

Tennessee Family Law

Valuation & Forensic Insights for Attorneys

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Newsletter Supplement

Industry at a Glance: Auto Dealers

This quarter's issue of the Tennessee Family Law Newsletter examines how/why you should involve your financial expert in the mediation process. We also feature an article on the valuation of stock options that are often part of the marital estate when a corporate executive is involved.

The AICPA issued a forensic services standard (effective January 1, 2020) and we link to that in this issue. Our case review analyzes the role of a forensic expert in the determination of income to serve as the basis for spousal support.

Finally, in this issue we introduce a new recurring feature – “Industry at a Glance.” We will highlight an industry where Mercer Capital has unique expertise through numerous engagements, organized research and written content. The first industry highlighted is the Auto Dealership industry. Read to discover additional information about this industry including valuation methodologies, unique aspects and terminology, and value drivers.

We appreciate the great feedback from the previous issues of this newsletter and encourage you to provide any suggested content topics or ideas that you'd like to see in future editions to **Scott Womack** or **Karolina Calhoun**.

Why Involve a Financial Expert in Divorce Mediations

Tennessee requires that parties must attempt to settle their cases at mediation prior to granting a trial date. Most family law cases settle at mediation or prior to trial. Considering both of these facts, when should a family law attorney involve a financial expert in divorce mediations?

Most family law cases that require the use of a financial expert share some combination of the following: a high-dollar marital estate, complex financial issues present, business valuation(s) performed, and/or the need for tracing/classification of certain types of marital and separate assets.

Of the family law cases that settle at mediation, most include motivated parties with experienced attorneys that have entered the mediation process properly organized and prepared to negotiate the various financial and parental aspects of the case.

How a Financial Expert Can Assist a Family Law Attorney and Client at Mediation

Depending on numerous factors, attorneys require attendance of their financial expert for either the full mediation or for a particular session of the mediation. In addition, sometimes financial advisors are required to be available by telephone should issues arise. While having your financial advisor involved in the mediation in this way can be costly, a talented financial expert provides benefits to the client and the overall process to aid in its success. This author has participated in divorce mediations as a financial expert many times over the years and, as a result, has identified five ways a financial expert can be helpful to a family law attorney and client during mediations.

Communicates Complex Financial Theory in an Understandable Way

Your financial expert may have performed a business valuation that resulted in a report or some communication of value conclusions. An experienced financial expert that can communicate those conclusions and other complex financial

issues in a clear and understandable manner to the client and the mediator is a priceless asset for your team. Because of this, often during mediation, that expert's role evolves from a valuation vendor to a trusted advisor. The mediation process can be lengthy and includes significant down time where the attorney, client, and financial expert sit around the table together. It is during this time that the financial expert truly becomes a trusted advisor to the client and their attorney by providing data and expertise to assist in the decision-making process.

Defends the Business Valuation

If a case involves a business valuation, there is usually contention around the value of the business. Often, valuation experts from each side are present at mediation and have the opportunity to speak to each other regarding their assumptions and disagreements on conclusions. A good financial expert helps quantify and elaborate on the key issues or differences in the valuations to the mediator to help bridge the gap in negotiations.

Helps with Asset Division

Property division is one of the crucial issues that must be solved for a mediation to be successful. Property division is often thought of as a puzzle, putting pieces together based on value, transferability, and the motivations/desires of each party to own certain assets. While the attorneys have compiled the marital estate, a competent financial expert assists with real-time decision-making and changing variables through the use of a dynamic model of the marital estate. The flexibility of a dynamic model allows for shifting assets/liabilities from one party's column to the other or calculating an equalization payment due to the illiquidity and lack of transferability of certain items.

Provides Insight into Alimony Calculations

While financial experts don't generally determine actual alimony amounts, they can assist clients and attorneys in understanding the amount, structure, and time value of the proposed alternatives. Often clients look for clarity in the amount either from the viewpoint of the payor (Can I afford to pay this monthly amount?) or from the viewpoint of the payee (Can I survive on this monthly amount?). Some structures of alimony also include accelerated amounts or prepayments of the entire amount. A financial expert aids in the decision-making by providing time value of money calculations to assist in the psychology of those financial decisions.

Performs Separate/Marital or Retirement Calculations

Financial experts often assist attorneys by performing tracing analyses and calculations to determine and/or quantify the separate and marital portion of certain assets. Assets often subject to dispute are retirement accounts that were owned prior to marriage. Tennessee law changed in recent years to

recognize not only the balance of such accounts at the date of marriage, but also the appreciation of that amount during the marriage as separate assets. Financial experts are often asked to perform and explain these calculations at mediation to protect the integrity of the separate portion of those assets.

Conclusion

While the costs of mediation may be high, they pale in comparison to the costs of going to trial. Since Tennessee law already requires that cases attempt mediation, why not head into mediation organized, prepared, and ready to do business? Consider involving a financial expert directly or indirectly to assist in that process and chances of settlement will certainly increase.



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AICPA Issues New Forensic Services Standard Effective January 1, 2020

Statements on Standards for Forensic Services ("SSFS No. 1") are issued by the AICPA's Forensic and Valuation Services Executive Committee. SSFS No. 1 provides guidance and establishes enforceable standards for members performing certain forensic and valuation services, specifically, for litigation and investigation engagements. These engagements are defined by **SSFS No. 1** as follows:

- **Litigation.** An actual or potential legal or regulatory proceeding before a trier of fact or a regulatory body as an expert witness, consultant, neutral, mediator, or arbitrator in connection with the resolution of disputes between parties. The term litigation as used herein is not limited to formal litigation but is inclusive of disputes and all forms of alternative dispute resolution.
- **Investigation.** A matter conducted in response to specific concerns of wrongdoing in which the member is engaged to perform procedures to collect, analyze, evaluate, or interpret certain evidential matter to assist the stakeholders (for example, client, board of directors, independent auditor, or regulator) in reaching a conclusion on the merits of the concerns

Prior to the issuance of these standards, litigation and investigation engagements were covered by the AICPA Statement on Standards for Consulting Services No. 1 and the AICPA Code of Professional Conduct. As the need for forensic services has grown and evolved, SSFS No. 1 serves to protect the public interest and increase the level of consistency across the profession. The issuance of SSFS No. 1 reflects a consolidation of relevant forensic services standards into one single standard.

These forensic standards are effective for engagements accepted on or after January 1, 2020. Ensure that your hired expert, if applicable, is aware of these new requirements and is aware of the applicable standards for the engagement. To download the Statement on Standards for Forensic Services [click here](#).

Valuation of Stock Options for Marital Dissolution

The valuation of stock options is a complex issue that divorcing parties may face during the determination and division of property. Designed to both reward performance and retain employees, these benefits can be difficult to value, particularly at a random moment for the purpose of marital dissolution.

The American Institute of Certified Public Accountants ("AICPA") Forensic and Valuation Services Section provides a quick reference guide on valuing stock options, [Valuing Stock Options: AICPA's Financial Instrument Quick Reference Guide](#) (section membership required). We excerpt from the Guide below in order to provide a few highlights.

What is a Stock Option?

A stock option is a contract that allows the owner of the right, but not the obligation, to buy equity in the company that issued the option at a certain price for a certain period of time. In its most basic structure, an option contract consists of:

- The identification of the equity that can be purchased or sold
- The price at which the equity can be purchased or sold
- A discrete time within which the equity can be purchased or sold, and
- A price for the right to own the right to buy or sell equity in the company that issued the option

Valuation Models

Valuation models can be as simple or as complex as the derivative they are valuing. Each step in the process requires a thorough technical understanding, as well as professional judgment to identify the model that works best for the particular valuation and ultimately be able to explain and support the resultant conclusions.

Lattice models are used to value derivatives when discrete, or distinct, points in time need to be part of the model (e.g., days, months). Common lattice models are binomial and trinomial models that are easy to use and highly adaptable to different types of options since it allows for changing assumptions between discrete measurements (e.g., volatility). These are structured by discounting a series of cash flows from the time of maturity to the beginning date of the option contract.

The Black-Scholes model is classified as a "close-form" model because it assumes the option is only exercised at the end of the contract term and the underlying assumptions remain constant over the term of the option. This model is useful when trying to value options such as the European options that only have one exercise date. The Black-Scholes model is based on six inputs:

1. type of option being priced (e.g., call or put option)
2. stock price,
3. strike price of the option
4. term of the option
5. appropriate risk-free rate
6. volatility of the underlying stock

The Monte Carlo Model (MC) is considered a stochastic model because this method generates a large number of time-dependent scenarios and estimates the value of the option as a statistical expectation of the outcomes of those simulations. Compared to the Black-Scholes formula, MC allows for much more flexibility, including large changes in the interest rates, volatility and the possibility of major events, such as mergers and acquisitions. Statistics are used to quantify the error in the estimates.

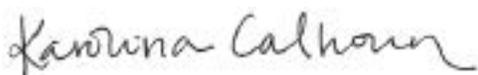
Accounting for Stock Options

There are three main ways to account for stock options. The way these are accounted for depends largely on why and how the options are being issued.

1. **Fair market value** - IRS Revenue Ruling 59-60 defines fair market value as "the price at which property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."
2. **Fair value measurement** - Accounting Standards Codification (ASC) 820: Fair Value Measurement, is the sole source for authoritative guidance on how entities should measure and disclose fair value in their financial statements under U.S. Generally Accepted Accounting Principles.
3. **Fair Value Based Measurement** - ASC 718 Compensation – Stock Compensation, defines fair value in the context of the employer/employee relationship.

Conclusion

Due to the complexity of valuing stock options, it is critical to consult a financial expert. As we can glean from the **AICPA Quick Reference Guide** (section membership required), not only must the financial expert apply professional judgment and technical understanding during the process, but he/she must be able to communicate the process and result conclusion(s). If the divorce case includes stock options, hire a financial expert to value these complex financial instruments. The professionals of Mercer Capital can assist in the process. For more information or to discuss an engagement in confidence, please contact us.



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Meet The Team

Scott Womack, ASA, MAFF

Scott is active in family law litigation (traditional litigated divorce and collaborative divorce) and corporate valuation. He also leads Mercer Capital's Auto Dealer Industry team.



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

Scott is married and has two boys. He is also a big sports fan. He supports Baylor athletics, the Tennessee Titans, the Nashville Predators, the Golden State Warriors, and is a lifelong fan of pitcher, Tom Glavine.

Karolina Calhoun, CPA/ABV/CFF

Karolina provides valuation and forensics services for family law, gift & estate planning, commercial litigation, transactions (M&A), and further matters related to privately held businesses. With her forensics accreditation, she provides economic and financial damages studies, asset tracing, lost profits, and lifestyle analysis.



Karolina is the Valuation Chair of the AICPA's 2020 Forensic and Valuation Services Conference Committee and a member of the AICPA's CFF Task Force. Prior to joining Mercer Capital, she was a Senior Auditor at EY Memphis in their Audit and Assurance Services practice.

Karolina is married and enjoys traveling with her husband. She is the president of the Memphis Chapter of TSCPA. She is also fluent in Polish. She was born in Poland and holds dual U.S.-Polish citizenship.

Tennessee Case Review

Tarver v. Tarver

Appeal from the Circuit Court for Shelby County January 16, 2019

This divorce involved issues of property division and alimony, among others. Husband worked for his father's railroad construction business (the "Company") since turning 18 years old and eventually was named Vice President, a position which he held for the duration of the marriage. Wife was employed in the health insurance industry, however, stopped employment in 2009 and did not work outside of the home over the remainder of the marriage. Wife filed a complaint for divorce in January 2014, and the trial court entered an amended final divorce decree in July 2017.

A key issue in the appeal involved Husband's salary and payments received from the Company. For background, in 2006, Husband's Grandfather purchased several unimproved parcels of land for a new business location. Grandfather titled these properties in his name and Husband's name as joint tenants with rights of survivorship. In 2010, the Company began operating the new location from this property and began paying rent to Husband and Grandfather. Husband received a salary from the Company in addition to the rent payment income. The Company also covered several personal expenses for Husband and his family such as property taxes on the marital residence, uncovered medical expenses, family dining expenses, groceries, clothing, furniture, and travel expenses. After the divorce complaint was filed, Grandfather reduced annual rent payment from the Company to Husband from \$180,000 per year to \$2,400 per year. Grandfather also stopped paying for Husband's health insurance policy and other expenses.

During the trial, Wife retained a forensic accountant and economist to calculate Husband's income for purposes of alimony and child support. Wife's expert calculated Husband's total annual income as either \$285,993 or \$216,958, dependent upon if rent was received at historical levels or a reduced rate based on fair market rental value. In the trial court determination, Husband's income was set at

\$188,488 per year based on the fair market rental value calculated by Husband's appraiser and value of personal expenses covered by the Company as calculated by Wife's expert witness. The trial court ordered Husband to pay \$1,332 in monthly child support and the children's private school tuition. Wife was awarded alimony in futuro of \$1,500 per month until the parties' twins graduate from high school at which time the alimony would increase to \$2,832 per month for ten additional years. As for the business interest valuation, the court was unable to conclusively determine whether Husband had any ownership interest in the Company. There was (potential) evidence that suggested a 10% ownership interest in the Company, but the weight of the evidence suggested that he did not in fact own any interest in the business.

On appeal, Husband raised the issue of whether the trial court erred in determining Husband's income for purposes of alimony and child support and in setting the amount of alimony, among other issues. According to the opinion, Husband did not present any analysis of the statutory factors to be considered when awarding alimony or include any discussion of the types of alimony. He did not provide any indication of what he thought an appropriate amount for his income would be. Husband rather argues that the trial court erred in "imputing to him the rental and other forms of income." In its determination of Husband's income and ability to pay, the trial court found it appropriate to consider Husband's base salary of \$78,500 in addition to the fair rental value of the property and the amount of personal expenses the Company paid for Husband. The Court notes that this is reasonable given that Husband received a salary of over \$250,000 in the three years prior to the divorce. Ultimately, the Court found no error in the trial court's determination of Husband's monthly income.

As shown in this case, the testimony of an expert witness can significantly assist in the court's determination of need and ability to pay, as well as historical earnings and "true income" in its decisions regarding spousal support. An experienced forensic accountant can provide a detailed analysis of income that accounts for all relevant sources of income.

Click [here](#) for the opinion.

Mercer Capital News

Speaking Engagements

February 20, 2020

Karolina Calhoun, CPA/ABV/CFF

"Valuation Adjustments & Potential Forensic Implications in Litigation," **Business Valuation Resources Webinar**

March 5, 2020

Travis Harms, CFA, CPA/ABV

"Family Culture and Dividend Policy," **Transitions Spring 2020** (Presented by *Family Business Magazine*), Tampa, FL

March 18, 2020

Mercer Capital Sponsoring

Family Law Section of the Memphis Bar March CLE Meeting
Memphis Bar Association, Memphis TN

April 28, 2020

Karolina Calhoun, CPA/ABV/CFF

"It May Start as a Valuation But End Up as a Large Forensics Engagement"

Financial Consulting Group, Atlanta, GA

May 14, 2020

Scott A. Womack, ASA, MAFF

"Valuation Issues in Litigation (Family Law and Commercial)"
Auto CPA Group Spring 2020 CPF, Kona, HI

May 18, 2020

Z. Christopher Mercer, FASA, CFA, ABAR

"The Highs and Lows of the Integrated Theory of Business Valuation: Tackling the Market Participant Acquisition Premium (MPAP) and the Marketability Discount (or DLOM)"
NYSSCPA/FAE Business Valuation & Litigation Services Annual Conference, New York, NY

June 19, 2020

NACVA's Business Valuation And Financial Litigation Super Conference, Philadelphia, PA

Karolina Calhoun, CPA/ABV/CFF

"Cautionary Tales of Valuation Adjustments & Potential Forensic Implications in Litigation"

Z. Christopher Mercer, FASA, CFA, ABAR

"Vision 2020: The Future of Our Profession & Your Role In It"

Litigation Support

Business Valuation & Forensics Services

Mercer Capital is a national business valuation and financial advisory firm. We are frequently engaged to provide support in litigation disputes. We bring a team of experienced and credentialed experts and over 35 years of experience to the field of valuations, forensic analysis, and litigation support. Assisting our clients through the entire dispute process, we provide initial consultation and analysis, as well as expert testimony and trial support. We provide high quality services evaluating and analyzing complex financial situations and communicating conclusions in a clear and concise manner.

- Family Law Litigation
- Business Litigation
- Buy-Sell Disputes
- Partnership Dissolution
- Shareholder Oppression
- Shareholder Disputes
- Estate & Gift Tax Valuations
- Collaborative Law
- Business Damages & Lost Profits
- Securities Litigation
- Breach of Contract
- Business Interruption
- M&A Disputes
- ESOP/ERISA Disputes
- Breach of Fiduciary Duties

Family Law Services

Mercer Capital is a national business valuation and financial advisory firm with offices in Memphis, Nashville, Houston, and Dallas. We bring a team of experienced and credentialed experts and over 35 years of experience to the field of dispute analysis and litigation support. Services for family law attorneys and advisors are listed below.

Valuation Services

- Valuations of Privately Owned Businesses and Professional Practices
- Valuations of Intellectual Property, Tradename, and Other Intangible Assets
- Valuations and Determination of Personal vs. Enterprise Goodwill and Active vs. Passive Appreciation
- Valuations of Stock Options, Restricted Stock, Pensions, Notes, and Other Investment Assets
- Valuations of Employment Contracts and Compensation Agreements

Forensic Services

- Assistance with Financial Affidavits
- Equitable Distribution Analysis
- Lifestyle Analysis
- Pay and Need Analysis
- Income Determination
- Alimony Calculation
- Classification of Assets and Liabilities
- Tracing Services
- Dissipation Analysis

Advisory Services

- Expert witness testimony
- Serving in mediation, arbitration, or as court-appointed and/or mutually agreed-upon experts
- Serving as the financial neutral in a collaborative divorce
- Assistance with discovery
- Critique of opposing expert reports
- Impact of transactions on valuation
- Economic research
- Public securities, market, and industry research
- Assistance with depositions and cross-examination
- Developing case strategy
- Preparation of demonstrative exhibits

Who We Serve

- Businesses – Private & Public
- Divorcing Spouses
- Attorneys
- Courts, Mediators, and Arbitrators
- Business Owners
- Family Offices
- High-Wealth Individuals
- Others in Need of Neutral, Independent Experts

Our Qualifications

- Deposition and testimony experience
- Technical and industry expertise
- National reputations for independence and objectivity
- Valuation and forensic credentials from the AICPA, the American Society of Appraisers, the CFA Institute, the Royal Institute of Chartered Surveyors, and the National Association of Certified Valuators and Analysts
- Trained in collaborative law

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Industry at a Glance

Auto Dealers

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.

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 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.

Value Drivers

Auto dealers, like most business owners, are constantly wondering about the value of their business. Dealers can actually influence the value of their store 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?

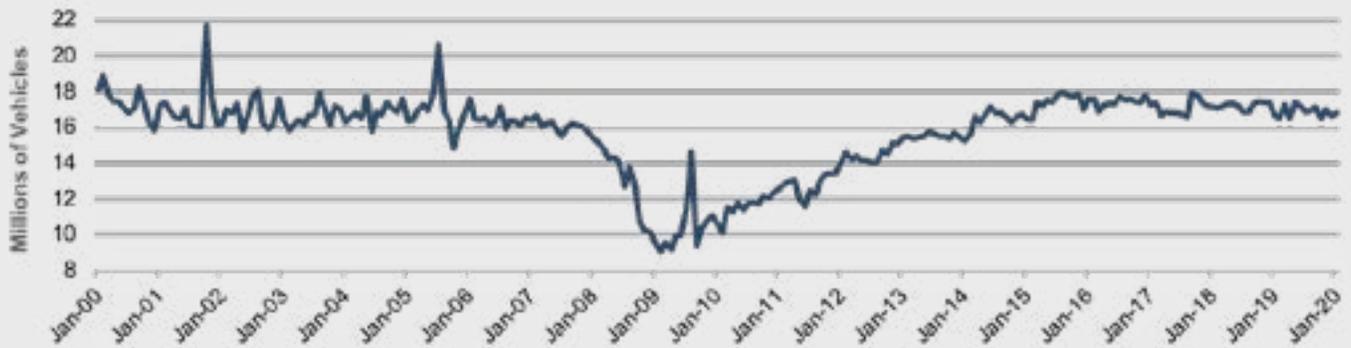
Franchise

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

Figure 1: Price/Earnings Multiples at Various Growth Rates



Source: FRED

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.

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.

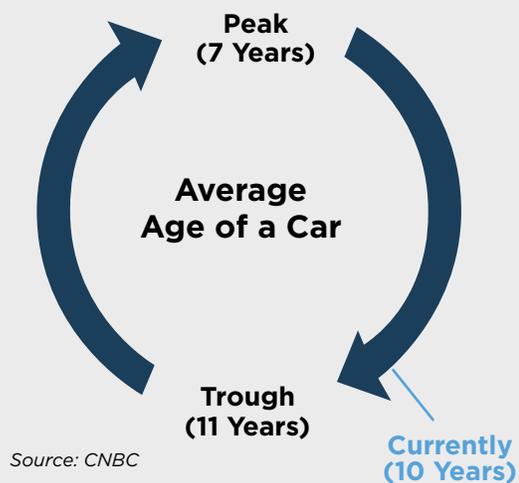
Recent Economic Performance

Like most industries, the auto industry is dependent on the national economy. The SAAR (Seasonally Adjusted Annual Rate) is an indicator of economic performance and future sales in the auto industry. Since Q4 2019, the SAAR has remained slightly below 17 million units. Auto dealers are focusing on used cars, parts and service, finance and insurance, and costs to combat sluggish new vehicle sales.

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. Figure 1 presents a long-term graph of the SAAR from 2000 to 2019.

This visual evidence demonstrates the cyclicity 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 cyclicity of the industry and not overvalue a store during a strong year or undervalue it during a sluggish year.

Figure 2: The Peak and Trough of the Auto Cycle in 2018



Source: CNBC

Another indicator of economic performance is an analysis of the auto cycle. Figure 2 illustrates the peak and trough of the auto cycle in 2018.

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 third quarter of 2019 transaction activity is down by approximately 30% over the same three quarters in 2019. Similarly, Kerrigan's figures reflect a decrease in M&A activity of approximately 10% for the same three quarters in 2019 vs. 2018.

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.

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. Value can be influenced by a variety of internal and external factors. 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.

The professionals at Mercer Capital can assist in a business valuation in the Auto Dealer industry. For more information or to discuss and engagement in confidence, please contact us.

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