

VALUE FOCUS

Auto Dealer Industry

Mid-Year 2018



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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.

Six Different Ways to Look at a Dealership

Along the road to building the value of a dealership, it is necessary and appropriate to examine the dealership in a variety of ways. Each provides unique perspective and insight into how a dealer is proceeding along the path to grow the value of the dealership and if/when it may be ready to sell. Most dealers realize the obvious events that may require a formal valuation: potential sale/acquisition, shareholder dispute, death of a shareholder, gift/estate tax transfer of ownership, etc. A formal business valuation can also be very useful to a dealer when examining internal operations.

So, how does a dealer evaluate their dealership? And how can advisers or formal business valuations assist dealers examining their dealership? There are at least six ways and they are important, regardless of the size. All six of these should be contemplated within a formal business valuation.

1. At a Point in Time

The balance sheet and the current period (month or quarter) provide one reference point. If that is the only reference point, however, one never has any real perspective on what is happening to the dealership.

2. Relative to Itself Over Time

Dealerships exhibit trends in performance that can only be discerned and understood if examined over a period of time, often years.

3. Relative to Peer Group

Many dealers participate in 20 groups. Among other things, the 20 groups can provide statistics that offer a basis for comparing performance relative to other dealerships.

4. Relative to Budget or Plan

Every dealer of any size should have a budget for the current year. The act of creating a budget forces management to make commitments about expected performance in light of a company's position at the beginning of a year and its outlook in the context of its local economy, industry and/or the national economy. Setting a budget creates a commitment to achieve, which is critical to achievement. Most financial performance packages compare actual to budget for the current year.

Six Different Ways to Look at a Dealership

5. Relative to Your Unique Potential

Every dealer has prospects for “potential performance” if things go right and if management performs. If a dealership has grown at 5% per year in sales and earnings for the last five years, that sounds good on its face. But what if similar locations have been growing at 10% during that period?

6. Relative to Requirements by Franchise

Increasingly, dealerships are subject to requirements by the franchise including facility enhancements, working capital levels, CSI and SSI ratings, sales volumes, profitability, etc.

Why is it important to evaluate a dealership in these ways? Together, these six ways provide a unique way for dealers and key managers to continuously reassess and adjust their performance to achieve optimal results. A formal business valuation can communicate the dealership's current position in many of these areas. Successive, frequent business valuations allow dealers and key managers the opportunity to measure and track the performance and value of the dealership or over time against stated goals and objectives.



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Value Drivers of a Store Valuation

Auto dealers, like most business owners, are constantly wondering about the value of their business. It's easy to see how this issue moves to the forefront around certain events such as a transaction, buy-sell agreement, litigation, divorce, wealth-transfer event, etc. As our previous article "[Six Different Ways to Look at a Dealership](#)" points out, there are many other instances when a dealer can evaluate the condition, progress, or value of their store. Dealers can actually influence the value of their store prior to these obvious events by understanding the value drivers of a store valuation and addressing them on a consistent basis. So what are some of the value drivers of a store valuation?

Franchise

A store's particular franchise affiliation has a major impact on value. Each franchise has a different reputation, selling strategy, target consumer demographic, etc. Public and value perception of franchises can be unique and are most easily illustrated through blue sky multiples. As the [Haig Report](#) and [Kerrigan's Blue Sky Report](#) indicate, these blue sky multiples can vary over time and from period to period. Often stores and franchises are grouped into broader categories, such as: luxury franchises, mid-line franchises, domestic franchises, import franchises and/or high line franchises.

Real Estate/Quality of Facilities

Typically, most store locations and dealership operations are held in one entity, and the underlying real estate is held by a separate, often related, entity. Several issues with the real estate can affect a store valuation. First, an analysis of the rental rate and terms should be performed to establish a fair market value rental rate. Since the real estate is often owned by a related entity, the rent may be set higher or lower than market for tax or other motivations that would not reflect fair market value. Second, the quality and condition of the facilities are crucial to evaluate. Most manufacturers require facility and signage upgrades on a regular basis, often offering incentives to help mitigate these costs. It's important to assess whether the store has regularly complied with these enhancements and is current with the condition of their facilities.

Value Drivers of a Store Valuation

Employees/Management

The quality and depth of management can have a positive impact on a store valuation. Stores with greater management depth and less dependence on several key individuals will generally be viewed as less risky by an outside buyer. Also, a store's CSI (Customer Service Index) and SSI (Service Satisfaction Index) rating can also influence incentives from the franchise and the overall perception of the consumer. A strong CSI and SSI are also a reflection of a strong service department and a commitment to quality customer service.

Recent Economic Performance

Like most industries, the auto industry is dependent on the national economy. We report later on the current SAAR (Seasonally Adjusted Annual Rate) which is an indicator of economic performance and future sales in the auto industry. Current conditions of rising interest rates and a leveling out of the SAAR compared to October 2017 could be predictors of stabilizing values and less activity in the M&A market in the months to come.

In addition to monitoring and understanding the current month's SAAR, the longer-term history of the SAAR and its trends also provide insight into the auto industry and a store valuation. Below is a long-term graph of the SAAR from 2000 to 2017.

Lightweight Vehicle Sales: Autos and Light Trucks (SAAR)



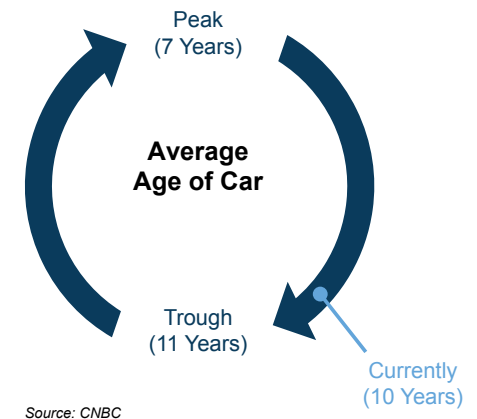
Source: FRED

Value Drivers of a Store Valuation

This visual evidence demonstrates the cyclical nature of the auto industry. Unlike some industries that may be seasonal or cyclical in a given year, the auto industry tends to be cyclical over a longer period of several years. For instance, it's common for a store to have stronger volumes and profitability for a period of 4-5 years, before experiencing a sluggish year or two. Store valuations should consider the cyclical nature of the industry and not overvalue a store during a strong year, or undervalue it during a sluggish year.

Another indicator of economic performance is an analysis of the auto cycle and where we are in that cycle based upon the average age of cars owned. The figure to the right illustrates the peak and trough of the auto cycle and **where we sit today**.

A store's value and performance can be greatly influenced by the local economy as well as the national economy—sometimes more so. Certain markets are dominated by local economies of a certain trade or industry. Examples can be store locations near oil & gas refining areas, mining areas, or military bases. Each is probably more dependent on local economy conditions than national economy conditions.



Buyer Demand

Buyer demand in the transaction market can illustrate the value climate for store valuations. Typically, buyer demand is measured by the deal activity in the M&A market. The **Haig Report indicated** that the second quarter of 2018 transaction activity increased by 87% compared to second quarter of 2017. Further, the activity for the first six months of 2018 increased by 23% over the same six months of 2017. Similarly, **Kerrigan's figures reflect** an increase in M&A activity of 13% in the first six months of 2018 compared to their data for the first six months of 2017.

Value Drivers of a Store Valuation

Location/Market

The value of a store location can be more complex than urban vs. rural or major metropolitan city vs. minor metropolitan city. Each store location is assigned a certain area or group of zip codes referred to as an "area of responsibility" or "AoR." Particularly, how does a location's demographic characteristics line up with a certain franchise? For example, a high line store would perform better and seemingly be more valuable in a major metropolitan area with a high median income level, such as Beverly Hills or South Beach in Miami than in a mid western city. Conversely, mid-line stores would probably fare better in areas with more moderate median income levels.

Single-Point vs. Over-Franchised Market

The amount of competition in a store's AoR, as well as the nearest location of a similar franchised store can also have an impact. It's important to make the distinction that we are talking about a market and not a single-point store. A single-point market refers to a market where there is only one store of a particular franchise. An over-franchised market would be a larger market that may contain several stores of a particular franchise within a certain radius. Often, a store in a single-point market would be viewed as more valuable than one in an over-franchised market that would be competing with its own franchise for the same consumers. Additionally, the stores of the same franchise in the same market could be drastically different in size. One may be part of a larger auto group of stores, while the other may be a single-point dealership location, meaning its owner only owns that one location.

Conclusions/Observations

As we've discussed, the value of a store can be influenced by a variety of factors. Some of the factors are internal and can be affected by the owner, and some are external and are out of the control of the owner. To find out the value of your store, contact one of the automotive industry professionals at Mercer Capital.



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Mid-Year Highlights

Autonomous Vehicles

Autonomous vehicles have been in the news and media in the first quarter of 2018, but unfortunately, it is not the publicity that the industry wants. In the early morning of March 19th, a pedestrian was struck and killed by a self-driving Uber. Although there was a backup driver in the car, the *New York Times* **reports** that the backup driver was distracted and systems failed to stop the vehicle. According to Google Trends, interest in “autonomous cars” reached its peak height in engagement after the crash occurred. Although the interest in these autonomous vehicles is relatively new, manufacturers have been racing to be the first to get their fully self-operational vehicles to market.

Technology Powering Autonomous Vehicles

The allure of the self-driving vehicle is that it removes human error when driving. Where a human's driving abilities and concentration can be affected by a multitude of outside influences, an autonomous vehicle's programming and technology means that it will always be alert and scanning for potential problems. *The Franklin Institute* has **identified three technologies** that make self-driving cars possible: sensors, connectivity, and software/control algorithms. The combination of these elements allows the vehicle to be able to make decisions like a human driver would, but with much more accuracy.

Key Players in the Self-Driving Market

According to *Bloomberg*, these are currently the **major players** in the self-driving vehicle market:

- **Waymo:** Currently the leader, running over 5 million road miles in 25 cities. They are expected to push a ride hailing service this year.
- **GM:** While GM's autonomous vehicles aren't as fast as Waymo's, with a safe speed of 25 mph, they are expecting to have a ride hailing pilot in a year.
- **Daimler:** Expecting a self-driving vehicle by the 2020s. Fully autonomous vehicles will be too expensive for purchase, so Daimler plans to start a ride share service. However, Mercedes will offer a somewhat autonomous vehicle for purchase in 2021.

Mid-Year Highlights

Autonomous Vehicles

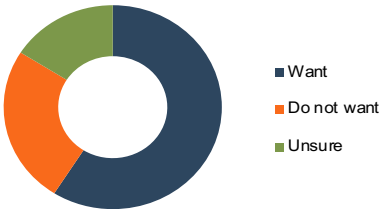
Much time and resources have been invested into making this autonomous vehicle technology great; however, consumers will ultimately decide if it is something in which they are interested and the general population is not yet sold on the idea. According to a AAA study, 78% of Americans are afraid to ride in a self-driving car. Furthermore, more than half of U.S. drivers feel less safe on the road if they had to share it with a self-driving vehicle.

These statistics prove the industry has to prove to people that self-driving technology is something they need. However, with the *National Safety Council reporting* that 2017 was the second consecutive year with automobile casualties topping 40,000, self-driving vehicles could be a step in making travel less dangerous.

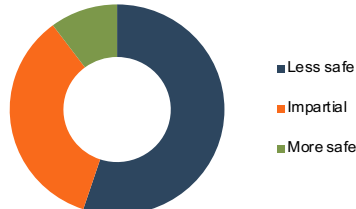
Riding in a Self-Driving Vehicle



Autonomous Vehicle Technology in Next Car



Sharing Road with Self-Driving Vehicle



Source: AAA

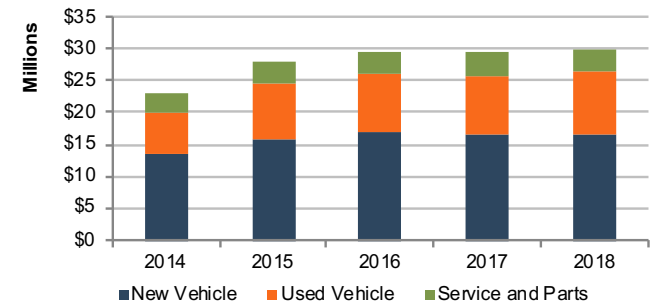
Average Annual Auto Dealer Profile

After years of increases in the number of new car dealerships in the U.S., the first half of 2018 saw a slight decrease to 16,794. This comes after a significant uptick in deals in the first half of the year as buyers may have been supported by extra cash from changes in the tax code while sellers may be looking to capitalize on relatively high valuations despite declining profits.

Average total sales per dealership increased 1.9% in the first half of 2018 compared to the same period last year despite new vehicle sales remaining relatively flat. The largest growth came from used vehicles which grew 5.7% over the same periods to \$9.7 million. The used-to-new ratio of average retail per dealership is up to 0.86x in the first half of 2018, the highest since 2012.

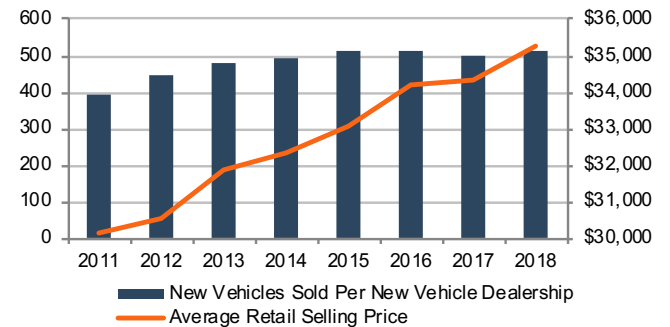
The number of new vehicles sold per new vehicle dealership increased in the first half of 2018 compared to the prior year, but remains just below levels seen in 2015 and 2016. Growth in average retail selling price for new cars followed a similar trend, increasing 2.7% in the first half of 2018 to \$35,249. The average retail selling price for used cars was \$20,390, or 58% of the price for a new car.

Total Sales of Average Light Vehicle Dealer



Source: NADA

New Vehicles Sold Per New Dealerships



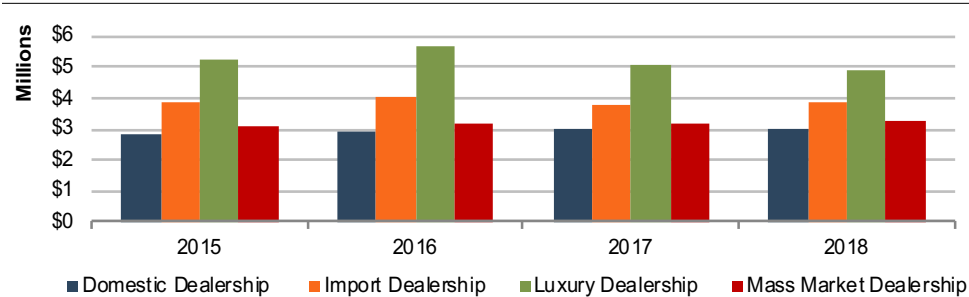
Source: NADA

Domestic, Import, Luxury, Mass Market Dealerships

Gross profits were mixed in the first half of 2018, with increases for import (+0.9%) and mass market (+1.8%) dealerships and declines from domestic (-0.2%) and luxury (-4.7%) dealerships. However, luxury dealerships continue to have the highest average gross profit at \$4.9 million.

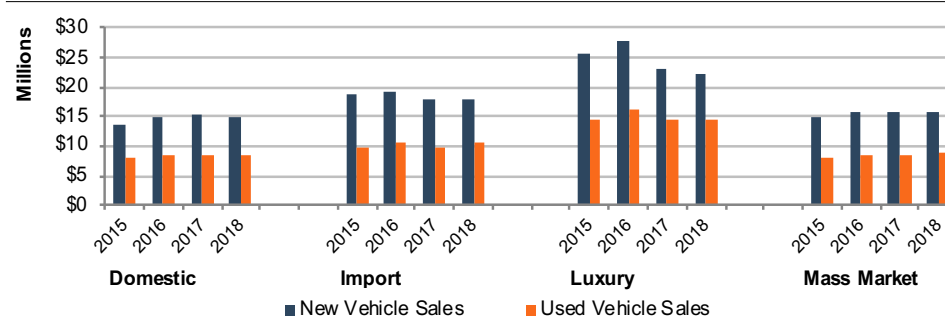
Average new vehicle sales were mixed in the first half of 2018, with the largest decline from luxury. Used vehicles, on the other hand, all increased, with import sales increasing 7% over the same period in 2017. This continues the trend of luxury dealers coming back to the pack somewhat as rising interest rates and gas prices may be hampering consumers' ability to spend on more expensive brands.

Gross Profit



Source: NADA

Vehicle Sales Domestic, Import, Luxury, and Mass Market

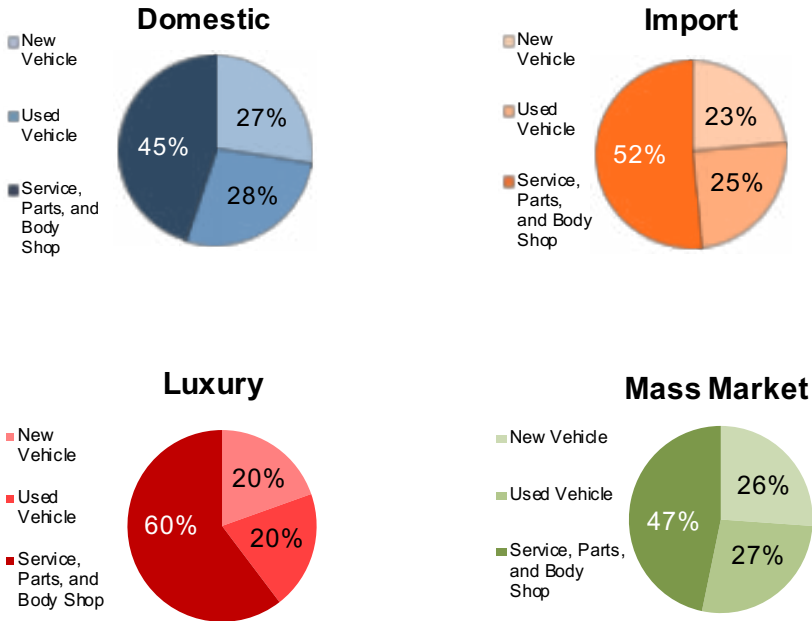


Source: NADA

Domestic, Import, Luxury, Mass Market Dealerships

Gross segmentation between new, used, and services and financing has been stable so far in 2018. 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

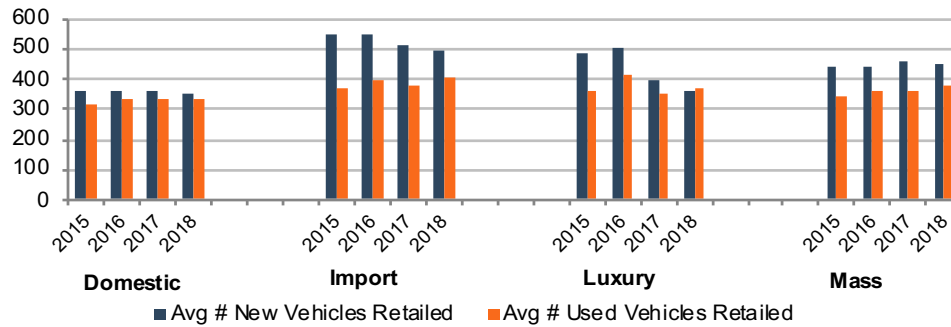


Domestic, Import, Luxury, Mass Market Dealerships

The average number of new vehicles sold declined across the board as used vehicles grew for all except domestic. The first half of 2018 was the first time in recent history that luxury dealerships actually sold more used vehicles than new. Imports had the widest disparity, with 55% of their retailed vehicles being new.

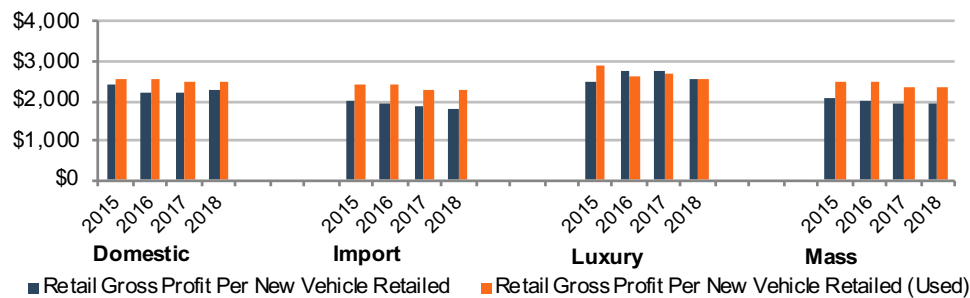
Average retail gross profit decreased across the board for both new and used vehicles, with the sole exception being a 1.2% increase in gross profit for new domestics. Retail gross profit has been trending down since 2015 despite increases in average selling prices.

New and Used Vehicles Retailed



Source: NADA

Retail Gross Profit

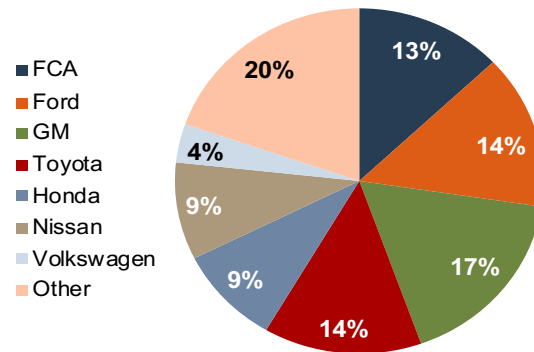


Source: NADA

Public Auto Manufacturers

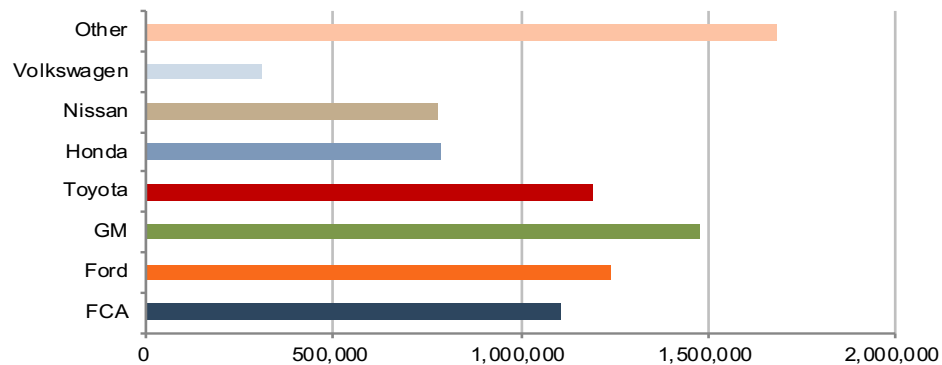
The "other" category continues to have the highest sales, showing consumers have continued to stay away from the historically large and successful manufacturing companies. GM and Ford continue to have the largest market shares, though they have each taken slight steps backward in the first half of 2018.

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



Source: NADA

Public Auto Manufacturer Sales



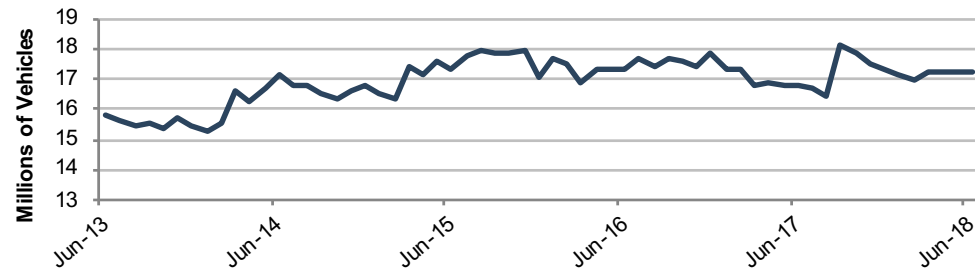
Source: NADA

Lightweight Vehicle Sales

Auto and Light Trucks (SAAR)

Despite numerous forecasts of SAAR dropping below 17 million in 2018, this has not been the case so far. Over the past twelve months, SAAR has been at 17.4 million, which is higher than 2017, though below the peak seen in 2016. Forecasters still believe this figure will drop to about 16.6 million for the year, which would require a noticeable dip in the second half of the year.

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



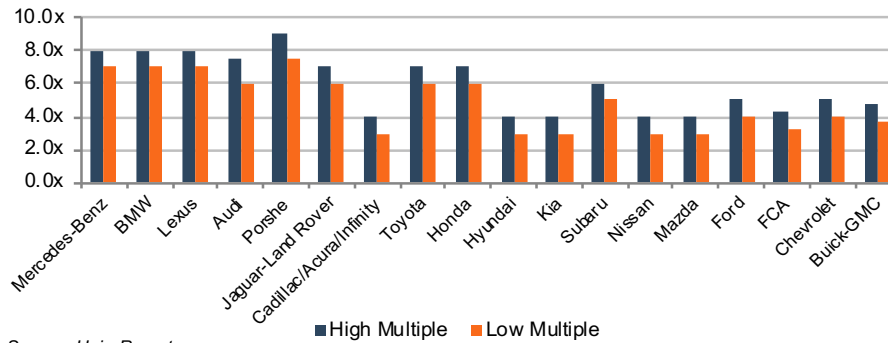
Source: FRED

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.

Multiples for Q2 2018 remained more or less in line with previous figures. The range increased for BMW but decreased for Kia, Ford, and Audi. Porsche continues to have the highest range of 7.5x to 9x while many franchises (Cadillac, Acura, Infinity, Kia, Hyundai, Nissan, and Mazda) all hover in the 3x to 4x range.

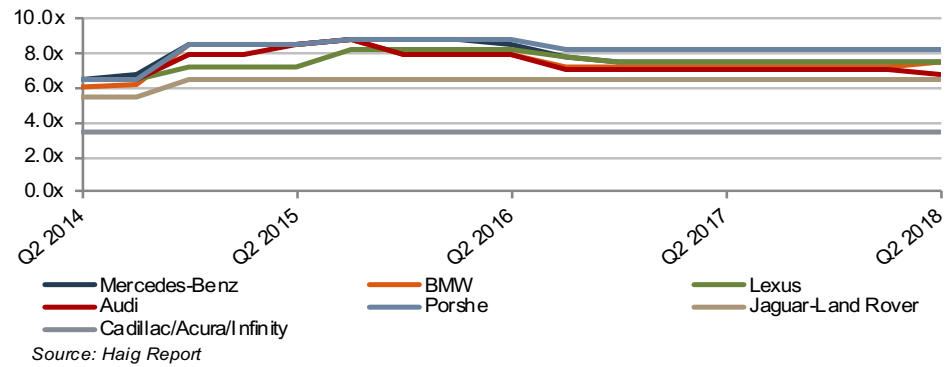
Q2 2018 Blue Sky Multiples



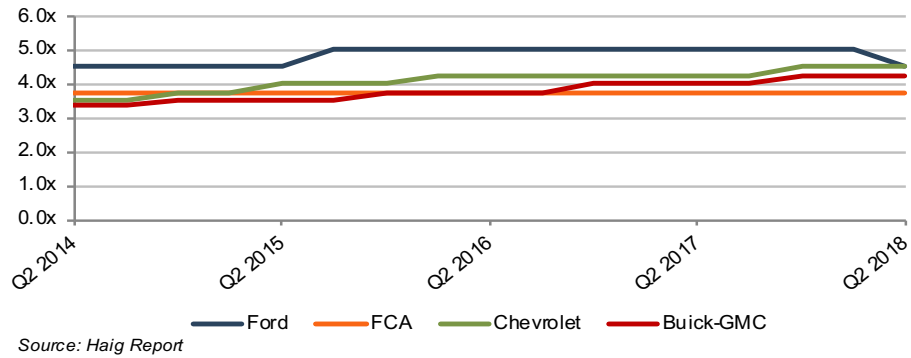
Source: Haig Report

Blue Sky Multiples History

Luxury Blue Sky History

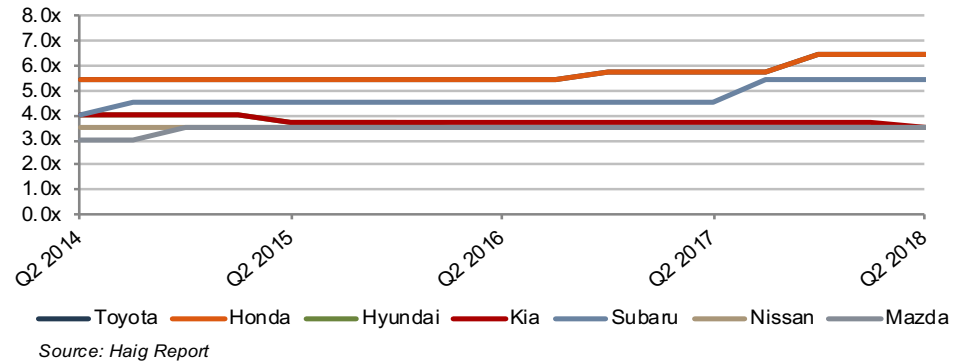


Domestic Blue Sky History



Blue Sky Multiples History

Midline-Import Blue Sky History



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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