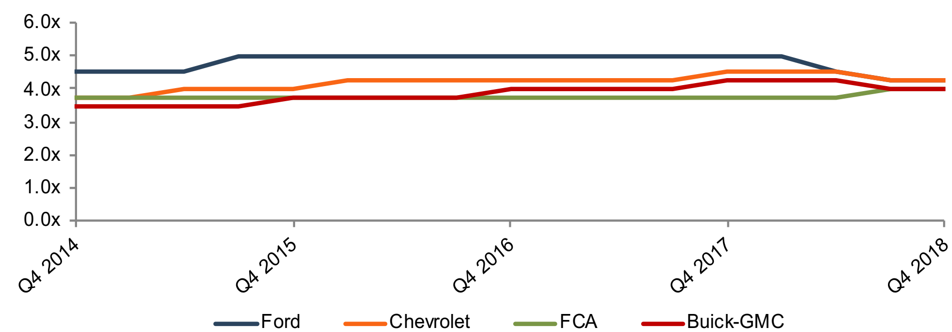
Blue Sky Multiples History

Luxury Blue Sky History



Source: Haig Report

Domestic Blue Sky History



Source: Haig Report

Blue Sky Multiples History

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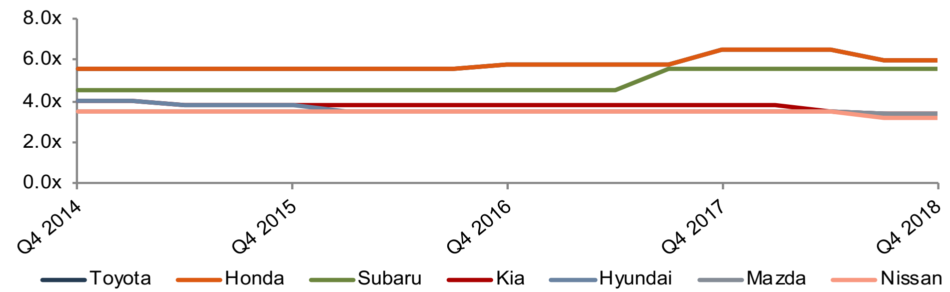
Midline-Import Blue Sky History



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.

Contact Us

Scott A. Womack, ASA, MAFF
615.345.0234
womacks@mercercapital.com

Nicholas J. Heinz, ASA
901.685.2120
heinzn@mercercapital.com

David W. R. Harkins
615.345.0272
harkinsd@mercercapital.com

MERCER CAPITAL
www.mercercapital.com

Mercer Capital

www.mercercapital.com