Investing In Car Dealerships How To Value Them

By: John Pico, BA, JD

Most business valuations are driven substantially by the company's historical financial statements, tempered by other factors such as: location, brand name, management and such. In truth and in fact, the dealership's balance sheet represents less than half the information necessary to properly value an automobile dealership. The balance sheet is but a starting point from which a number of factors must be added and subtracted in order to determine the true value of the assets.

Valuing new car dealerships has to do with projecting future profits and opportunities based upon the 'dynamic' of the particular dealership being valued and of the automobile business itself.

The Internal Revenue Service recognizes that valuations include more than financial statements: "The appraiser must exercise his judgment as to the degree of risk attaching to the business of the corporation which issued the stock, but that judgment must be related to all of the other factors affecting the value**. *Revenue Ruling 59-60, Section 3.03*.**

DEFINITION OF MARKET VALUE

The definition of market value according to the American Institute of Real Estate Appraisers' Dictionary of Real Estate Appraisal, is: "The most probable price in cash, terms equivalent to cash, or other precisely revealed terms, for which the appraised property will sell in a competitive market under all conditions requisite to fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self interest, and assuming that neither is under duress." ***American Institute of Real Estate Appraisers, The Dictionary of Real Estate Appraisal*. (Chicago: American Institute of Real Estate Appraisers, 1984), 194 195.**

In *Revenue Ruling 59-60*, the Internal Revenue Service defines "fair market value" as follows'. . . the price at which the business 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 and relevant fact'

The purpose of Revenue Ruling 59-60 is to outline and review in general the approach, methods and factors to be considered in valuing shares of the capital stock of closely held corporations. The methods discussed in the Revenue Ruling apply to the valuation of corporate stocks on which market quotations are either unavailable or are of such scarcity that they do not reflect the fair market value.

The Ruling goes on to state that no set formula can be devised to determine fair market value of closely held stocks and that the value will depend upon such considerations as:

(a) The nature of the business and the history of the enterprise from its inception. (b) The economic outlook in general and the condition and outlook of the specific industry in particular. (c) The book value of the stock and the financial condition of the business. (d) The earnings capacity of the company. (e) The dividend-paying capacity. The ability to pay dividends is often more important than a company's history of distributing cash to shareholders, especially when valuing controlling interests. (f) Whether or not the enterprise has goodwill or other intangible value. (g) Sales of the stock and the size of the block of stock to be valued. (h) The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter. With respect to an individual dealership sale, the best comparable is the amount the public company paid or received for buying or selling a similar dealership, not what the public company's stock value or earnings multiple, per se, that is reflected on the stock exchange.

VALUATION FORMULAS

In practice, in arriving at the fair market value of a new car dealership, several different formulas have been used:

1. Return on Investment (or earnings valuation) Formula: The value of a business to a particular purchaser based upon a return on investment analysis. This value varies from purchaser to purchaser according to the purchas's investment criterion and it may or may not reflect fair market value. The National Automobile Dealers Association (NADA) refers to this value 'Investment Value'. ***A Dealer Guide to Valuing an Automobile Dealership*, NADA June 1995, Revised July 2000.**

The capitalization rate is determined by the stability of the dealership's earnings and the risk involved in the automobile business at the time of sale, investment, or valuation. This method is highly subjective as the capitalization rate is based upon the particular appraiser's perception of the risk of the business; consequently, the lower the appraiser perceives the risk, the lower will be the capitalization rate and the higher will be the price he would expect a potential purchaser to pay for the business.

In short, the capitalization rate is the appraiser's opinion as to a rate of return on investment that would motivate a prospective purchaser to buy the dealership. Considerations include those specified in Revenue Ruling 59-60, as well as available rate of return on alternative investments.

2. Adjusted Net Worth Formula: Net worth of the company, adjusted to reflect the appraised value of the assets used in the day to day operations of a

business, assuming that the user or purchaser will continue to make use of the assets. To this "net worth" value will be added blue sky or goodwill, if any. The "Adjusted Net Worth Formula" is the most common method used in purchasing and selling a new car dealership.

3. Orderly Liquidation Formula. This method values the assets as if all of them had to be sol' not at a "fire sale," but in an orderly manner and without time constraints. Normally, if the dealership is profitable, some value will still be placed upon goodwill.

4. Forced Liquidation Formula. The lowest of all values, forced liquidation means that all of the assets must be sold at a forced sale such as an auction, creditors' sale or by order of a bankruptcy court. A bankruptcy proceeding regarding a new car dealership almost never brings goodwill. This might be the most appropriate formula if the dealership has no lease (or only a short term remaining on its lease) and cannot, as a practical matter, relocate.

5. Income Formula. The income formula is basically taking the stores earnings and multiplying it by an appropriated capitalization rate. The trick here is the definition of earning. In determining earnings a perspective purchase could use any combination of the following:

(a) current earnings (b) average earning' add the last five years together and divide by 5 (c) weighted average earning' usually an inverted weight with the current year multiplied by five, last year by four, the year before last by three, four years ago by two, five years ago by one, then adding them together and dividing by 15 (d) cash flow net income plus agreed add-backs such as depreciation, LIFO, personal expenses, excess bonuses and such (e) forecasted earning' future projected earnings discounted to present day value.

6. Fair Value Formula. NADA also refers to a third value in addition to ‘Market Value’ and ‘Investment Value' and it call 'Fair Value.' NADA describes 'Fair Vale' as being'. . . primarily used when a minority shareholder objects to a proposed sale of the company in assessing liquidating damage' and defines it as: 'The value of the minority interest immediately before the transaction to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the transaction and without reference to either a minority or non-marketability discount.'

The NADA guide states: It is not common for auto dealers to run across this particular valuation standard. This author has never used, nor has ever seen this value used with respect to valuing automobile dealerships. As can be seen in this report, this author in discussing valuations excludes what NADA describes a 'Fair Value'.

7. The Greater Fool Theory. The National Automobile Dealers Association publication (*A Dealer Guide to Valuing an Automobile Dealership*, NADA June

1995), bemuses, in part 'A Rule of Thumb is more properly referred to as a 'greater fool theory.' It is no 'valuation theory, however.'

The considerations for valuing new car dealerships are more complex than those used for valuing most other businesses. Dynamics such as the unique requirements of automobile manufacturers and distributors can limit the amount of monies that may be paid for a dealership, regardless of what perspective purchasers may offer to pay for the store.

Therefore, the value of a new car dealership varies based upon the needs and ability of the purchaser and, consequently, the same dealership could have two different values to two different purchaser and both values would be correct.

Thus, our valuation of the subject dealership should be considered in the context and limitations of the facts and history of new car dealership sales as delineated herein.

Although the terms "blue sky" and "goodwill" are sometimes used interchangeably, in our experience they are two separate items.

BLUE SKY AND GOOD WILL

"Goodwill" reflects the intangible value, over and above the hard assets (net worth) of a going concern, when the business is run profitably. It has to do with the operation of the business. It reflects the fact, for example, that the day the purchaser closes on the purchase of a dealership, customers will be lined-up in the service drive, the dealership's phone number will already be listed in the yellow pages, existing customers will have relations with employees of the store, the back-end (parts and service) will have an established gross profit, and a plethora of other advantages that do not exist with the opening of 'new point'

"Blue Sky", on the other hand, is the intangible value of the business opportunity itself. It is the value, for example of being able to own a particular franchise with a certain retail sales potential, or having a business in particular location, or the fact that a particular franchise or location will complement other franchises or locations of a potential purchaser, or the fact that there are few competitors in the area, or the fact that the franchise is ideal for a certain location.

Examples of pure 'blue sky' would be the purchase of a letter of intent (LOI) to establish an heretofore non-existent dealership, or the difference in value between a Subaru franchise in snow country, versus the desert, or the difference in value of a domestic franchise in Flint, Michigan versus Marin, California, or vice-versa, the difference in value of a Nissan store in Marin, California versus Flint Michigan.

In short 'blue sky' may exist whether or not the business is profitable, or ever opened, as with a LOI. When a store is profitable, however, the distinction still *exists, although the term becomes blurred as dealers generally use the terms "blue sky" and "goodwill" as synonymous.*

In valuing an automobile dealership, it is common to:

- *use the American Institute of Real Estate Appraisers' Dictionary of Real Estate Appraisal and the IRS Revenue Rulings 59-60 definition of "Market Value" and we used the Adjusted Net Worth formula with "Market Value - Continued Used" when valuing the assets;*
- *use "blue sky" and "goodwill" synonymously, as the dealership is profitable;*
- *assume an asset sale and (1) add the assets of the corporation a buyer would normally purchase to the blue sky and goodwill values to determine a sales value, (2) then add and subtract from/to that value the assets and liabilities that will remain with the seller.*
- *consider the unique requirements of the industry with respect to the ownership and capitalization of a new car dealership;*
- *value blue sky/goodwill based upon what the seller could reasonably expect as a sales price, if the seller's interest were actually sold pursuant to the American Institute of Real Estate Appraisers' Dictionary of Real Estate Appraisal definitions of "Market Value", but with regard to what the factory and a lending institution would require to approve the sale and issue a flooring line.*
- *consider, if appropriate, a minority discount*
- *land and buildings are valued separately.*

Note too: NADA states that in valuing an automobile dealership 'market value' is interchangeable with 'fair market value' unless specified otherwise. NADA refers to this value as being used for computation of taxes, divorce, Employee Stock Ownership Plans (ESOP) and shareholder agreements. See: National Automobile Dealers Association (NADA) publication: A Dealer Guide to Valuing an Automobile Dealership, NADA June 1995, and Revised July 2000.

NEW CAR FRANCHISES CANNOT BE SOLD

The term "sale" of a new car franchise is a misnomer, in that a new car dealership franchise cannot be sold. Each and every factory and distributor issues a contract called a "Dealer Service and Sales Agreement" which is entered into between the dealer and the factory and which agreement specifically states the franchise cannot be sold.

What actually occurs in the "sale" of an automobile dealership is that the parties sign a Purchase Agreement with respect to dealership assets or stock and give the Agreement to the factory for factory approval of a number of approvals that must be obtained before the sale can be consummated and the purchaser appointed as the seller's successor dealer. These approvals include:

(1) the purchaser's character; (2) the operator's experience; (3) the dealership's location, with respect to current demographics; (4) the adequacy of the facility, with respect to current planning volume; (5) the dealership's capitalization; (6) the dealersh's projected viability as a profitable entity; and (7) the investor's source of funds

Consequently, the fact that a particular prospective purchaser has "the highest off' does not mean that a dealership can be (1) sold to that prospect or (2) that the dealership has the value offered. A new car dealership may only be sold to a candidate that meets all of the qualifications of the manufacturer and distributor with respect to capital, experience and projected viability. Although many courts, especially bankruptcy courts have attempted to ignore this rule and value the dealership at the value placed upon it by the highest bidder, the fact that the highest bid does not establish the value of a new car dealership has been upheld by state and federal appellate courts in every jurisdiction in the United States, including bankruptcy court.

See: In re Pioneer Ford Sales, Inc., 729 F.2d 27 (1984), where the Bankruptcy Court, 26 B.R. 116, had approved the transfer, which ran from Pioneer to Pioneer's principal secured creditor, to Toyota Village. The Court of Appeals reversed both the bankruptcy court and the district court finding that Ford's disapproval was not unreasonable. See too: Ferrari v Simms, US Ninth Circuit Court of Appeals, Case No: 9916059, April 27, 2000, wherein: the US Bankruptcy Court approved the sale of a bankrupt Ferrari dealership and Court of Appeals reversed stating: the manufacture'. . . did not unreasonably withhold its consent'.

Thomas M. Pitegoff, in his article: Franchise Relationship Laws: A Minefield for Franchisors, THE BUSINESS LAWYER, Vol. 45, No. 1, November 1989, states at page 289. "A franchisor at common law and under the Sherman Act may also withhold consent to a transfer on the basis that the price at which the franchisee is offering to sell the franchise is so high that it would jeopardize the financial stability of the business and hinder the transferee's ability to succeed.

It is well established that the franchisor has an interest in ensuring that the purchaser will have a chance to realize a reasonable return on his investment. " See: In re Beverage International, Ltd., [1986-1987 Transfer Binder] Bus. Franchise Guide (CCH) " 8636 (Bankr. D. Mass. 1986); Walner v. Baskin-Robbins, 514 F.Supp. 1029 (D. Tex. 1981); Hawkins v. Holiday Inns, 634 F.2d 342 (6th Cir. 1980), cert. denied, 451 U.S. 987 (1981); Kestenbaum v. Falstaff Brewing Corp., 514 F.2d 690 (5th Cir. 1975), cert denied, 424 U.S. 943 (1976); Hanigan v. Wheeler, 504 P.2d 972 (Ariz. 1972).

REAL PROPERTY AND FACILITIES

Insofar as the operations of a new car dealership are concerned, a factory/distributor will not approve the "sale" of the dealership without passing upon:

(1) the condition of the physical facility; (2) the rent factor; and (3) the lease. Furthermore, the value of real property and facilities to a manufacturer and to a new car dealership does not necessarily relate to the market value of land and buildings in the market area. See: John Pico 'Buying and Selling Automobile Dealershi', National Legal Publishing Company (1986). There are "per car" rental factor and percentage of sales formulas used to determine whether or not a dealership could even survive servicing a proposed rent factor.

Additionally, unless there are extenuating circumstances (such an anticipated move in location), manufacturers and distributors generally will not approve a sale without a candidate securing at least a five year lease on the dealership on an "approved" facility. In some instance, the prospective purchaser's problem with relocating could be that the state has a mileage law.

CURRENT STATE OF THE DEALERSHIP ECONOMY

There are three major factors to consider when discussing "the economy": (1) The health of the national economy; (2) The health of the local economy; and (3) The fiscal health of the franchise and its dealers.

IMPORTANCE OF LOCATION

The strategic importance of location in valuing a dealership, especially this dealership, cannot be overstated. Michelle Krebs and Donna Harris, Staff Reporters for *Automotive News*, wrote an article on January 21, 2002, detailing the importance of a dealersh's location stating that location, always an important asset, has become even more so in valuing a dealership. See too: Dealer Magazine, June 2000'Defining Blue S'; Beers and Cutler, (beersandcutler.com)'Auto Dealer Repo', Issue 2, 2001; and MerillLynch, in its April 19, 2004 report on Auto Dealers wrote:

THE CONDITION OF THE FACILITY

See the Donna Harris *Automotive News* article of January 27, 2003 entitled 'Showroom renew', wherein she state 'More makers than ever want dealers to remodel their store' She quotes Lou Porreco, president of five dealerships in Pennsylvania and Florida, is at the top of the district in customer satisfaction and sales volume: "When there is a buy-sell agreement, and a new dealer is coming in or a dealer is getting a new franchise or a dealer wants to relocate, the factory makes it contingent on remodeling."

See too: Michael Bradfo's February 4, 2004 *Automotive News* Article entitled 'Dealers Respond' Redesign', whose investigative reporting reached the same conclusion.

ONE MAN SHOWS

Revenue Ruling 59-60, Section 4.02 (b) states 'A sound appraisal of a closely held stock must consider . . . The loss of the manager of a so-called one-man business may have a depressing effect upon the value of the stock . . . In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration.

POTENTIAL PURCHASERS

Public Companies

At this time, public companies are no longer the darlings of the industry and as a rule are no longer spending huge sums remodeling dealership facilities they once were and many manufacturers and distributors are rejecting offers by public companies to purchase their dealerships. For example, in 2005 Ford Motor Company refused to approve a public company's $87 million offer for the a Dealership Group. The rejection was upheld by both the California New Car Dealer Board and the state courts. In 2005 Mercedes-Benz blocked another public company from purchasing one of its dealerships by exercising its right of first refusal. In the same time span, Ford Motor Company repurchased yet another public company's Ford dealership and turned it into a company store.

In addition, manufacturers and distributors have limited public companies to a specific number of franchises they may own (for example, Lexus only allows a company to own a combined total five Lexus dealerships in the entire United States) and they have implemented rules prohibiting companies from owning dealerships in the same market.

COMPARABLE DEALERSHIP SALES

Comparable sales are relevant to the extent that the stores being sold are truly comparable to the dealership being valued, with respect to potential, facility, location, brand, demographics, and so forth. As no two stores are truly identical, the blue sky paid for a comparable store would need to be adjusted for the each of the factors mentioned in this article in order to accurately reflect comparable value.

Starting in 1972, Pico entered the automobile business by representing dealership groups such as Tasha Corporation (once the 17th largest dealer group in the country before it sold to AutoNation), and handling sales such as Lucy DiGulio's sale of her deceased husband's share of Prospect Motors (currently the largest General Motors dealership in the nation) to Skip Halverson.

Before retiring from the active practice of law in 1980 Mr. Pico and his law firm represented numerous automotive dealers in the reorganizations, purchases, and sales of dealerships. He both tried cases as the attorney for the dealerships and arbitrated and mediated dealer related cases.

Mr. Pico built upon his experiences and became a student of the industry by receiving training and attending seminars with respect to the various departments in new car dealerships, participating in National Automobile Dealer Association (NADA) Management Education Program, having "hands-on "experience" operating a store by filling in as General Manager on an "interim" bases. In 1986, after five years of research and two years of writing, Mr. Pico authored and National Legal Publishing Company published the nation’s first book on Buying and Selling Automobile Dealerships.

Mr. Pico is recognized as an expert in the field of buying, selling and investing in automobile dealerships. In addition, both State and Federal Courts have also recognized Mr. Pico’s expertise and in various legal proceedings he has been:

- Approved by the U.S. Bankruptcy Court, 10th Circuit, District of Colorado, pursuant to Rule 202 of the Bankruptcy Code, as "Consultant to Debtor" in sale of a new car automobile dealership;
- Approved by the U.S. Bankruptcy Court, 9th Circuit, Northern District of California, pursuant to Rule 202 of the Bankruptcy Code, as "Consultant to Debtor" in sale of a new car automobile dealership;
- Approved by the U.S. District Court, 8th Circuit, Wisconsin, as Arbitrator/ Appraiser in new car Dealership litigation;
- Approved by the District Court of Colorado as expert in dealership valuation litigation;
- Approved by the Superior Court of California as :(a) “Consultant to Court Appointed Receiver" in check-kiting case,(b) "Expert Witness", with respect to dealership valuations, and(c) Superior Court Mediator in dealership/lender litigation.