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Analyzing a Consolidating Industry: Auto Dealerships

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Future articles in *CCH Business Valuation Alert* will focus on the trend towards consolidation occurring in many industries that have traditionally been comprised of smaller, localized, closely held companies. So-called consolidators, which are companies backed by either private equity or flush with cash from an initial public offering of stock, are moving to consolidate individual industry groupings driven by hoped-for economies of scale, synergies, and benefits from professional management. Alternatively, in a hot stock market, many consolidators are trying to buy smaller companies for a given range of price-earnings (or other measures) multiples, then take the consolidated group of companies public at a higher, inflated stock market multiple, realizing a financial windfall.

This article will give an example of an industry that is typical of this trend, the privately held auto dealership. It will examine the forces at work in the industry prodding it towards consolidation, and the ramifications to the closely held dealership owner in deciding whether or not to join the mating dance when approached by a consolidator. The owner of the typical privately held auto dealership faces hard decisions about his business transition planning, specifically: if, when, and how to untap the personal wealth tied up in the company, usually his largest personal asset. The rapidly changing world for the traditional privately owned local auto dealership has created enormous opportunities to cash in on this wealth at all time high values that may never occur again. At the same time, major risks are on the horizon that could serve to diminish or eliminate dealership values in the future. This article will give a brief overview of the current trends that will impact the value of an auto dealership and why there may be greater pressure now for owners to consider the current and future actions that will lead to a realization of this value.

Why Should an Auto Dealer Be Concerned?

While presently dominated by locally owned dealerships selling to local markets, the auto dealer landscape is undergoing a significant change as recently formed, publicly traded mammoth dealerships seek to consolidate the industry. This grab of market share by these "megadealers" is beginning to change the economics of the business. While it remains to be seen whether their business models will work long-term, these giants have tapped huge pools of cheap public capital to put their plans into action, gobbling up privately owned dealerships throughout the country. At the same time, the private dealer has benefited from an unprecedented growing economy, making it easy to make money in recent years and lulling dealership owners into inaction about planning for the future. Selling autos has always been highly cyclical, and the inevitable down cycle will come, taking profits and the days of easy money with it. Furthermore, key demographic clouds are on the horizon that cast a significant shadow over the long-term demand for automobiles. This suggests that the remaining glory days of the private dealership may be limited.

These industry changes have enormous potential implications for the dealership owner regarding estate and succession planning, realization of the maximum amount of wealth from his or her shares, and, in some cases, the very survival of private dealerships. Many owners want to ignore the fundamental shifts occurring or pretend that it will not affect them. The rationalizing away of the potential impact of these changes could be dangerous.

While there is no guarantee of what tomorrow may bring, a number of signs suggest that the time to think strategically is today. Values of some private dealerships may be at or near their peak, and future forces suggest that the greater risk is that the days of high values may be numbered. The private-dealer owner needs to act now to determine the value of the dealership; if, when and how this value can or should be tapped; and how he or she can work in close consultation with legal advisors to develop the appropriate tax, gift, estate, and succession plan. Finally, the owner needs to take steps today to position the dealership to be sold in the future for the highest possible value should this at some point become the appropriate course of action.

The Emergence of the Publicly Traded Dealership

Until recent years, there were no publicly traded automobile dealerships whatsoever. Even today, the overwhelming ma-

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jority of dealerships, including megadealers, remain privately held. According to the National Automobile Dealers Association, there are presently about 22,700 new car dealerships. The average dealership is typically small, has one or several locations, and is privately held. The typical dealership owner is actively involved in all aspects of the business, and is a sales-oriented individual. Most owners either inherited the family business, bootstrapped themselves into dealer ownership by winning the rights to open a new location from one of the major car manufacturers, or bought a dealership where they had previously worked as a general manager for a part-time or absentee owner. The dealership owner succeeded by having the right brand, and selling hard and fast against other similar locally based competitors. Thus, the formula for success was simple and made the dealership owner the classic prototype of the American entrepreneur. This led to a highly fragmented industry with a local focus and an orientation towards sales. While these factors helped the dealer succeed, these same attributes gave rise to perceived opportunities to capitalize on weaknesses inherent in these local dealerships.

Privately Owned Megadealers Lead the First Assault

First came the megadealers (basically large private dealerships with many locations) who saw the opportunity to grow by acquiring small dealerships that generally were in larger urban areas. This allowed the dealership to grow both geographically as well as by brand. One of the theories to their business model was that by being large, the overhead of the business (such as accounting and administrative needs) could be spread across a large number of locations. This allowed the dealership to realize economies of scale and cost savings. In a competitive business where the price of the car is increasingly subject to being squeezed, the megadealers believed they would be able to make a profit at lower car prices than would the smaller private dealer. This gave the megadealer a competitive advantage in the business.

Additionally, television and newspaper advertising in a given market typically covers a wide geographic area. By having numerous locations throughout an advertising region, the same fixed ad dollars could support numerous locations resulting in further economies of scale. Furthermore, it was believed that the ability to commit to purchase massive numbers of cars, parts inventories, and other needs might lead to possible purchasing efficiencies not available to the smaller, local dealership. The current system of large numbers of small dealers is a highly inefficient distribution system that adds significantly to the ultimate price of a car.

Finally, megadealers believed that they would bring professional management to the picture. This included the ability to look at the business in a big picture way, and to have a staff able to develop and implement coordinated marketing strategies. The small dealership owner, meanwhile, lacked the time to do these things, spending much of the day selling; dealing with the parts, service, and body shop; working with the sales manager; buying and selling used cars at auction; talking to banks and so on. This complete immersion in the day-to-day operations left little time for strategic planning for the individual dealership owner.

Megadealer Growth Through Acquisition

As a result of the above trend, the private megadealers grew as rapidly through acquisition as their retained earnings and bankers would allow. Availability of capital acted as the primary constraint on growth. The enduring bull stock market, meanwhile, by the mid-1990s, had led to extraordinarily high valuation multiples paid by public investors for public companies in general. With the impediment to abundant and cheap capital now eliminated, entrepreneurs seized upon the opportunity, taking companies public in a wide variety of industries. The sole mission of these entrepreneurs was to consolidate, through acquisition, industries that had traditionally been dominated by small, locally oriented private companies. What better example of such an industry than the traditional privately held auto dealership?

In 1996, 1997, and continuing into 1998, a number of large auto megadealers went public. Examples include Republic Automotive (AutoNation), CarMax, United Auto, Group 1 Automotive, Inc., Lithia Motors, Cross-Continent Auto Retailers, and Sonic Automotive, to name a few. While these companies are massive (United Auto, for example, had revenues of $3.3 billion in 1998), they still control only a small percentage of the total industry. According to Group 1 Automotive's public offering, the U.S. automobile retailing industry has estimated annual sales in excess of $600 billion, with the 100 largest dealer groups generating less than 10% of total sales and controlling about 5% of the 22,000 dealership locations nationwide.

The Wal-Mart Approach to Selling Cars

If one looks at the man leading the charge of the public companies, the threat to the future of private auto retailing should be apparent. Wayne Huizenga, the highly successful entrepreneur who founded Blockbuster Video, leads AutoNation, the unit of publicly traded Republic Automotive. Circuit City, the nation's leading electronics retailer, meanwhile, is in the thick of the fray with CarMax. These are retailers of the most sophisticated kind—those who see auto selling as just another fragmented retail business itching to be transformed. How many independent local video retailers or electronics store chains are left today after the assault by mass merchandisers? For years, independent retailers believed their local focus, service orientation, and long history protected them from "foreign" competition; however, history has proven them wrong in a wide variety of retailing segments. In general, wherever mass-merchandising has taken hold, the independents have been severely damaged if not entirely eliminated. There is a very real risk this same fate will befall the private auto dealer as well.

Acquisition Trends

In just a few short years these publicly traded megadealers alone have acquired hundreds of dealerships in an acquisition binge that appears to be gaining momentum. With the massive amounts of capital these companies possess in their war chests, it is possible that the acquisition trend will continue. The initial acquisitions have tended to be of two main varieties, either the large private dealer with multiple locations and brands, or the one- or two-location larger dealer with key brands in a large urban market.

These first acquisitions have given the public dealers powerful beachheads in many large urban markets. As these companies develop dominance in a local geographic area, they have the potential to increase competition and erode the profit margins of those private dealers that remain. Once dominance in a local market has been fully achieved, the public dealerships may have less of a need to buy the remaining local private dealers. Even if the megadealer wants to buy the local private dealer, it may not be at the higher prices paid earlier in the game when their goal was to gain initial entry into the market. In other words, the early-bird seller may get the worm. This makes timing critical to the private auto dealership considering its options.

Auto Manufacturers Fail in Attempts to Stop the Trend

Auto manufacturers appear to be very concerned that the industry balance of power will shift from the manufacturer to the large dealerships. Thus manufacturer's have fought the trend towards consolidated dealer ownership. Such a shift could give the large dealerships greater clout in dictating the cost of vehicle purchases as well as the ability to make or break a particular brand. This battle has proceeded to the courts as manufacturers have tried to use the power of the dealership agreement to veto the sale of private dealers to their public brethren. Dealer franchise agreements normally name an approved dealer owner and manager and give the manufacturer the right to approve any change. Several recent court cases in various states have gone against the manufacturers. Additionally, several out-of-court settlements have leaned towards the side of the megadealers with the main caveat being agreements on some limitations on dealership concentrations by certain brands. In general, these trends suggest that the floodgates to greater public ownership are likely to open further and there will be few constraints to stop the consolidation from moving ahead.

The Industry is Booming: Is Now the Time to Sell High?

The automotive industry has always been enormously cyclical. Any auto dealer knows that when the economy and consumer confidence turns down, the first thing to suffer is auto sales. Unless the consumer absolutely has to replace an aging vehicle, the purchase of a new car is put off. The typical auto dealer has a high fixed cost structure. This includes a large investment in facility costs (such as a high rent) that must be covered regardless of whether times are good or bad. When revenues turn down and fixed costs remain level, the usual result is little or no profit or even losses in the typical dealership.

Recent times have been very good, aided in large part by an unparalleled economic expansion that has made selling cars almost easy and has kept profits at or near peak levels. The valuation of most dealerships ultimately depends on their current and anticipated future prospects and profitability. Times have been so good for so long that the actions of buyers and investors presently border on giddy. This is reflected in the general view of dealership values, and the goodwill (or "blue sky" to auto dealers) buyers are willing to pay in many cases (goodwill represents the value over and above the hard assets of the dealership). In short, it seems that investors have forgotten the fundamental up and down nature of the auto business.

Investor Psychology Could Cause Dealership Values to Collapse

However, this buyer's mentality could quickly shift in the event of an economic downturn, as unwary investors would be shocked by the magnitude of the change in the industry's fortunes. This could lead to quickly declining values for dealerships, both public and private. No one can predict accurately the timing or magnitude of such a downturn. However, the current economic expansion has been extremely long by virtually all historic measures. Therefore, it is at least reasonable to assume that the risk of a cyclical downturn in the auto industry increases with each month the current expansion continues.

Even if the private owner does not consider the potential threat of the public megadealer, there is another factor that requires careful consideration by the auto dealer who is currently at a crossroads with respect to action. Do they have a son or daughter with the interest, skills, and ability to take over the business? Selling cars is a hard business, and most current dealership owners worked very hard, for long hours, and at great personal sacrifice to build the business. Many owners often complain, however, that their children, even if they are interested in the business, lack drive or motivation. In the brave new world of mass merchandising auto retailing that appears to be around the corner, do the owner's children have what it takes to take over the business without compromising the value of what is usually the single largest asset of the private dealer, namely, the dealership?

Other Threats to the Industry

As if these changes were not enough, other threats are also on the horizon. In 1996, the Project 2000 Committee of the National Association of Auto Dealers (NADA) published its report that raised a number of longer-term concerns that might impact the outlook for automobile sales and the profitability of dealerships. The Project 2000 report indicates that powerful economic and demographic forces are underway in the industry that will shape the demand for new vehicles as well as increase the pressure on profit margins of vehicles sold.

The Project 2000 Committee believes that the demographic shift occurring as the "Baby Boom" generation ages may have profound implications for the demand for new vehicles. The Committee indicates that older consumers in their 50s often reduce spending for consumer goods as retirement planning, college tuition, and other factors predominate. When coupling this with greater economic insecurity, the Project 2000 Committee suggests that the long-term outlook for auto sales may not be very good.

There are yet further forces and trends that are creating added uncertainty. One of these trends is the millions of vehicles anticipated to come off lease in the near future. Because the average price of cars has risen to such a high level, leasing has been used as a way for manufacturers and dealers to be able to continue to move vehicles in an affordable manner. These leases are now maturing and will create an added supply of used cars. This could potentially drive down the profit margins on used cars as well as having a negative impact on the pricing structure of new car sales. Some auto dealers do not see this as a threat, indicating that certified used car programs may actually increase auto dealer sales of used cars where many say they make better profits.

What if a Megadealer Approaches Me?

Not all deals are created equal, and this is certainly true in the acquisition of auto dealerships. Each of the public companies mentioned earlier employs different strategies in the pricing and payment for auto dealerships they acquire. Some megadealers will appear to pay what seems to be the highest price, concentrating some or all of the payment in the form of the stock of the acquiring public company. This public company stock is sometimes restricted stock governed by Rule 144 B of the Securities and Exchange Act. Rule 144 B makes it very difficult for the holder of the shares who received them to sell the shares for the first year. Even after the first year, there may be additional restrictions placed on the sale of the stock based on market trading activity and other factors. Therefore, the risks of holding illiquid shares in the short run may make the public company shares received worth less than the current trading value of the public company's unrestricted shares. Therefore, what seems to be the highest price may not indeed be the case.

A competent business valuator can accurately estimate the actual cash equivalent value of the offer. This will enable the potential seller to make a more informed decision by being able to readily compare the all-stock deal, the all-cash deal, or any combination of the two. Other factors also can be crucial such as:

- **The Public Company Stock as an Investment.** If some part of the purchase price is received in public company stock, how is that stock performing? Does the stock have upside potential, or is there a significant risk that the price will deteriorate? How strong is the company financially? If the shares are inherently risky, how much personal wealth should be tied up in this stock? This last question will be a key determinant in assisting the owner in the structuring of the transaction. It may be better to take a lower all-cash (or mostly cash) offer in order to sleep better at night.

- **Dealership Real Estate.** The second largest personal asset of most dealership owners is often the dealership real estate, which typically is owned personally and leased to the company. Will the public company buy the real property or lease it? If they buy it, what amount will net after capital gains taxes? If they lease it, will they enter into a reasonable lease rate that protects against inflation? Will they lease it for a longer-term lease period? Are they a long-term, creditworthy tenant and can the public company be counted on to live up to the terms of the lease agreement? An auto dealership is truly special purpose real estate. If the lessee abrogates or defaults on the lease, it is often very difficult real estate to sell or convert to an alternative use.

- **What Will the Prior Owner's Role Be in the Acquired Company?** Will the previous owner play a role after the sale? To whom will she report? Will she have any authority? How long will she be needed? What will she be paid? These sound like simplistic questions, but to the auto dealer who has always been in control of his or her own destiny, they are crucial issues they might never have had to deal with before. Many prior owners might find being an employee to a new boss very difficult.

What Could Change These Trends?

Two key caveats may hold the key to whether public megadealers ultimately become the dominant force in the industry or whether they are unable to achieve their goals and become a failed experiment in capitalism.

First, their business model is still unproven and only time will tell if the presumed efficiencies, new notions of retailing, and the clout over the auto manufacturer all bear their anticipated fruit.

Second, individual and institutional investor sentiment for the shares of these public companies could turn negative, driving down stock prices. Alternatively, an overall correction in stock market values in general might have the same impact. The ability of the publicly traded dealerships to carry their business plans forward depends in large part on having a strong stock price. That strong stock price gives them access to cheap capital by means of raising additional funds through new stock offerings. Also, it gives the public megadealers the ability to use their high priced share currency to cheaply acquire dealerships. If weakened stock prices affect either of these factors, the consolidation trend in the industry could slow dramatically or even stop altogether. While this may be good news to some private dealership owners fearing competition, the bad news is that it may also drive down the potential value of their dealership. Less buyers means less demand to buy dealerships with the result being lower dealership values.

Conclusion

The bottom line is that nobody knows what the exact future will hold for auto dealerships or any other industry. The future may be rosy for privately held, smaller auto dealers. However, this article gives a glimpse of how threats and opportunities can be analyzed and used to draw conclusions that may be of value to clients.

Now is the time to present an honest assessment of these issues to auto dealer clientele. In summary, the owner of a private auto dealership has two choices. First, the owner can choose to plan ahead and seek to be a beneficiary of current trends. Or second, the owner can choose to move ahead, and disagree with the assessment of the possible future risks and threats facing the industry. Irrespective of current trends in industry ownership, the automotive business has always been cyclical, and there is an increasing risk that the industry will enter a down cycle in the near-term future. Longer term factors such as demographics, the impact of auto leasing, and the threat of public megadealers all increase the risk to the private owner and bring with them the prospect of potential deterioration in profitability and dealership values.

The current demand and ability of publicly traded dealerships to grow through acquisitions creates a key opportunity for the owners of privately held dealerships to liquefy their business interests, possibly at historically high prices that may never be seen again. Thus, each individual owner must decide if the window of opportunity discussed in this article is worth investigating or if the dealership is better off with the status quo. Not every dealer will have a valuable dealership. Factors such as profitability, brands carried, the degree of local competition, and management ability all affect the value of a particular dealership. If any or all of these factors diminish a specific dealership's value, the time to act to rectify them is now and not at the time the owner is ready to sell.

Should the business be passed on to the owner's children? Is it important that gifts be made now to transfer the wealth to later generations? Should selling be considered now? A thorough and fully supported valuation of the dealership (or any other closely held business) enables the owner to know where the business stands now, how to answer these questions, and how to plan more intelligently for the future. Also, this analysis of a specific industry illustrates the many issues a business appraiser must consider when undertaking a determination of value of a company in any industry. ◆