

Investing in Car Dealerships: Doing Your Homework

By: John Pico, BA, JD

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This article attempts to help give the investor a broader basis upon which to decide whether a dealership merits their time, money and attention.

Interviewing Factories and Financial Institutions

Lenders have an affirmative duty not to promiscuously disclose the financial condition of their debtors. In addition, most Sales and Service Agreements contain confidentiality agreements, with respect to the unauthorized disclosure of a dealer's business. Consequently, questions directed to factories and finance companies should be limited to pertinent, non-confidential questions.

The Buyer's Responsibilities

230 Kan. 684, 640 P2d 1235 held that not only was a bank under no duty to disclose information to a borrower intending to purchase a dealership, but that the investor could not avoid responsibility of exercising reasonable diligence for his own protection. See too: 387 NW2d 373 (Iowa) and 773 F2d 771 (7th Cir.) A buyer may not abandon all caution and responsibility for his own protection and unilaterally impose a fiduciary relationship on another without a conscious assumption of such duties by the one sought to be held liable as a fiduciary. 724 SW2d 343

Courts have even held that a seller's accountants upon discovery its client's financial statements were misleading at the time they were given out, had no duty to correct them, even though they were included in a prospectus. See: 513 FSupp 608 N.D. Ga.

The Physical Inspection of the Dealership

Due diligence requires more from a physical inspection of the dealership than searching for defects in the facility, or potential EPA or OSHA problems. A skilled advisor can surmise how well a potential seller is operating by a visit to the facility. Such things as whether the sales people are energetic, or lethargic; the amount of time it takes sales personnel to greet customers; whether the store is clean and well maintained; whether awards plaques are kept up to date, all indicate the financial condition of the dealership.

Public Information

Data can be obtained from public information to determine not only the financial strength of the dealership, but it can also suggest how to structure an offer more

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attractable to a seller. Sometimes a seller will accept less money because of the manner in which the offer was structured. Determine what a seller needs, then find a way to enable him or her to get it.

UCC-1, title and mechanic's lien searches all supply information without having to seek permission to obtain credit reports and without violating contractual relationships with lenders.

The Fallibility of Dealership Financial Statements

Dealers are required to file financial statements each month. These statements, however, should not be materially relied upon in making projections.

A profitable parts department and a losing service department may mean the service department is doing poorly, or that a strong parts manager is intimidating the service manager into paying too much for the part.

Industry Guides are available for each area of a dealership's operations. Guides, however, are good servants but bad masters. They are prepared by many different groups, using a variety of sources. A prospective purchaser should:

- (1) Compare the selling dealer's actual performance figures, to the guides and obtain explanations for any variances; and
- (2) Prepare a pro forma statement, based upon expected sales and forecast gross profits and expenses, based upon personal experience, rather than the selling dealer's experience.
- (3) Recognize inconsistencies and irregularities in the statements, and pursue a more thorough investigation of those items.

Financial statements do not provide answers about a dealership; they present a method to formulate intelligent questions in order to pursue answers.

Keys to Analyzing Dealership Financial Statements

Basic flags when analyzing dealership financial statements: see our website: <http://www.advisingdealers.com> for a checklist of some basic flags.

Consistency should exist from month to month in each individual account. All inventory and expense accounts should be compared. Note and receive an explanation with respect to major fluctuations.

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Buying Without Relying

One buys a dealership without relying solely upon a seller's financial statements in the same way in which a manufacturer opens a new point. Major differences in these approaches generally inure to the buyer's benefit. For example, when opening a brand new store, there will be no existing wholesale parts business, retail sales base; yellow page advertising; or vehicles lined up for service the day after the escrow closes.

Buying an existing business, on the other hand, provides all that, as well as historical versus projected data to use with forecast

In addition to reviewing financial statement, three additional questions should be answered before making projections for a new dealership:

- (a) the current retail sales volume;
- (b) the planning potential, at closing; and
- (c) the new rent factor.

With those three figures, one may guesstimate the dealership's earnings under proper management; and, he answers to those questions may be obtained from the factory and a reading of the lease.

Officer, Director and Shareholder Approval

Most dealerships are incorporated, or LLCs, and a check with the Secretary of State or Corporations Commissioner will reveal the shareholders, directors and officers of the corporation, and the members of an LLC. A check of local records will generally reveal a d.b.a., or general partnership, whether or not a partnership agreement or stock has been pledged or encumbered and, if so, to whom.

Information, regarding shareholders and officers should be acquired from sources in addition to the factory, as the factory may not have all the information needed to assure the buyer he or she is actually negotiating with the person who possesses the authority to make a contract. Dealers sometimes have silent partners, or sell an interest in the business without informing the factory. In either instance, a potential purchaser could be misled into negotiating with the wrong party.

You need that information to be sure you are negotiating with the right party. In 796 F2d 345 (10th Cir), Michael Gage, president of Michael Gage Chevrolet, signed a "Memorandum of Agreement" to sell his store. He had no approval from either the Board of Directors, or the shareholders of the corporation. Subsequently, the Board and

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the shareholders rejected Gage's agreement and entered into and approved a Buy-Sell Agreement, with another party that was consummated.

Gage sued the Board and the shareholders. The state court dismissed and Gage re-filed in federal court. The federal court held that when Gage (the dealer) signed a "Memorandum of Agreement" to sell, he had no approval from either the Board or the shareholders and "without such authority (he) could not validly contract to sell the corporation's assets."

Be aware too: states vary with respect to the number of shareholder votes required. Some require 100%, some a two-thirds vote and some a simple majority.

Attorneys, Accountants, Brokers and other Automotive Advisors

Attempt to determine the other party's advisors and whether they possess talent; are knowledgeable with respect to the automobile business; and their reputations for veracity and keeping their word. After an investigation is completed, a decision should be made whether or not to proceed. Some purchases are better avoided, regardless of the attraction.

Questions to Ask about the Business

Why did the Dealership Fail or Succeed?

As in "Valuation of Dealerships" (a topic for another article), the critical question is not whether a selling dealership's financial statements reflect a profit or a loss, but rather why?

The fact a financial statement shows a large net operating profit and a large number of vehicles sold is not enough answer to answer why it is profitable. See our website (advisingdealers.com) for a checklist of questions. The questions must be answered before projecting whether new management will make a profit and before deciding upon a reasonable offer for the dealership.

Actual Sales vs. Planning Potential

Planning potential is important for several reasons, such as vehicle allotment, build-out allotments, capitalization requirements and reasonable expectations. A low planning potential and high volume sales may mean the working capital requirements are unrealistic. It is almost impossible to be profitable when a dealership is capitalized too high, or too low.

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When questioning the factory about planning potential, not only inquire as to the number, but also as to the manner in which the planning was derived, the date it was determined, when it is expected to be updated, whether it reflects actual sales in the market area and if not, why not.

Area of Sales and Service Responsibility

The dealership's area of geographic sales and service responsibility is important both with respect to surrounding dealers, and with respect to whether or not the factory intends to close an open store, or open a new store. Past service and sales numbers will be of less value to future projections if the factory intends to add or delete points.

Inquire of the factory, as to what the planning potential requirements would be, taking into consideration the newly closed or opened point.

Significant Document Checklist

Although some of the following items are more important when dealing with a stock sale, versus an assets sale, visit our website (advisingdealers.com) for a list of documents the prospective purchaser should have his or her advisors collect.

In addition, the advisors should be certain to verify addresses on insurance policies, as we have encountered instances where the address being insured was not the address where the dealership was located.

Finally, the appropriate advisors should have an understanding of past, pending and potential litigation, DMV, factory and finance company problems, along with any settlements, payment of sales taxes and whether or not favorable state unemployment insurance rates may be transferred.

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,

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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.

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The one place to go for advice when investing in an automobile dealership is
Advising Automobile Dealers LLC.

www.AdvisingDealers.com