

VALUE FOCUS

Auto Dealer Industry

Year-End 2017



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Mercer Capital is a large valuation and financial advisory firm with offices in Memphis, Dallas, and Nashville. 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 seek to 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.

Automobile Dealership

Valuation 101

Valuation of a business can be a complex process requiring certified business valuation and/or forensic accounting professionals. Valuations of automobile dealerships are unique even from valuation of manufacturing, service, and retail companies. Automobile dealership valuations involve the understanding of industry terminology, factory financial statements, and hybrid valuation approaches. For these reasons, it's important to hire a business valuation expert that specializes in automobile dealership valuation and not just a generalist business valuation appraiser.

Terminology

Blue Sky

Unlike most valuations used in the corporate or M&A world, cash flow metrics such as Earnings Before Interest, Taxes, and Depreciation ("EBITDA") are virtually meaningless in automobile dealership valuations. Instead, this industry communicates value in terms of Blue Sky value and Blue Sky multiples. What is Blue Sky value? Any intangible/goodwill value of the automobile dealership over/above the tangible book value of the hard assets is referred to as Blue Sky value. Typically, Blue Sky value is measured as a multiple of pre-tax earnings, referred to as a Blue Sky multiple. Blue Sky multiples vary by franchise/brand and fluctuate year-to-year.

Dealer Financial Statements

Another unique aspect of automobile dealership valuations is the reported financial statements. Unlike valuations in other industries where the preferred form of financial statements might be audited/compiled or reviewed financial statements, most reputable valuations of automobile dealerships rely upon the financial statements that each dealer reports to the franchise/factory, referred to as Dealer Financial Statements. Why are Dealer Financial statements preferred? Dealer Financial statements provide much more detailed information pertaining directly to the operations of the dealership than any audited financial statement. Valuable information includes the specific operations and profitability of the various departments including, new vehicle, used vehicle, parts and service, and finance and insurance. Each department is unique and has a different impact on the overall success and profitability of the entire dealership. Automobile dealerships are required to report these financial statements to the factory on a monthly basis. However, an experienced business valuation expert knows to request the 13th month dealer financial statements. If a year only has twelve months, then what are the 13th month dealer financial statements? The 13th month dealer financials typically include the year-end tax adjustments such as adjusting the value of new/used vehicles to fair market value by reflecting current depreciation and other adjustments.

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Valuation Approaches

Asset-Based Approach

The asset-based approach is a general way of determining a value indication of a business or a business ownership interest using one or more methods based on the value of the assets net of liabilities. Asset-based valuation methods include those methods that seek to adjust the various tangible and intangible assets of an enterprise to fair market value. In automobile dealership valuations, the asset method is utilized to establish the fair market value of the tangible assets. This value is then combined with a Blue Sky "market" approach to conclude the total fair market value of the automobile dealership.

Income Approach

The income approach is a general way of determining a value indication of a business or business ownership interest using one or more methods that convert anticipated economic benefits into a single present amount.

The income approach can be applied in several different ways. Valuation methods under the income approach include those methods that provide for the direct capitalization of earnings estimates, as well as valuation methods calling for the forecasting of future benefits (earnings or cash flows) and then discounting those benefits to the present at an appropriate discount rate. The income approach allows for the consideration of characteristics specific to the subject

business, such as its level of risk and its growth prospects relative to the market.

How is the income approach unique to the automobile dealership industry? First, projections are rarely produced or tracked by automobile dealers, so historical capitalization methods are mostly used. Second, most automobile dealerships are dependent on the national economy, and sometimes to a larger degree, their local economies. This is important because business appraisers need to analyze and understand the dependence of each dealership to the national and local economy which usually affects the seasonality/cyclicality of operations and profitability. Once again the automobile dealership is unique in that it can experience seasonal/cyclical fluctuation in a given year, or more importantly, it fluctuates over a longer period of more like five-to-seven years.

Market Approach

The market approach is a general way of determining the value indication of a business or business ownership interest 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

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of a valuation subject is also a method under the market approach.

In the automobile dealership industry, traditional market approaches are basically meaningless. While there are a few publicly traded companies in the industry, they are large consolidators and own numerous dealership locations of many franchises in many geographic areas. Private transactions exist, but generally not in a large enough sample size of the particular franchise to provide meaningful comparisons.

So, how does a business valuation expert utilize the market approach in the valuation of automobile dealerships? The answer is a hybrid method utilizing published Blue Sky multiples from transactions of various franchise dealership locations. Two primary national sources, Haig Partners and Kerrigan Advisors, publish Blue Sky multiples quarterly by franchise. As discussed earlier, these multiples are applied to pre-tax earnings and indicate the Blue Sky or intangible value of the dealership. When combined with the tangible value of the hard assets determined under the Asset Approach, an experienced business valuation expert is able to conclude a total value for the dealership using this hybrid approach and communicate that result as a multiple of Blue Sky that will be understood and accepted in the industry.

Normalizing Adjustments

Normalizing adjustments adjust the balance sheet and income statement of a private company to show the financial results from normal operations of the business and reveal a “public equivalent” income stream. Some typical areas of potential normalization adjustments in the automobile dealership industry include, but are not limited, to the following.

Inventories

Most dealerships report the value of their new and used vehicle inventories on a Last-In, First-Out (“LIFO”) basis. LIFO accounting allows the dealership to reduce the value of their inventories and pay fewer taxes. General valuation theory calls for inventories to be restated at First-In, First-Out (“FIFO”) basis. The FIFO adjustments affect both the balance sheet and the income statement. The inventory adjustment on the balance sheet generally raises the value of the inventory. On the income statement, the inventory adjustment affects the cost of goods sold, and ultimately, the gross profit margin.

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Officer/Dealer Compensation

Like all valuations, the compensation of the officer/dealer is important. Typically, a business valuation expert will review actual compensation paid and determine a replacement or market equivalent compensation level.

Rent

Most automobile dealership entities contain the operations of the dealership only and not the underlying real estate. Typically, the underlying real estate is owned by the dealer in a related entity. As such, the dealership pays rent to the related party entity. It's important for the business valuation expert to determine if the rental rate paid is equivalent with a market rental rate. Often, this rental rate is set to create additional profitability at either the dealership entity or the real estate entity.

Working Capital

Most factory dealer financial statements list the dealership's actual working capital, along with the requirements from the factory. It's important for the business valuation expert to assess whether the dealership has adequate working capital, or perhaps an excess or deficiency.

Fixed Assets

As discussed earlier, most dealerships do not own the underlying real estate. In those cases, most dealerships still report some cost value of land or leasehold improvements on their factory dealer financial statements.

It's important for the business valuation expert to determine who owns the real estate, and if not owned by the dealership, the value of the land and leasehold improvements needs to be adjusted, reflecting the true value of the tangible assets of the dealership.

Failure to properly assess and make this adjustment will skew the implied Blue Sky multiple on the concluded value for the dealership.

Other Income Items

Most factory dealer financial statements have a line item on the income statement for other income items/additions. This category can be a sizeable number for a dealership depending on its sales volume and level of profitability. The business valuation expert should determine the items that comprise this category and how likely they are to continue at historical levels.

Some common items that appear in this category include factory dealer incentives on sales volume levels for

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vehicles, factory dealer incentives for service performance, document/preparation fees on the sale of new and used vehicles, and additional costs for financing and other services sold as a part of the vehicle transaction referred to as PACKs.

Hiring a business valuation expert that specializes in this industry rather than a generalist business valuation appraiser can make all the difference in providing a reasonable valuation conclusion.

Conclusion

The valuation of automobile dealerships can be more complex than other valuations due to their unique financial statements, varying cost structures and profitability of departments, different terminology, and hybrid valuation methods.



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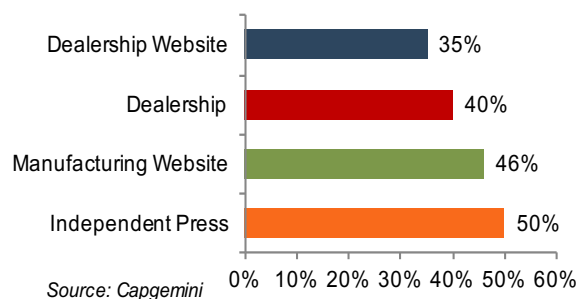
Year-End Highlights

Online Dealerships

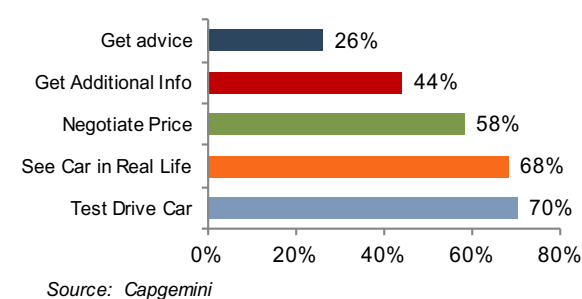
With the brick-and-mortar retailers already feeling the heat from online shopping platforms, the trend of moving to a completely digital way of shopping has hit almost every goods market. However, the auto industry so far is strikingly absent from the shift. With the world becoming so digitalized, the traditional way of buying a car through visiting a dealership, looking through all the cars on the lot, and haggling with a salesman seem outdated. Although purchasing from dealerships is still the primary way to buy a new vehicle, online car dealers are beginning to gain momentum in the market.

Further evidence of dealers going digital in the future is how consumers have shifted in the ways that they shop for a new vehicle. A survey done by Capgemini in 2017 found that 42% of consumers said they are “likely” or “very likely” to buy a car online in the future (up from 35% in 2015). This increase could be due to the changing ways consumers shop for cars. In 2015, the dealer/manufacturing websites and the dealerships themselves were the number one place consumers received information about vehicles. However, consumers are now relying on the independent press for information, meaning dealerships are becoming less important as an information source. However, consumers still visit dealerships to view and test drive cars. Online dealerships face the hurdle of convincing consumers to buy without test driving or seeing the car.

Sources Used Researching Next Car (2017)



Reasons for Visiting a Dealership (2017)



Average Annual Auto Dealer Profile

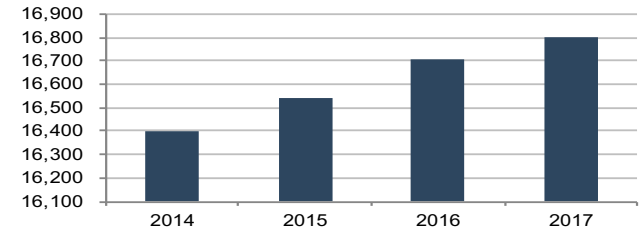
2017

The number of dealerships in the U.S. is continuing to increase every year, as a booming economy and job increases are making it easier for people to purchase cars. However, the increase in sales percent per year is beginning to decrease.

Although total sales have been increasing over the past 4 years, the rate of this increase is beginning to slow, with a percent growth from 2016 to 2017 being less than one percent. Although the industry is still profitable, the slowing rate could be pointing to a shift in auto dealer profitability in the coming years.

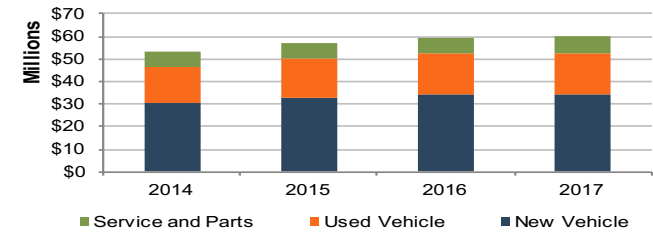
The number of new vehicles sold per new vehicle dealership plateaued in 2016 and then saw a small decrease (2%) in 2017. This decrease could be due to the average vehicle life continuing to increase, with the Department of Energy's latest reported age increasing to 11.6 years in 2016, and growth expected to continue. However, with average retail price up almost 1% from 2016, and service and parts revenue up 3%, auto dealers are still seeing relatively stable revenues.

Dealerships



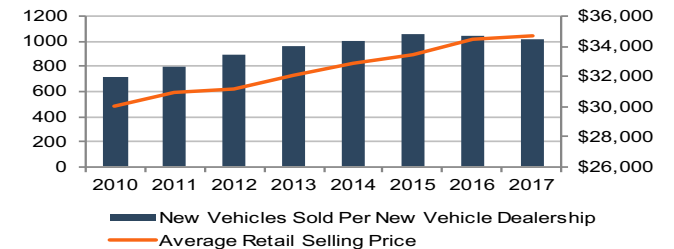
Source: NADA

Total Sales of Average Light Vehicle Dealer



Source: NADA

New Vehicles Sold Per New Dealerships



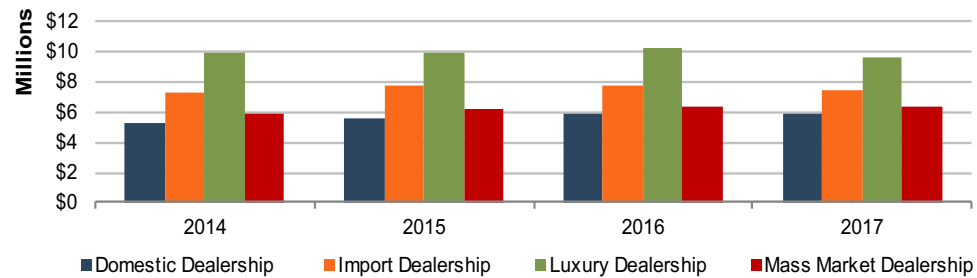
Source: NADA

Domestic, Import, Luxury, Mass Market Dealerships

Gross profits for domestic and mass market dealerships have remained relatively stable from 2016 to 2017. Luxury dealerships on the other hand have seen a decrease in gross profit of 5.5%, while import dealerships saw a decrease of almost 2%.

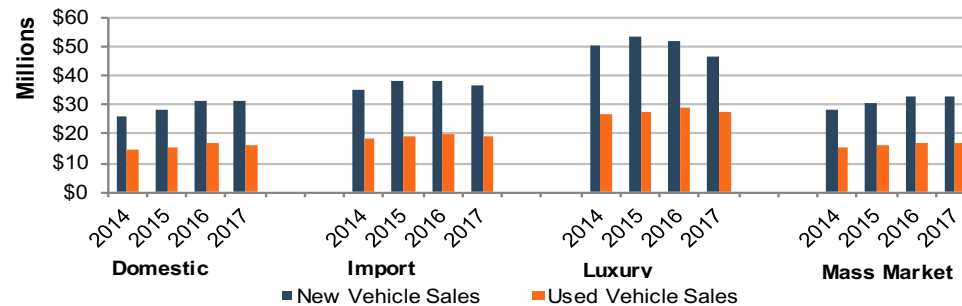
Vehicle sales for domestic dealerships were stable from 2016 to 2017, while their used vehicles sales dropped about 1%. Luxury dealerships saw the biggest decreases in new and used vehicle sales, decreasing 11% and 5.5% respectively. Import vehicles saw a decrease in new and used vehicles by 4% and 2%. Mass market vehicle sales remained relatively unchanged with a small increase in new vehicles and a small decrease in used.

Gross Profit



Source: NADA

Vehicle Sales Domestic, Import, Luxury, and Mass Market

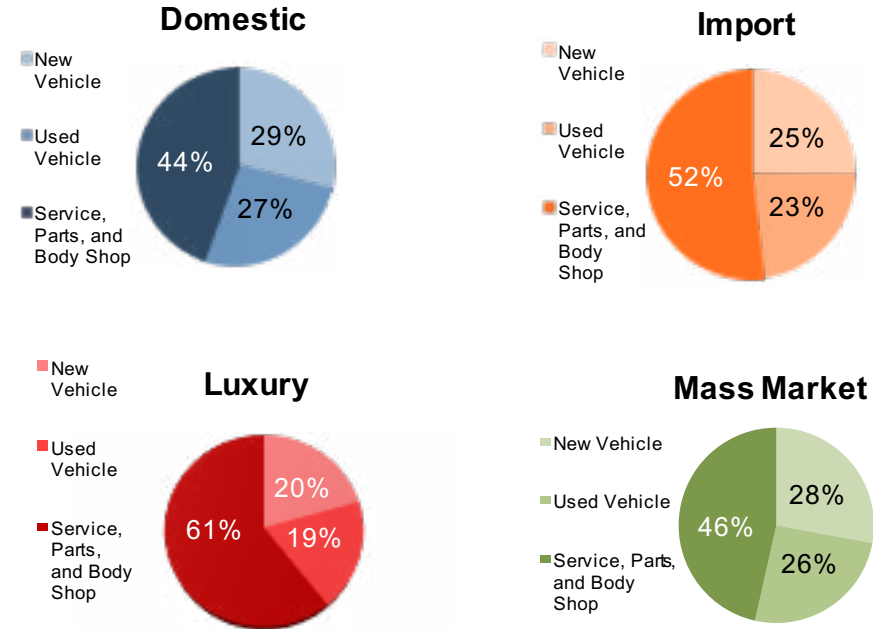


Source: NADA

Domestic, Import, Luxury, Mass Market Dealerships

Percent of total gross of both used vehicles and new vehicles have seen decreases across the board. The parts and services department and financing department growth are contributing to these decreased percentages, as well as increasing age of vehicles. For all of the different types of dealerships, the service and parts department's gross percentage is about half of total gross percentage for the dealerships.

Total Gross Percentage Breakdown

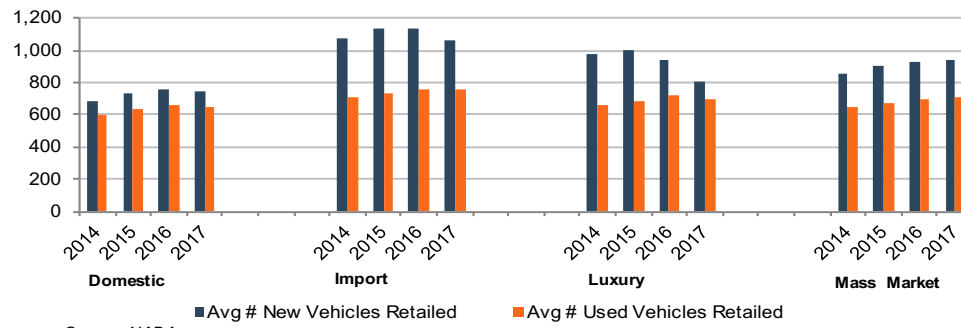


Domestic, Import, Luxury, Mass Market Dealerships

The average number of new and used vehicles retailed decreased across the board, except for mass market dealerships, which saw increases in new vehicles retailed for both new and used both by 1%.

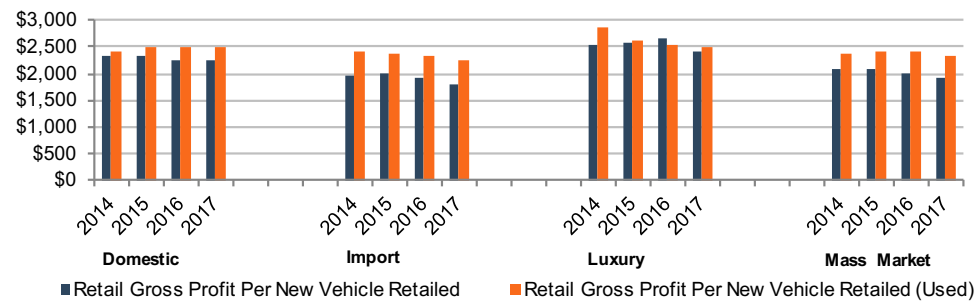
Retail gross profit decreased for both new and used vehicles in each category. The largest decrease (9%) was found in new luxury vehicles.

New and Used Vehicles Retailed



Source: NADA

Retail Gross Profit



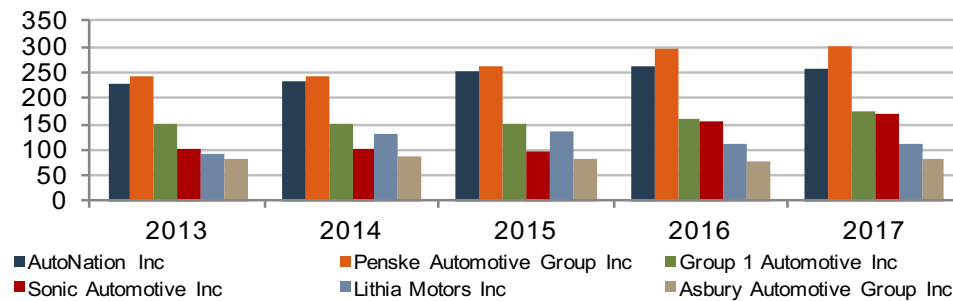
Source: NADA

Public Auto Dealers

All public auto dealerships saw an increase in the number of dealerships except for AutoNation, which had a slight decrease of two dealerships from 2016 to 2017. These increases come from mom and pop dealerships selling because they are no longer able to compete given decreasing profit margins on vehicles. When large auto dealers buy these shops, it gives them a competitive edge by increasing sales volume to counter the decreasing margins.

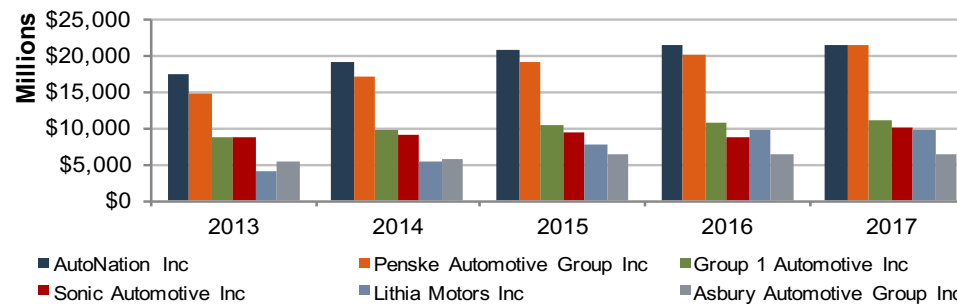
From 2016 to 2017, auto dealers saw increased revenues except for AutoNation and Asbury, with AutoNation's revenue plateauing and Asbury's seeing a decrease around 1%. Increases in revenue show that public auto dealers are turning over larger volumes to make up for decreasing profit margins.

Total Number of Dealerships



Source: AutoNews

Auto Dealer Revenues

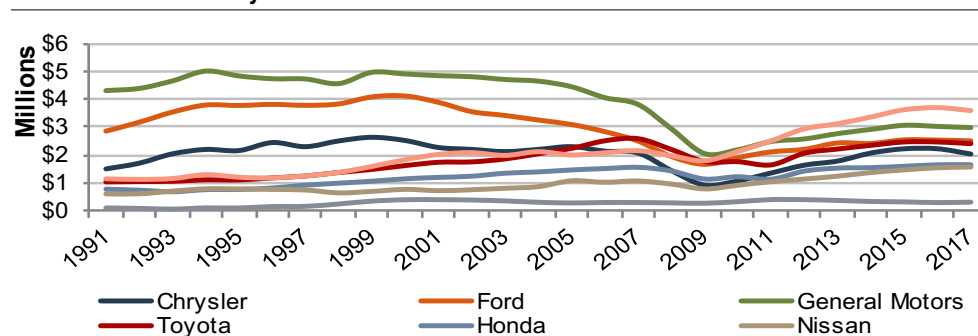


Source: AutoNews

Public Auto Manufacturers

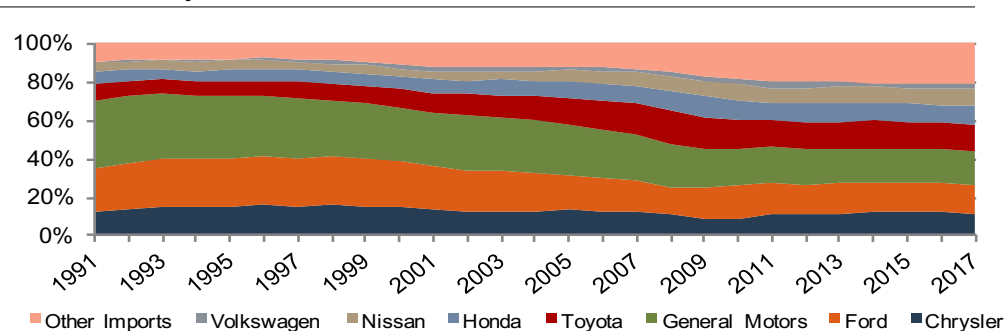
New vehicle sales saw its sharpest decrease in 2009 during the recession. Since then, there has been a trend of growth until the past two years, with sales starting to slump a bit across all manufacturers. The "other" category now has the highest sales, which means consumers are breaking away from the historically large and successful manufacturing companies. This can be seen in the second graph with other imports increasing from around 10% of the market share to nearly 20%. GM has the second largest percentage of the market share at 17.5%, followed by Ford at 14.7%.

New Vehicle Sales by Manufacturer



Source: NADA

Market Shares by Manufacturer



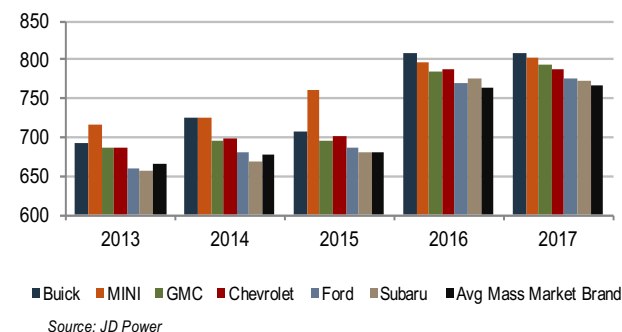
Source: NADA

Public Auto Manufacturers

Every year, JD Power releases the *Sales Satisfaction Index Study*, gauging the experience of customers that purchase and do not purchase vehicles from either a dealership or elsewhere. The JD Power website explains that satisfaction level is based on 6 criteria: dealer personnel (28%), delivery process (21%), working out the deal (18%), paperwork completion (16%), dealership facility (13%), and dealership website (4%). Rejected 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.

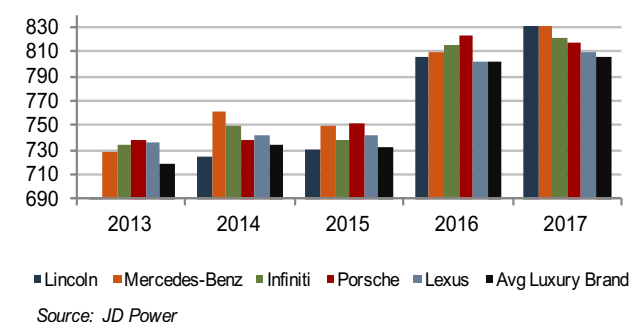
For mass market vehicles, Buick had the highest SSI at 808. Not far behind, MINI had a score of 803, followed by GMC at 793. Rounding out the top 5 were Chevrolet with a score of 788 and Ford with a score of 776. Buick, MINI, GMC, and Chevrolet were in the top 5 last year, but Ford managed to push out Subaru after gaining 6 points from the 2016. The average score for 2017 was 766, up 2 points from last year.

U.S. Sales Satisfaction Index (SSI)- Mass Market



For luxury vehicles, Lincoln and Mercedes-Benz tied for first with scores of 830, both up from last year. Infiniti was third with a score of 821, and the top 5 was rounded out with Porsche at 818 and Lexus at 810. Porsche dropped from first to fourth this year, dropping 6 points, while Lincoln gained 24 points to push them from sixth to first.

U.S. Sales Satisfaction Index (SSI)- Luxury

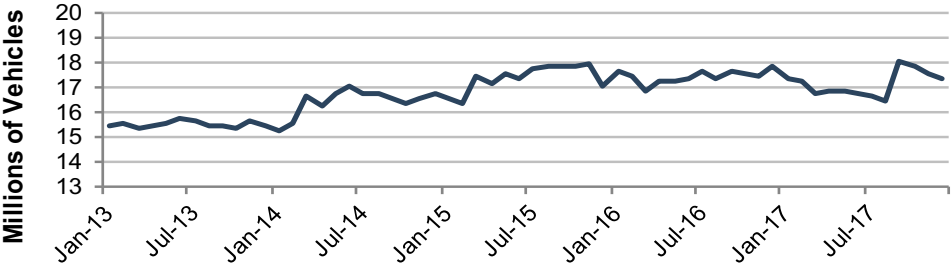


Light Weight Vehicle Sales: Auto and Light Trucks (SAAR)

Forecasts from Edmunds, Cox Automotive, NADA, and Toyota all place new U.S. vehicle sales below the 17 million threshold for 2018, which would be the first time in four years it dipped below this mark. A regression of about 2% in 2017 down to 17.2 million vehicles sold was the first decline since 2009, snapping a century old record of growth. It appears dealers are equipped to deal with this decline as revenue has more than compensated for volume declines. If this trend continues, however, dealers may feel margin pressure to drop prices or match the incentives offered at competing dealerships.

Edmunds' projection for 2018 is 16.8 million, while Cox's revised post-tax reform projection is 16.7 million. Toyota also projected in December 2017 that sales would be in the "mid-to upper 16 million" range. Despite the decline, it should be noted that this is still a good year, a point NADA was sure to make along with their projection of 16.7 million.

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



Source: FRED

Blue Sky Multiples

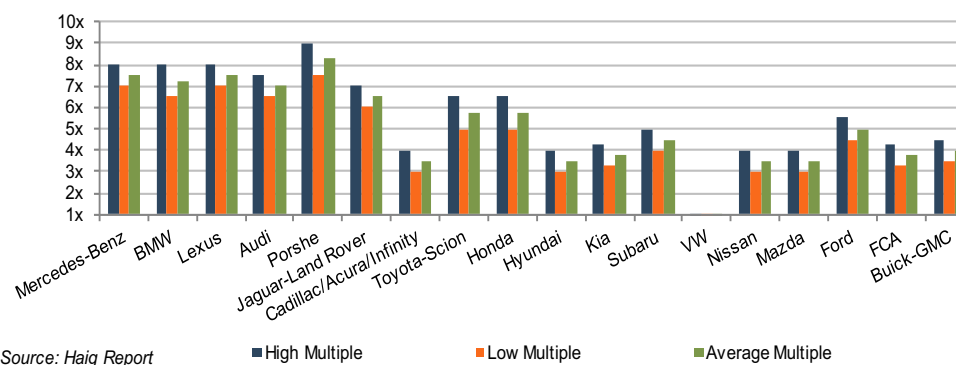
These Blue Sky multiples come from the Haig Report and are calculated as a multiple of adjusted pre-tax profits. The ranges are an expression of what buyers in a competitive situation will pay for the goodwill of dealerships. Dealerships that are underperforming or in desirable markets will have high multiples while those that are over-performing, are in less desirable markets, or have significant real-estate issues will have lower multiples.

Porsche currently has the highest Blue Sky multiple for luxury franchises (Mercedes-Benz, BMW, Lexus, Audi, Porsche, Jaguar-Land Rover, Cadillac/Acura/Infiniti) with an average of 8.25x, followed by Mercedes-Benz and Lexus who have averages of 7.5x. Cadillac/Acura/Infiniti has the lowest multiple range for luxury brands at 3.0x-4.0x.

For midline-imports (Toyota-Scion, Honda, Hyundai, Kia, Subaru, VW, Nissan, Mazda), Toyota-Scion and Honda have the highest multiples, both averaging 6.5x. The lowest Blue Sky for mid-line imports is VW. Since VW dealerships are currently either losing money or having slight profits, it is valued based on a dollar amount for potential future profits. Haig has their value range at \$1,000,000-\$2,500,000.

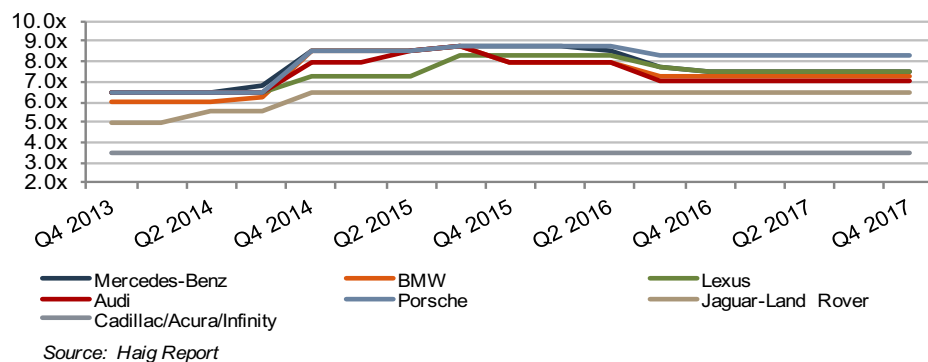
The highest Blue Sky multiple for domestic franchises (Ford, FCA, Chevrolet, Buick-GMC) for Q4 2017 is Ford, with a multiple range of 5.5x-5x. FCA has the lowest multiple range for domestic franchises at 4.25x-3.75x.

Q4 2017 Blue Sky Multiples

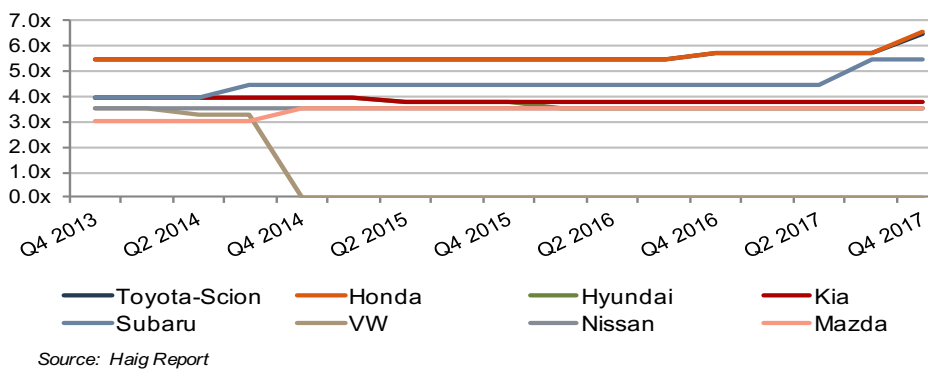


Blue Sky Multiples History

Luxury Blue Sky History

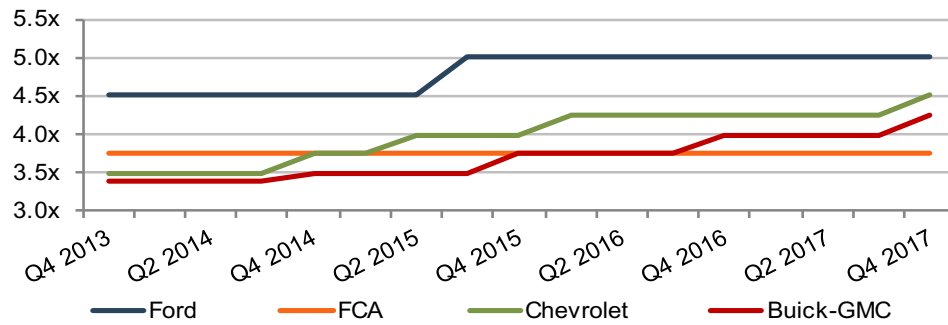


Midline-Import Blue Sky History



Blue Sky Multiples History

Domestic Blue Sky History



Source: Haig Report

Mergers and Acquisitions

M&A Announced Date	Transaction
12/19/2017	National Truck Funding, LLC bought by Power Land, LLC
12/12/2017	Prophet Equity LLC sold New Action Mobile Industries LLC to WillScot Corporation
11/01/2017	Northeast Great Dane bought by Trudell Holdings, Inc
10/23/2017	Abrams Capital Management LP sold Prime Motor Group to Capstone Automotive Group
9/19/2017	Bales Motor Company, Inc bought by Bachman Auto Group, Inc
8/30/2017	Jerry Ulm Dodge, Inc bought by Morgan Auto Group, LLC
8/15/2017	Mike Scarff Motors LLC bought by Rairdon Auto Group
7/14/2017	Kenny Ross Automotive Group bought by GPB Capital Holdings, LLC
7/06/2017	indiGO Auto Group LLC bought by Pon Holdings B.V.
7/03/2017	II Diamond Motors, Inc. bought by Team Automotive Group
6/23/2017	Four Stars Auto Ranch, LLC bought by Hernco Inc.
6/14/2017	Old Dominion Truck Leasing, Inc. bought by Penske Truck Leasing Co., L.P.
6/03/2017	Toyota Motor Corp sold Tesla, Inc.
6/01/2017	RLJ-McLarty-Landers Automotive Holdings, LLC sold Schaefer & Strohminger, Inc to Atlantic Automotive Corp

Source: Capital IQ

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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