POWER STEERING

Steering your dealership to higher profits

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New vehicle dealers reflected August 2016 as being a much better profit month than July 2016. There are still several dealers that lost money in August and several dealers that are in a loss position for the year. As you can see below, 20% of the dealers had their best month of the year and 35% of the dealers had a pre-tax profit margin as a percentage of sales of 3.0% or better. We are still seeing dealers with reasonable profits and overall profit margins continuing the trend that started in 2010.

August Profit Trends

	AUGUST BETTER THAN JULY	AUGUST WORSE THAN JULY	AUGUST BEST MONTH	AUGUST 3.0% PROFIT OF SALES	AUGUST LOSS MONTH	AUGUST LOSS Y-T-D
CHRYSLER	50%	50%	20%	30%	10%	10%
FORD	55%	45%	10%	20%	5%	5%
G.M.	65%	35%	20%	35%	10%	0%
IMPORTS	80%	20%	35%	45%	5%	5%
OVERALL	65%	35%	20%	35%	5%	5%

Leasehold Improvements

Every few years, we write about leasehold improvements. The issue is how to treat them when rent is to be determined, and to be fair and reasonable to both the owners of the dealership and owners of the real estate upon the sale of the dealership. Many times, the rent of the dealership is determined based on some percentage multiplied by the value of the real estate. If the dealership has paid a reasonable amount for leasehold improvements, say over $100,000, then the value of the rent should be say 8% of the total value of the real estate reduced by 8% of the unamortized leasehold improvement (or cost of leaseholds). In other words, the dealership should not have to pay rent on the value of the leasehold paid for by the dealership and included in the total value of the real estate.

The second leasehold issue is what happens when the dealership is sold or the dealership real estate is sold. To be fair and reasonable to all owners of the dealership and the real estate entities, there should be an agreement between the dealership and real estate entity reimbursing the dealership for some amount of the leasehold improvement paid by the dealership upon the sale of the dealership or dealership real estate. If this is not done, the dealership stockholders could be shorted and the real estate owners could possibly obtain a windfall. If the two entities have the same owners, it might not matter, but common ownership might change sometime in the future when it would matter.

"When everything seems to be going against you, remember that the airplane takes off against the wind, not with it." -Henry Ford

Inside

Profit Margin

As we have written in the past, pre-tax net profit as a percentage of sales is one of the two best metrics to measure profit effectiveness. The second metric is pre-tax profit as a percentage of gross profit and other income. The National Automobile Dealer's Association reports pre-tax net profit as a percentage of sales this year to be 2.3% of sales and the computed pre-tax profit as a percentage of gross profit and other income to be 17%. We analyzed two dealerships that reported pre-tax net profit as a percentage of sales to be only 1.5%.

Below are some of the observed reasons these two stores were below average in their overall profits as a percentage of the department's gross profit:

New Compensation for sales persons, sales managers, and F & I persons is 40%. This is too much.

New Compensation for sales persons, sales managers, and F & I persons is 42%. This is too much.

Used Compensation for sales persons, sales managers, and F & I persons is 37%. This is too much.

New Gross advertising and promotion is 32%. This should be much less.

New Gross advertising and promotion is 27%. This should be much less.

Used Gross advertising and promotion is 26%. This should be much less.

New floor plan interest expense is twice as much as the interest credits. It should be close to the interest credits.

Parts compensation was 38%. This should be much less.

Used front-end retail gross profit was $937. This is way too low and most dealerships cannot make a reasonable overall profit margin with such low gross profit margins. As an aside, this dealership used a national website used vehicle pricing service which we regularly see yields low used retail front-end gross profit margins.

For these two stores, more sales of vehicles would not change these trends materially unless they froze advertising expense and new inventory levels expense. This is because the total department compensation would probably go up proportionally. In other words, the pay plans and number of sales employees is out of line, high with expense. If you make less than 2.0% pre-tax profit of sales, why not have someone point out to you where you are out of line with expenses? Send your financial statement to us and we will perform this analysis at no charge.

Blue Sky

Many dealers and some "experts" value the Blue Sky of new vehicle dealerships based on a multiple of "earnings." We do not agree with this for several reasons. Sometimes, we see charts that might reflect multiples of earnings for franchises from maybe a low of 3 to a high of 10. Several questions have to be asked. How many actual transactions make up each data point on the chart to make it valid? Is the data from the actual sales detailed enough to know how much was really paid for Blue Sky? What definition of "earnings" is used? Were the earnings: five year reported earnings? Five years "adjusted or normalized" earnings? Expected earnings? Was the real estate valued at true market value, or over/under valued? Was the real estate value in line with the size of the dealership? Based on these concerns, the reliability on using multiples is limited. If the multiple used is say 8, then the return on investment would be only 12.5%, which in most cases is far too low. After allowing for capital to be invested for Blue Sky, fixed assets, and working capital, this 8 multiple, 12.5% return, might now be 10% return on invested capital. Also, if the buyer limits the capital invested by having a large loan for capital, the buyer can reflect maybe a 20% return, but still have funds at risk, which will yield misleading results.

We have seen some valuators use a multiple, but have a test of determining what the return on investment is for a sanity test on the multiple. If the sanity test return on investment is too low, the valuator might then lower the multiple. Looking at the algebra of this, valuators might as well use return on investment to determine Blue Sky and dispense with using multiples. If a dealership never made any money and had no immediate expectation of making money, the multiple method would reflect zero Blue Sky, though most stores have some Blue Sky except some in small markets and those with high out-of-line rent factors. To summarize, we do not believe in multiples of earnings to determine Blue Sky, as it is too fraught with inaccurate results, especially with not knowing for sure what the real earnings are and if someone has allowed for expected earnings. As an aside, it appears we are past the high for Blue Sky value, and it seems it is going down slightly at this time. The only way to confirm this is to talk to the buyers at the public auto companies and large private groups to find their opinion.

National New Vehicle Inventory Sales Trends

We have measured and kept track of national new vehicle sales for over 40 years. Nationwide new unit sales this year, 2016, are expected to be the best ever at approximating 17,500,000 new cars and light-duty trucks. However, in our opinion, this comment needs to be qualified. Nationwide annual new unit sales were as follows: 1978: 15,100,000; 1986: 16,100,000; 2000: 17,400,000. If you allow for population growth, there has been no real increase in nationwide new unit sales per person. Also, the annual growth in nationwide new unit sales from 1978 to 2016 is only 0.24% per year. This is one quarter of one percent growth in new vehicle sales, which is well less than the population growth.

Labor-In-Process Write-Offs

Recently, we had a dealer that had a large percentage of labor inventory write-offs at the end of each month. This means there was an excess labor inventory, due to many reasons, that had to be written off. Most dealers' statements have a cost of sales account (expense line) for this amount in the service department. We did a survey of over 50 dealers to see their results on labor in process inventory write-offs. We found the average dealer had a labor inventory write-off as a percentage of total service labor sales with the average being 3% and the median being 2%.

Advertising Effectiveness

We recently had an opportunity to attend an advertising meeting at a dealership. At the meeting, there was a discussion on how the dealership was allocating its advertising budget. The most interesting part of the meeting was a discussion on the dollars allocated to traditional media, such as newspapers. The number of young people in their 20s and 30s that read newspapers is a fraction of what older generations do. Social media seems to be where the growth is. We concluded that dealerships need to allocate more of their advertising budget to social media outlets and less to print advertising. We might also suggest that you have some employees in their 20s and 30s attend your advertising meetings to make sure some of the media that you use is directed towards that age group.

Rent and Equivalent Expense Metrics

For dealers that lease their facility, rent and equivalent expense as a percentage of sales approximates 0.94% of sales based on the NADA reported percentages. Our group of dealers is close, but slightly above the NADA. Rent and equivalent includes rent, maintenance, facility insurance, and property taxes. How do you compare? Are you intentionally charging too much?

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