MERCER CAPITAL

UNDERSTANDING THE VALUE OF YOUR

TRUCK DEALERSHIP

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It can be tempting to rely on a simple rule of thumb when determining the value of your truck dealership. If life was that simple, you would not need to read the rest of this article, but keep reading. There are many reasons why a truck dealership can be worth more or less than a standard rule of thumb might imply, and many reasons why a particular business interest in a truck dealership can be worth more or less than the pro rata value implied by that rule of thumb. This article provides useful information as to how truck dealers are valued and what impact that might have on their owners.

At this point, you may be tempted to respond "I just want to know what time it is, not how the watch works." But this is dangerous, because a lack of knowledge can cost you dearly. Giving some thought to why your business is worth what it is worth can be of great value. Understanding how truck dealers are valued helps owners understand the value of what may be their biggest investment. It also may help them understand how to grow the value of their dealership, and maximize their return when it comes time to sell.

WHEN DO YOU NEED TO KNOW WHAT YOUR DEALERSHIP IS WORTH?

An owner who is contemplating any kind of transaction or agreement based on value needs to know what their dealership is worth. And that includes everyone.

Selling Out?

In the most obvious case, someone who is planning to sell their dealership needs to know what it is worth. Probably the hardest issue a business owner encounters is cashing-out his or her life's work. Beyond the myriad emotional issues you will face are the raw economics of how you will sell and for how much. In our experience, most transactions fall apart because of terms, not price. Are you going to sell your stock or your assets? Should a working capital adjustment be part of your deal and, if so, how should it be structured? Are you selling your real estate along with the dealership or keeping it and leasing it to the new owner? There are hundreds of issues that may arise in a transaction. Many of them ultimately affect the proceeds of the transaction to the seller. Knowing what you should be able to expect will let you evaluate whether or not a particular offer for your company is reasonable.

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Selling In?

If you are planning on transferring ownership to your children or your management team, you will need to know what the interests in the business being transferred are worth. For reasons discussed below, this may be much less than a pro rata interest in the total value of the dealership. Ignoring this issue can cost you a lot of money. If, for example, you gift 10% of your company to your children, and pay gift taxes on the transfer at 10% of the total value of your business, you could be paying considerably more in gift taxes than you should. But more on this later.

Buy-Sell Agreements: Handshake or Arm-Wrestle?

Many business owners fail to understand the valuation implications of buy-sell agreements. If you have other shareholders in your business who are non-family, and maybe some who are, you probably have some kind of buy-sell agreement between the shareholders that describes how the business (or business interests) will be valued in the event of a shareholder dispute, death, or departure from the business (even on friendly terms). In our experience, buy-sell agreements almost never sufficiently describe the mechanism to be used to value the business. The process looks simple when the buy-sell is being drafted and a transaction is not on the table. However, when the day comes that a buy-sell agreement is invoked, you will want the process delineated very clearly. We have studied this issue for a long time at Mercer Capital, and believe that, at a minimum, a buy-sell agreement should stipulate:

- **The Standard of Value.** You may have heard of something called fair market value, which is a defined standard of value implying a hypothetical transaction between hypothetical parties who are informed and capable of engaging in a transaction and who are not operating under any compulsion to perform the transaction. This is the standard of value used for gift and estate tax appraisals and many buy-sell agreements. But without defining the standard, a buy-sell could be interpreted to mean a specific buyer and seller, or some kind of investment value or intrinsic value, or something else entirely. This is a big money issue not to be ignored.

- **The Level of Value.** We will discuss this in detail below, but in general your buy-sell agreement should be crafted from the standpoint of a change of control value of your business, or from the perspective of a minority investor in an illiquid stock. For example, if your buy-sell is being executed in a circumstance where a 70% owner is buying out a 30% owner, each party will have his or her own opinion of the appropriate level of value unless it is specified in the agreement (and maybe even if it is).

- **The "As Of" Date.** We provided services in an extremely large dispute that hinged on the lack of specificity with regard to the "as-of" date in a buy-sell agreement. Do you value the stock being transacted as of the date one party offers to sell, as of the date of the closing of the transaction, or something in-between?

- **Qualifications of Appraisers.** Who is qualified to value your company? Do you want an industry expert or a valuation expert? What credentials should they possess? Obviously, we would suggest you specify someone from Mercer Capital to value your business. But, more generally, you need a qualified business appraiser, and you will want to specify their qualifications in the agreement.

- **Appraisal Standards.** What appraisal standards are to be followed in the valuation of your business? Is this to be written on the back of a cocktail napkin, or do you want a full appraisal report? Different credentialing bodies within the appraisal community have different standards, and you would be well advised to know, in advance, what kind of work product you want for your buy-sell agreement.

- **The Funding Mechanism.** What is the funding mechanism to be used to facilitate the transaction? Is it seller-financed or will the buyer arrange his own financing? What happens if the buyer cannot be financed?

At this point you might want to open your desk drawer and look at your own buy-sell agreement. It probably does not stipulate all six elements discussed above (we hardly ever see one that does). If you find your buy-sell agreement lacking on any of the points above, it may be time to revise the agreement. Forewarned is forearmed.

Value Management

Finally, maybe you are not currently contemplating a transaction in your dealership. You do not plan to sell the dealership in the next few years, you are not planning on transferring it to your children, and you are not entering into any buy-sell agreements or shareholder agreements based on the value of the dealership. Then why do you care? Because knowing the value of your business can be a tremendously effective management tool. Ultimately, you will get two returns from your business – what in the valuation community we call interim cash flows, and terminal cash flows. Interim cash flows might be your salary, your benefits, and your dividends. You know what these are and what you can do to influence them. But your biggest cash flow may be the terminal cash flow – when you go to sell your business. Are you managing your business in a way that increases its value or not? Do you know?

THE WHEN AND THE WHY OF BUSINESS VALUATION

Most owners of truck dealerships are consumed with day-to-day activities. Many fail to acknowledge that life (and business) cycle events do happen to them, their partners and their families and that these events will require that their businesses be valued. Alternatively, some business owners use business valuation as an essential tool for creating ownership stability and assessing management performance. Mercer Capital professionals have spoken for years about the "things that happen to you" and the "things you make happen".

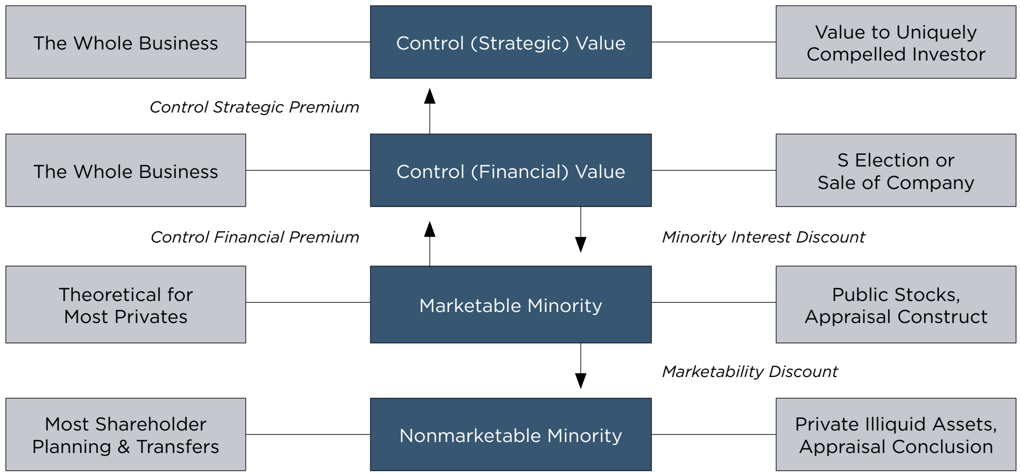
The Ownership Transfer Matrix	**PARTIAL SALE/TRANSFER**	**TOTAL SALE/TRANSFER**
THINGS YOU MAKE HAPPEN	ESOP Outside Investor(s) Sale to Insiders/Family Combination Merger/Cash Out Gifting Programs Going Public Buy-Sell Agreements	Sale of Business Stock-for-Stock Exchange w/ Public Co. Stock Cash Sale to Public Co. Installment Sale to Insiders/Family ESOP/Management Buyout Buy-Sell Agreements
THINGS THAT HAPPEN TO YOU	Death Divorce Forced Restructuring Shareholder Disputes Buy-Sell Agreements	Death Divorce Forced Restructuring Bankruptcy Shareholder Disputes Buy-Sell Agreements

LEVELS OF VALUE

Does it make a difference in value per share if I own 10% or 75% of a dealership? You bet it does. The former is a minority interest and does not enjoy the prerogatives of control which the latter does. How does this affect value per share? Well, the minority owners are relegated to bearing witness to a process over which they have no control or discretion. In effect, they often play the role of silent partners. They cannot control compensation or distributions, and they certainly cannot dictate the strategic direction or operational management of the business. Thus, the fair market value per share of a minority owner is likely worth less per share than the shares of a 75% owner.

To add further insult to injury, a minority owner of a dealership likely has no ready market in which to sell his or her interest. Minority ownership in a publicly traded company enjoys near instantaneous liquidity given that such interests can be traded on organized and regulated exchanges. The unique uncertainties related to the timing and favorability of converting a private, minority ownership interest to cash gives rise to a valuation discount (for lack of marketability) which further distances the minority owner's per share value from that of a controlling owner's value per share.

The following chart provides perspective on the various levels of value. In most cases a valuation is developed at one level of value and then converted to another level of value by way of a discount or premium. Knowing when to apply such adjustments and quantifying the size of these adjustments is no simple matter.



So what does all this have to do with selling trucks? A lack of basic knowledge will leave you short of the required vocabulary and understanding needed to comprehend the context with which the value of a business interest is developed.

HOW DOES VALUATION WORK?

It comes as a surprise to many owners to learn that there is not a single value for their business. Numerous legal factors play important roles in defining value based upon the circumstances of the transfer of equity ownership. While there are significant nuances to each of the following topics, our purpose here is to help you combine the economics of valuation with the legal framework of a transfer (either voluntary or involuntary).

Without offering a full dissertation on business valuation, you need to understand that there are fundamentally three commonly accepted approaches to value: asset-based, market-based, and income-based. Approaches refer to the basis upon which value is measured.

Asset-Based Approach

The asset based approach can be done different ways, but in general refers to the market value of a company's assets minus the market value of its liabilities. For instance, the rule of thumb that truck dealers are worth book value would be an asset based rule of thumb.

Book value is not an altogether incorrect way to look at the value of a truck dealership, but it also is not the only way. Imagine, for example, two truck dealers both have a net asset value (appraised or estimated market value of the assets minus the market value of the liabilities) of, say, $5 million, but one is in an attractive and growing market and has pre-tax income of $1 million per year while the other is in a mature to declining market and has pre-tax income of $500 thousand per year. In the case of the first company, the pre-tax return on net asset value is 20%, and in the second company the pre-tax return is only 10%. Are both dealerships worth book value?

Investors make investments based on perceived rates of return, and only look at assets as a source of return. Given that truck dealerships are asset intensive businesses, the presence of significant book value is important, but primarily to the extent that it generates a rate of return. Given a choice, the truck dealer that generates more profit for each dollar of book value or net asset value should attract more investor attention and, therefore, more value, than a truck dealer that generates less profitability.

The composition of the balance sheet is important as to what kind of earnings it can produce. Is your balance sheet tied up in new inventory, or do you have a large rental fleet? Are you invested in parts, or are you expanding your used truck business? The composition of the balance sheet says a lot about what management's expectations are for the future and what kind of earnings your dealership can produce. A client of ours saw the last downturn in the heavy truck market coming a little earlier than most and started slashing inventory levels to the bone. One of his manufacturer's reps called him one day and asked, "What would it take for you to put some of my new trucks on your lot?" His response: "A lobotomy." His company made it through the downturn without any losses because he managed the balance sheet aggressively. He knew that "book value" would not save him if no one wanted to buy trucks.

The Market Approach

The market approach goes to the heart of valuation: a company is worth what someone is willing to pay for it (and what the counterparty is willing to sell it for). In some industries, there are a significant number of publicly traded companies that can be relied on to provide a market based indication of value, such as price to earnings. This is not generally the case in truck dealerships, but that could change some day. There was a time when there were no publicly traded conglomerates of car dealerships, and now there are a half dozen which analysts use to benchmark the valuation of auto dealers.

Another way to use the market approach is to look at comparable transactions. If there are transactions in a given franchise of truck dealerships which provide a rationale for valuing a given dealership, then comparable transactions can be used as a market-based indication of value.

The market approach is not without its perils. A national operator of a hundred or more auto dealerships is obviously not the same thing as one Honda dealer in a suburb of Birmingham. But, the conglomerates act to consolidate the industry, and as such, are responsible for many of the transactions which effectively set the tone, or pricing, that will be paid for a given dealership. Similarly, no two transactions are alike, and the fact that one investor paid a certain multiple of EBITDA (earnings before interest, taxes, depreciation and amortization – a common measure of cash flow) for one business doesn't mean it necessarily holds true for another.

For example, the market approach can take into account industry factors that would not necessarily be reflected in the asset base approach or the income based approach. In a cyclical industry such as this one, sales and profitability can fluctuate year to year based on any number of industry or broader economic drivers. Despite the fact that earnings may drop in a given year, the price to earnings multiples in truck dealerships may actually go up that same year, which seems counterintuitive. You would think that companies which are performing well below historical norms should be worth less, all things considered, and this is generally true, but only to the extent that poor performance is expected to continue. If the public market pricing holds the same or even declines slightly while profits are plummeting when compared the prior year, the valuation ratio (the Price/Earnings ratio, or P/E) will actually be higher.

Why? Other than the simple example of the denominator in the ratio going down more than the numerator, it is because average future earnings are expected to be greater than earnings in the current year. While you may expect to do relatively poorly one year, more often than not, you are likely to bounce back in the next year or two. The value of your business should take this into account. Using the market approach, the price/earnings multiples implied by current transactions could very likely expand in a down year, even though dealerships will be doing relatively poorly and prices paid may be somewhat flat in comparison to the previous year. Thus, the market approach can be a valuable tool in determining the value of your truck dealership.

The Income Approach

Finally, the income approach is often appropriate in the valuation of a truck dealer. The income approach first looks at the profitability of a dealership, usually its earnings or cash flow after taxes, and then applies a multiple to those earnings based on market returns. The income approach can be the most relevant way to value a truck dealership given that asset based approaches can be misleading because of differences in profitability relative to a given amount of book value and the problems you can have finding truly comparable market data. The income approach can also be implemented with a discounted future benefits method.

The income approach can take into account factors that are specific to your company and that would not necessarily be reflected in the asset based approach or the market based approach. In general, the income approach has two key components: a measure of earnings (or some other measure of profitability) and a multiple that is applicable to that measure of earnings. While measures of earnings at almost all dealerships reflect adherence to the same set of reporting guidelines and principles, nearly every company has incurred a special non-recurring cost, paid above or below market compensation to owner-managers, or experienced some unique event that impacted earnings. The income approach should consider these income statement items. Likewise, the earnings multiple that is appropriate for your company should reflect the unique aspects of your business. If your dealership would struggle to maintain operations without you, all else equal, the future earnings of your dealership are more risky than the earnings of a dealership which would smoothly transition from one owner-manger to the next. This risk often goes by the name of key-man risk or key-person dependency, and it reduces earnings multiples in the context of the income approach. Unadjusted earnings multiples derived under the market approach do not reflect specific company issues, such as key-person dependency.

FINAL THOUGHTS

Mercer Capital has valued many truck dealers over the years, and we have witnessed many of the hardships and successes in the industry. We hope this information, which admittedly only scratches the surface, helps you better shop for business valuation services and understand valuation mechanics. We encourage you to extend your business dialogue to include valuation – sooner or later a valuation is going to happen. Proactive planning and valuation services can alleviate the potential for a negative surprise which could make worse an already stressful time in your personal and business life. Perhaps Yogi Berra wasn't specifically commenting on valuation, but his advice is nonetheless sage: "You got to be careful if you don't know where you're going, because you might not get there."

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ABOUT MERCER CAPITAL

Mercer Capital is a national business valuation and financial advisory firm. Our clients include private and public operating companies, financial institutions, asset holding companies, high-net worth families, and private equity/hedge funds. Since 1982, Mercer Capital has been bringing uncommon professionalism, intellectual rigor, technical expertise, and superior client service to a broad range of public and private companies and financial institutions located throughout the world.

Mercer Capital provides valuation and transaction advisory services to the transportation industry.

MERCER CAPITAL'S TRANSPORTATION INDUSTRY TEAM

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