Valuing New Car Dealerships

By: John Pico, JD

Many formulas have been proffered for determining the goodwill and blue-sky value of a new car dealership. Advisors have suggested such methods as multiples of earnings, multiples of 12 month trailing earnings, concluded earnings values, and so forth. The fact is that none of those formulas fully answer the question.

If a Toyota store in Marin, California, goes broke no one would argue that the store had no value because goodwill or blue-sky should be described as a multiple of earnings. Likewise, if the store has lost money for five years in a row, no one would argue that the selling dealer should pay the buyer for the purchase.

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

To make things more complicated based on the factors described herein, the value of a new car dealership varies based upon the needs and ability of the purchaser. Consequently, the same dealership would have two different values to two different purchaser and both values would be correct.

DEFINITION OF MARKET VALUE

The definition of market value according to the American Institute of Real Estate Appraisers' Dictionary of Real Estate Appraisal, to wit:

> "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), at 194-195.

In Revenue Ruling 59-60, the IRS 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 facts.

(Note: Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property. Revenue Ruling 59-60, Section 2.02.)

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 earning capacity of the company.
(e) The dividend-paying capacity.
(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.

In practice, in arriving at the fair market value of a new car dealership, several different formulas may be 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. 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 higher the appraiser perceives the risk, the higher will be the capitalization rate and the lower will be the price a potential purchaser will 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 local competition, available rate of return on alternative investments and the size of the dealership.

The "Return on Investment", or" Earnings" method is rarely used by purchasers of new car automobile dealerships as one cannot purchase a new car dealership without a qualified dealer operator who, by definition, must be knowledgeable in the business. Hence, the prospective purchaser knows from personal, practical experience what he or she thinks can be earned in the dealership and what he or she is willing to pay for the business and the franchise opportunity.

2. Adjusted Net Worth Formula: **Net worth of the company**, adjusted to reflect the value of the assets appraised at "Market Value - Continued Use", which is the 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. (Note: "Fair Market Value" of the assets would be 20 to 25 percent less than "market value - continued use", as Fair Market Value reflects only the price the assets would bring if sold, usually piecemeal, to a user who would have to remove them to a new location and re-install them for use. Contraire, the "Replacement Cost - New" formula gives the highest dollar value, and is used almost exclusively for appraisals requested to secure insurance coverage.) To this "net worth" value will be added blue-sky and 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 sold - not at a "fire sale," but in an orderly manner and without time constraints. Normally, some value will still be placed upon blue-sky and the dealership may even bring some goodwill.

4. **Forced Liquidation**. 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, although most times, some lower value will be placed upon blue-sky.

The terms "Blue-Sky" and "Goodwill" are generally used interchangeably when speaking about the value of new car dealerships although they are, in our experience, two separate items.

"**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, and a plethora of other advantages will exist that do not exist with the opening of a "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 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. When a store is profitable, however, the distinction still exists, although it becomes blurred as dealers generally use the terms "Blue Sky" and "Goodwill" as synonymous.

In our valuation of the dealership, we:

- used 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;

- used "blue-sky" and "goodwill" synonymously, as the dealership is profitable;

- considered the unique requirements of the industry with respect to the ownership and capitalization of a new car dealership;

- valued blue-sky/goodwill based upon what the seller could reasonably expect as a sales price, if the seller's interest were actually sold on January 1st, 2006, pursuant to the American Institute of Real Estate Appraisers' Dictionary of Real Estate Appraisal definitions of "Market Value", without regard to a potential purchaser's estimated return on investment, but with regard to what the factory and a lending institution would require to approve the sale and issue a flooring line.

UNIQUE FACTORS IN VALUING NEW CAR DEALERSHIPS

Background

New car dealerships generally sell for the "fair market value-continued use" of hard assets, which include such items as parts, accessories, furniture, fixtures, equipment, plus an amount for goodwill and blue-sky that would vary among purchasers according to their assessment of such factors as enumerated above (desirability, need, location, competition, history and such).

It should also be noted 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 "Service and Sales Agreement" which is entered into between the dealer and the factory and which agreement specifically states the franchise can<u>not</u> be sold.

In point of fact, what happens 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 items, such as:

(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 dealership's projected viability as a profitable entity; and
(7) the investor's source of funds

that must be obtained before the sale can be consummated, and the purchaser appointed as the seller's successor dealer**.**

Consequently, **<u>the fact that perspective purchaser has "the highest offer" does not mean that a dealership can be sold to that prospect.</u>** 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. This fact has been upheld by appellate courts in every jurisdiction in the United States, including bankruptcy courts.

See, for example, **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. Toyota Village had offered $75,000, for the parts and accessories, plus $10,000 Blue Sky. Ford would have paid between $45,000 and $55,000, for the parts and accessories. Both the bankruptcy and district courts allowed the bankrupt Ford dealer to assign its Ford franchise, over Ford's objection, to the Toyota dealer who had the higher offer. Ford appealed the Federal District Court decision.

The Court of Appeals held it must look to state non-bankruptcy law to determine whether or not the Service and Sales Agreement was assignable.

Rhode Island Law provided:

> "[N]o dealer . . . shall have the right to . . . assign the franchise . . . without the consent of the manufacturer, except that such consent shall not be unreasonably withheld. R.I. Gen. Laws Sec.31-5.1-4(C)(7).

The court went on to hold:

> (1) "The statute by its terms, allows a manufacturer to veto an assignment where the veto is reasonable, but not otherwise. The statute's language also indicates it applies 'whether or not' the franchise contract itself restricts assignment. The basic question that (this) case presents is whether Ford's veto was reasonable in terms of the Rhode Island law."

> (2) "Although the district court did not explicitly decide whether Ford's veto was unreasonable, it decided a closely related question. . . . Pioneer is in default, but the bankruptcy and district courts found 'adequate assurance.' For the sake of argument, we shall assume that this finding is equivalent to a finding that Ford's veto of the assignment was unreasonable."

The Court of Appeals reversed both the bankruptcy court and the district court finding that Ford's disapproval was not unreasonable because Ford's dealer guidelines had a minimum working capital requirement and, the court held:

> "We do not see how the few positive features about Toyota Village. . .can overcome the problem of a history of losses and failure to meet Ford's capital requirements. In these circumstances, Ford would seem perfectly reasonable in withholding its consent to the transfer. Thus, Rhode Island law would make the franchise unassignable."

Ford contended that Michigan law should govern, but the court held it had no reason to believe Michigan law differed from Rhode Island law. See: Mich. Stat. Ann. Sec. 19.-856(34)(1)(i) [M.C.L.A. Sec. 445.1574(1)(i)].

In light of the above, **the amount of money a willing buyer would pay a specified amount for a new car dealership does not in and of itself establish the value of that dealership.** This information is important because at the date of this appraisal (January 1, 2006), public companies are no longer the darlings of the industry they once were and many manufacturers and distributors are rejecting offers by public companies to purchase their dealerships. For example, last summer Ford Motor Company refused to approve The Asbury Group's (a public company) $87 million offer for the Baker Group in San Diego. The rejection was upheld by both the California New Car Dealer Board and the state courts. Last November Mercedes-Benz rejected prohibited Lithia Automotive Group (a public company) from purchasing one of its dealerships in northern California. In addition, Ford Motor Company required Lithia to sell its Concord, California dealership and, in the same time span, Ford (Motor Company) repurchased Sonic's (another public company) Ford dealership (Friendly Ford), on Capitol Expressway, in San Jose and turned it into a company store.

In addition, since Mr. Anderson originally sold his Honda store to AutoNation, 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). Furthermore, manufacturers and distributors have set rules prohibiting public companies from owning dealerships in the same market.

For example, AutoNation could not purchase Fremont Toyota because it already owns Hayward Toyota, even if it (AutoNation) met all of the other requirements of the factory and even if AutoNation were offering the highest bid for Fremont Toyota. Another example would be that because certain public companies already own Honda dealerships in the area, they would be prohibited from purchasing Anderson Honda, thus taking them out of the mix of potential purchasers. The effect of the manufactures' limitations on the value of the dealership is discussed later in this report.

The History of New Car Dealership Sales

Until the late 1990's, almost 100 percent of all dealership sales had been asset sales because of the myriad of liabilities (such as: accrued vacations, notes payable, trade payables, leased equipment, pension funds, outstanding retail paper, insurance tails and such) normally accrued by an automobile dealership. Within the past few years, however, a greater number of stock sales have been occurring.

There are also contingent liabilities such as the dealer's contingent liability for outstanding retail- paper, (which could take up to 72 months to liquidate. In the case of a domestic franchise, it could cost approximately six percent of the outstanding liability to liquidate the outstanding paper. See Volume I, page 21-4, *Buying and Selling Automobile Dealerships*, National Legal Publishing Company 1987), contingent liability for outstanding extended service contracts and liabilities for undiscovered torts or undiscovered tax liabilities.

With respect to asset sales, work in process, factory orders, prepaid items and in some instances reserves, would be sold to the purchasing dealer; however, the selling dealer generally does not sell such assets as factory and customer receivables.

Consequently, if one is considering a sale of corporate stock, a seller must be prepared to make liberal concessions to compensate a purchaser for liabilities he or she would not have assumed had there been an asset sale, as well as known, future tax liabilities such as "LIFO".

Further, in the case of a stock sale, Service and Sales Agreements also provide for the same factory approvals concerning items such as adequate capitalization, the purchaser's character and previous car experience, source of funds, et cetera, as are inherent in an asset sale, plus more.

Revenue Ruling 59-60 Section 4.02 Lists as factors to consider:

> (a) The history of a corporate enterprise will show and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered.
>
> (b) It is important to know that the company is more or less successful than its competitors in the same industry. Prospective competition which has not been a factor in prior years should be given careful attention. The loss of the manager of a so-called `one-man' business may have a depressing effect upon the value of the stock of such business

In the final analysis, however, it should be remembered that

> ". . . an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the-relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance." Revenue Ruling 59-60, Section 3.

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.

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