Driven

NADA MANAGEMENT SERIES BM15

A DEALER GUIDE TO

Dealership Valuation

NADA
NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Disclaimer
This publication is offered for informational purposes and is not intended as accounting or legal advice. It is essential that dealers consult with their tax practitioners, attorneys, and other professional advisors when contemplating or conducting a dealership valuation for purposes of sale, tax reporting, ownership change, and other circumstances.

NADA has prepared this management guide to assist its dealer members in being as efficient as possible in the operation of their dealerships. The presentation of this information is not intended to encourage concerted action among competitors or any other action on the part of dealers that would in any manner fix or stabilize the price or any element of the price of any good or service.

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Introduction

A Dealer Guide to Dealership Valuation is intended to serve as a resource for dealers and their advisors who seek to understand the process of valuing automobile and heavy-truck dealerships in a variety of contexts. Dealers should seek expert advice from a qualified CPA, valuation specialist, attorney, and transaction advisor or business broker as appropriate when considering ownership changes or sale of an entire dealership.

The goal of the appraisal process is to obtain an objective and realistic valuation of a dealership or dealership group. This guide aims to provide an analytical and thoughtful approach well-grounded in financial principles.

Valuation procedures can vary, as can the resulting opinion of value, depending upon the reason for conducting the valuation. This guide will cover a variety of situations in which the value of a dealership is needed:

- Buy-sell transactions.
- Estate and gift tax planning or reporting.
- Ownership succession planning.
- Owner buy-in or buy-out.
- Tax reporting resulting from entity restructuring.
- Divorce, dispute, and other litigation settings.

Valuation of an automobile or heavy-truck dealership, or any business, should be well-reasoned and supported. We discourage the use of any standard formula based on "rules of thumb" as a sole valuation methodology. Valuation formulas, often called "multiples," are regularly published for the automotive brands, but like all rules of thumb, they are general in nature and have a limited ability to account properly for all of the relevant factors in valuing any specific dealership interest; further, they are simplistic, obscuring a lot of detail. As a result, they do not differentiate operating characteristics affecting risk from one business to another, such as greater or lesser emphasis on used-vehicle sales or fixed operations, or a need for significant future capital expenditures. In addition, rules of thumb don't address unique conditions that exist in different market areas, such as stronger or weaker future demand for the brand's products, expected population growth, and economic prospects.

Many dealerships, however, do transact on the basis of a multiple, along with other valuation methods. To the extent that the multiple accurately reflects the relevant factors, and can provide confidence in capitalizing a single dollar amount into perpetuity, this approach may be reasonable as long as the underlying assumptions support the earnings and multiplier that are the basis for the value estimate. The sources of these multiples caution that any specific buy-sell may vary from the range due to unique characteristics of each dealership transaction.

This guide emphasizes these overarching principles:

- Analyzing adjusted historical earnings and cash flow is essential.
- More important, however, is estimating expected future cash flow. The future benefits are most relevant to an investor.
- Properly determining the rate of return required to convert future benefits to present value is equally critical. This rate of return should reflect the risk or degree of uncertainty surrounding realization of the future cash flow. It should afford the owner a reasonable return on investment.

The guide provides a framework for independent, professional business appraisal opinions by helping dealers and their advisors to understand the various elements affecting the value of their dealerships. We'll look at standards and credentials applicable to independent business appraisers. We'll describe the important steps in the appraisal process, including how the changes resulting from tax reform enacted in late 2017 are factored in. And we'll address how and when certain discounts should be employed, plus income tax considerations specific to automobile and heavy-truck dealership valuations.

To properly conduct a valuation investigation, one must gather pertinent information. We provide a checklist of documents and information often requested for a typical automobile or truck dealership.

We'll address the steps to analyzing financial information, and discuss comparable guideline data. We'll also consider the importance of non-financial factors that influence value. The independent appraiser's investigation differs from that of a CPA's financial audit or other due diligence: The appraiser's investigation emphasizes historical trends and generally presumes the balance sheet accounts are in order while the audit examines the balance sheet supporting schedules and data.

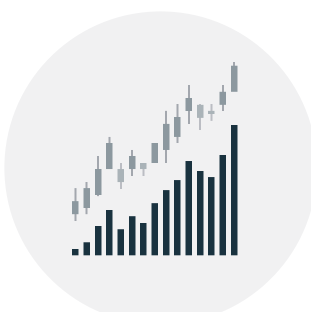
Due diligence in areas such as contracts-in-place, management and employees, and legal claims, plus their impact on the balance sheet and profit results or overall risk, often differ among an audit, appraisal and third-party transaction.

A dealership preparing for an independent appraisal should expect to undergo, generally, a five-year historical analysis of financial statements and other data. Financial auditors, in contrast, generally emphasize the year ended with comparison to the prior year. Third-party buyers are often somewhere in between the two. This means that the dealership team should expect to gather different types of documents, schedules, and information depending on the type of outside investigation the company will undergo.

Three broad approaches are used for the valuation of a business ownership interest:

Income Approach

The Income Approach uses estimated future returns converted to present value at an appropriate rate of return for the investment.



Market Approach

In the Market Approach, valuation ratios—based on multiples derived from the publicly traded auto and truck retailers or from published transaction data of publicly traded or privately held dealerships—are applied to the subject business's earnings, cash flow, or other figures.

Asset-Based or Cost Approach

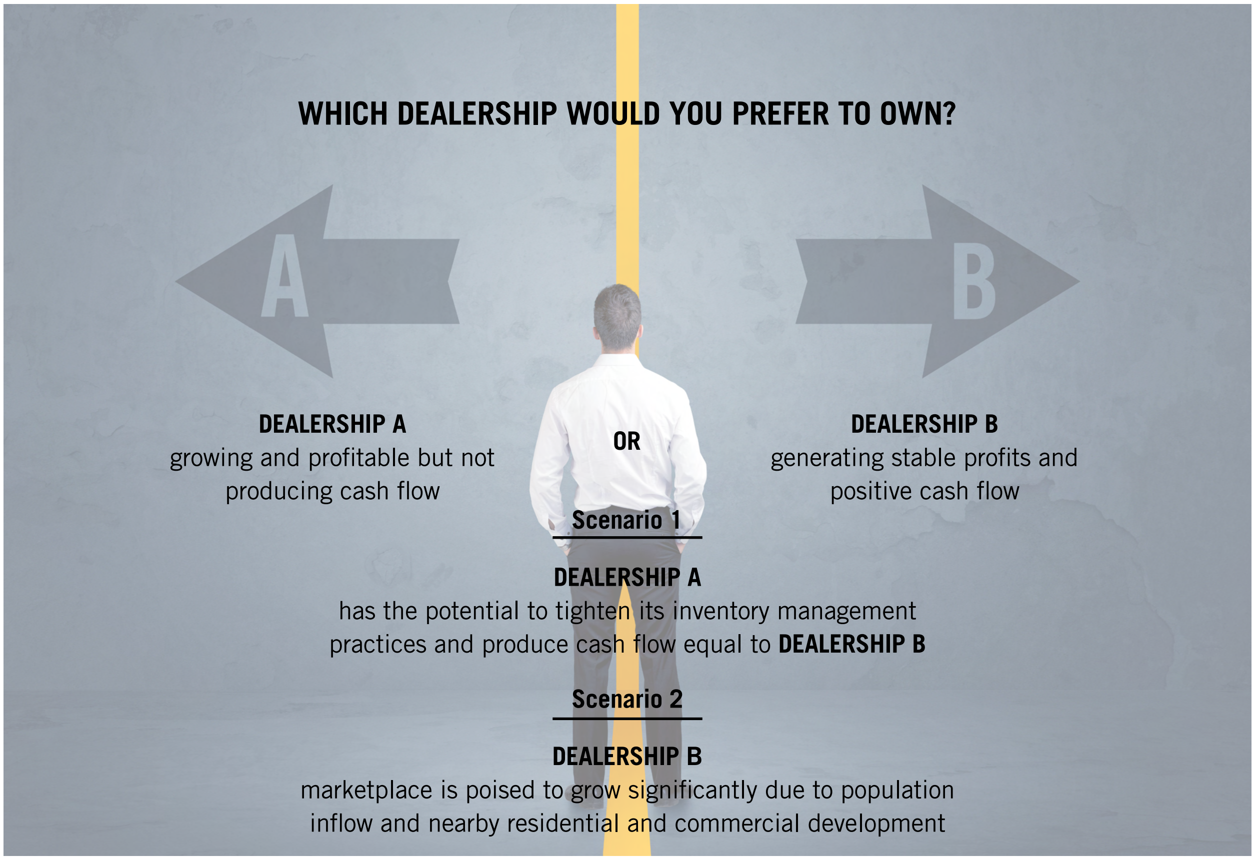
The Asset-Based Approach analyzes the assets and liabilities of the business and restates them from historical book value to market value.

The three approaches are described in detail in this guide.

The valuation opinion may be influenced by certain owner-level factors, such as the size of the ownership interest being valued and control issues, restrictive agreements in addition to franchise agreements affecting ownership rights (for example, shareholder agreements), the marketability or ability to convert the ownership interest to cash, and voting rights of the subject interest.

Lastly, if the goal is to sell your dealership for the maximum value, this guide provides some ideas for creating a plan to do so. Setting a time frame and strategy focused on the most likely buyers will allow you to take active steps to enhance the value of your dealership.

An additional benefit of having an independent appraisal may be the identification of potential improvements to the dealership. The appraisal investigation process evaluates the historical and current conditions and innumerable aspects of the financial, operating, and external factors that affect value. An impartial assessment of how the dealership functions can lead to a fresh perspective that may allow the owner to optimize cash flow or reduce investment risk.



I. BEGINNING THE APPRAISAL PROCESS

The above scenarios and choices illustrate that valuing a dealership should not be done in a vacuum. Historical earnings and cash flow are important. Historical results allow management and owners to evaluate past practices and make changes that can lead to improvement in cash flow. From a valuation perspective they provide a basis, along with other internal and external factors, for analysis of the dealership's potential results and prospects.

Sophisticated investors evaluate future expected cash flow, presumably over a long-term horizon, to determine investment decisions. Independent appraisers consider these areas as well.

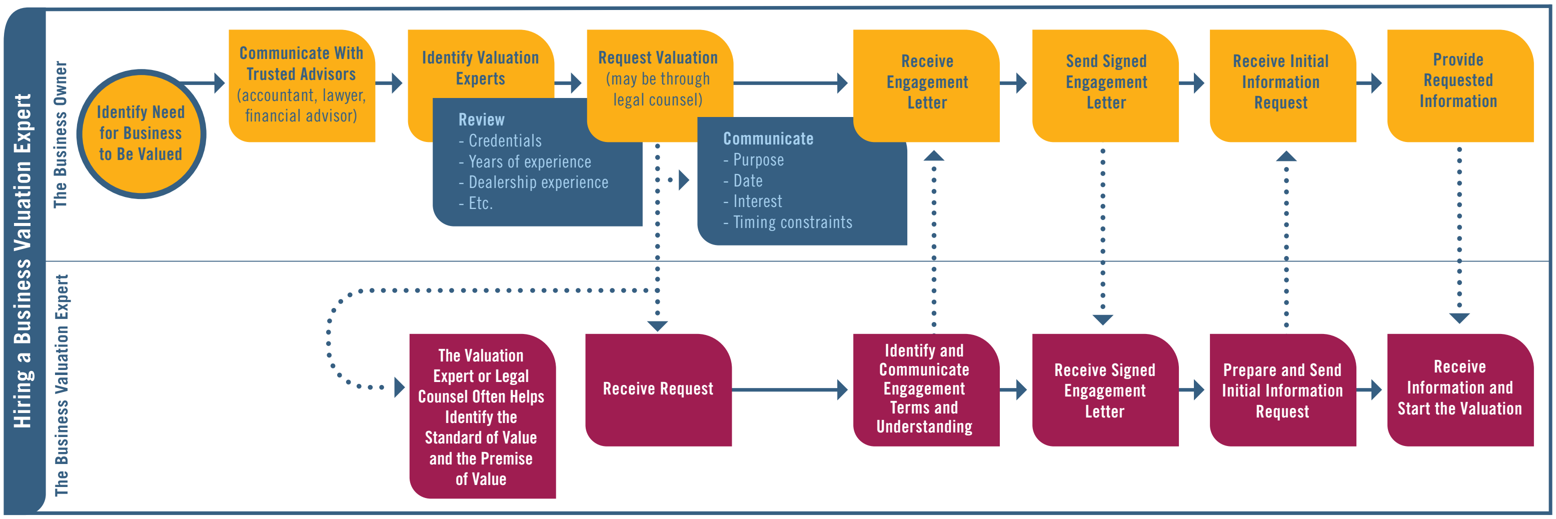
What factors may *decrease* cash flow in the future?

- Is facility maintenance that has been deferred needed in the near term?
- Is the manufacturer requesting that the dealership upgrade its facilities to comply with current image standards? If significant reinvestment in facilities and equipment is needed for a dealership, this will lengthen the time it will take for the investment to pay off or provide a reasonable return to the owners. In addition, the construction process may be disruptive to daily operations. These considerations have a dampening effect on value.
- Has a competing dealership been acquired by a more capable operator?

What factors may *increase* cash flow?

- Has the dealership been managed effectively?
- Has the dealership recently completed large reinvestment projects and now has available cash flow?
- If new product sells well in the marketplace, is the dealership receiving sufficient new car or truck units?
- Could the dealership's excess assets provide a one-time cash benefit?

These are just a few of the many questions an investor or appraiser must ask when determining the value of a dealership. In most situations the future cash flow of the business provides an investor a return on his or her investment and is often the most relevant factor in determining the business's value.



A. Hiring a Business Appraiser

The process of hiring an independent, professional business appraiser can be time-consuming for those just learning about the profession. Most business owners will consult trusted advisors (such as their accountant, lawyer or financial advisor) when looking to identify a valuation expert. The valuation expert's credentials, experience with valuing dealerships, and other expertise as it relates to the purpose of the valuation should all be taken into account when deciding on which valuation expert is the most qualified for the appraisal assignment.

If the purpose of the valuation assignment, for example, is for marital dissolution, then your legal counsel should look to hire a valuation expert who has expertise in valuing dealerships and prior experience in valuation for divorce proceedings.

1. Appraiser Credentials

It's important to understand the qualifications of the individual appraiser responsible for the opinion of value. Table 1 outlines the primary appraisal organizations in the U.S. that award professional appraisal designations to their members, along with their specific requirements for education, appraisal coursework and examinations, experience, testing, and peer review of actual work product. There are additional forensic and litigation-related designations that are not shown in the table.

2. Appraisal Standards

Each of the professional appraisal organizations publishes its own business valuation standards that are applicable to its members. In addition, credentialed members of the American Society of Appraisers (ASA) must comply with the Uniform Standards of Professional Appraisal Practice (USPAP) as promulgated by the Appraisal Foundation. Overall, the various standards address the same issues and are relatively consistent. It is critical that the work performed follow generally accepted business valuation procedures, meet the standards of the valuation expert's credentialing organization(s), meet the needs of the assignment, and be reasonably understood by the client.

For your reference, almost all of the business valuation credentialing organizations publish a glossary of business valuation terms that can be accessed through their respective websites—ASA, National Association of Certified Valuators and Analysts (NACVA), American Institute of Certified Public Accountants (AICPA), International Valuation Standards Council (IVSC), as well as Business Valuation Resources (BVR).

B. Defining the Appraisal Assignment

Typically, the appraisal of an automobile or truck dealership is not a do-it-yourself project. There are five key elements that should be defined in any valuation project; they will drive the ultimate conclusion of value:

1. **The purpose of the valuation.**
2. **The date of the valuation.**
3. **The interest being appraised.**
4. **The standard of value.**
5. **The premise of value.**

1. The Purpose

The purpose for the business appraisal determines the procedures the appraiser will use. Suppose, for example, a business appraisal is requested for a buy-sell situation where the buyer could obtain cost savings due to the size or proximity of its existing stores. The appraiser may need to consider the savings when projecting future

Table 1. Primary Valuation Credentials and Appraisal Organizations					
Organization	**Certification**	**Education**	**Courses/Exam**	**Reports**	**Experience**
American Society of Appraisers (ASA)	Accredited Senior Appraiser—ASA	4-year college degree or equivalent	4 three-day courses and half-day exam following courses, or complete full-day challenge exam and USPAP exam	1 actual recent report for peer review	5 years of full-time appraisal experience or equivalent
ASA	Accredited Member—AM	Same as ASA above	Same as ASA above	Same as ASA above	2 years of full-time appraisal experience or equivalent
American Institute of Certified Public Accountants (AICPA)	Accredited in Business Valuation—ABV	AICPA member in good standing (as of 2018 non-CPAs are able to obtain the credential)	2-part, 6-hour exam or hold an ASA, AM, Chartered Financial Analyst (CFA), or Chartered Business Valuator (CBV) credential	None	150 hours of business valuation experience
National Association of Certified Valuators and Analysts (NACVA)*	Certified Valuation Analyst—CVA	4-year college degree in field of business	5-hour exam. Optional 5-day training course offered	Complete a sample case study developed by NACVA or submit an actual valuation report prepared in prior 12 months	Non-CPAs need 2 years of valuation experience

* As of 2017 the Institute of Business Appraisers (IBA) was dissolved. The Certified Business Appraiser (CBA) and Master Certified Business Appraiser (MCBA) are no longer awarded but are still supported by NACVA. Contact NACVA for more detail concerning these credentials.

cash flows. These cost savings would not be considered, however, in an appraisal for the same dealership if the purpose is to make gifts to family members.

Similarly, a dealership appraisal for divorce purposes may require adjusting the rent expense if the dealership real property is owned by an affiliated entity. The same rent adjustment might not be made in the appraisal for the purpose of making gifts to family members. So the purpose of the business appraisal affects the value opinion for the dealership.

2. Effective Date of Value

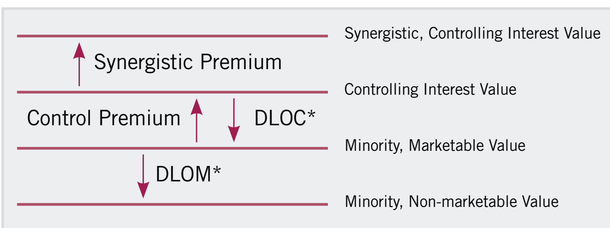
The date for which the business is being valued is important because circumstances can change from one date to another. In the majority of valuation projects the effective date determines what information an appraiser can consider during the course of his or her procedures. Circumstances known or knowable at the valuation date are generally the only ones included in the appraisal process. This includes the financial information for the dealership being appraised, as well as comparable data, industry data, economic data, and guideline company data.

3. The Interest Being Appraised

Defining the appraisal assignment involves specifying the interest to be appraised—for example, a 15% minority ownership interest in the common stock of ABC Dealership, or a 75% controlling ownership interest in the common stock of ABC Dealership. The ownership percentage may signal the control rights inherent in the interest appraised. However, the underlying ownership agreements of the company or state law governing the corporation, limited liability company, or partnership are essential in understanding any specific ownership interest's rights, including those related to control and degree of marketability.

The following basic levels of value chart illustrates the four most common levels of value in terms of ownership characteristics. The adjustments made and the discounts or premiums applied are directly related to the interest being appraised and the level of value that is being determined in the appraisal assignment. The levels of value chart provided should not be considered all-encompassing. For example, there may be an ownership interest that is neither fully controlling nor fully minority, such as an interest in a company that has swing vote potential—say, the case of a 2% interest where there are two other equity owners each having a 49% interest, and a greater than 50% vote is needed for matters requiring a vote. This same 2% interest would not hold the same value if the remaining 98% interest in the company was held evenly by 10 other interest holders, as the value of the swing vote potential would be essentially eliminated.

Basic Levels of Value Chart



**DLOC = discount for lack of control, DLOM = discount for lack of marketability*

4. Standard of Value

Standard of value is a definition of the type of value to be determined. Each standard of value includes multiple assumptions that affect the ultimate conclusion of value and thus the standard chosen needs to match the purpose of the specific assignment. The primary standards of value, and their common purposes, are defined in Table 2.

5. Premise of Value

Most frequently, businesses are valued under the assumption that they will continue operations into the future, which is the *going-concern premise of value*. In contrast, the *liquidation premise of value* is the concept that the business will not continue in the ordinary course of business.

The liquidation premise of value can be either orderly or forced, with the difference being the exposure time that the assets have to their respective markets. Under an orderly liquidation the assets are assumed to have market exposure timing enough to achieve a price reflective of normal market conditions for the respective assets. For example, an orderly liquidation may be assumed in a situation wherein an auto group is permanently closing a specific dealership location but is not under compulsion to do so, thus allowing the auto group to divest the assets at a pace that is most reasonable for the assets in terms of price achieved and costs incurred. Under a forced liquidation the market timing is reduced and normal market exposure is not assumed for the respective assets; this situation is commonly referred to as a "fire sale," as in insolvency or bankruptcy situations. The liquidation value may also be determined under an *assemblage of assets concept* wherein the assets are assumed to be sold as a whole but not in their current use.

C. Appraisal Procedures and Due Diligence

1. Factors Considered in a Business Valuation

The self-described purpose of the IRS's 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 for estate tax and gift tax purposes." Although the ruling specifically addresses IRS-related appraisals, the following factors contained in the Revenue Ruling are considered applicable to almost all business appraisals using the fair market value standard of value and in most appraisals under the fair value for financial reporting and fair value for litigation standards of value:

- The nature of the business and the history of the enterprise from its inception.
- The economic outlook in general and the condition and outlook of the specific industry in particular.
- The book value of the stock and the financial condition of the business.
- The earning capacity of the company.
- The dividend-paying capacity.
- Whether the enterprise has goodwill or other intangible value.
- Sales of the stock and size of the block of stock to be valued.
- The market price of stocks of corporations engaged in the same or a similar line of business and actively traded in a free and open market, either on an exchange or over the counter.

Table 2. Standard of Value		
Standard of Value	**Definition**	**Common Purpose**
Fair Market Value	The price at which the property 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 of relevant facts. 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 the market for such property *(IRS Revenue Ruling 59-60)*. The value determined is generally assumed to be a single-point estimate versus a range and to be in cash or cash-equivalent terms.	• Estate and gift tax. • Charitable contributions. • Buy-sell transactions. • Shareholder buy-in or buy-out transactions. • Employee Stock Ownership Plans (ESOP). • Marital dissolution (some states).
Investment Value	The value to a particular investor based on individual investment requirements and expectations (*American Society of Appraisers' Business Valuation Glossary*). Investment value may consider these factors: • Economies of scale available with the buyer's existing operations. • Synergies available with the buyer's existing operations. • Differences in future earnings estimates. • Differences in perceived risk. • Differences in tax status.	Sale of an entire business with a specific buyer or type of buyer in mind.
Fair Value for Financial Reporting	Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date *(Financial Accounting Standards Board [FASB] Accounting Standards Codification [ASC] 820)*. This standard focuses on the price to sell, not acquire, an asset or liability. Generally market data is weighted more heavily.	Financial reporting.
Fair Value in Litigation	Defined under state statute or by case law. Items that often vary across case law: • Relevance of discounts and premiums. • The relevant date of value. • The premise of value. • Weight afforded to each of the three approaches to value (income, market, and asset-based).	• Dissent and oppressed shareholder appraisal rights. • Marital dissolution (some states).

2. Information Needed

When buying, selling, or valuing a dealership or interests in it, it's important to gather all pertinent information in order to properly evaluate the subject dealership. This process should be thorough in order to minimize surprises and possible disputes and litigation later, particularly for buyers in the sale of an entire dealership.

Appendix A is a checklist you can use for the due diligence process. Depending on the purpose for the valuation, not all of the information may be necessary. However, the following may be requested by a professional valuation expert, broker, or prospective buyer:

- Information on the dealership's history.
- The market area assigned by its franchise agreement(s).
- Sales trends and customer retention and satisfaction data.
- The competitive landscape.
- The operating strategies employed and their suitability to the marketplace.
- The tenure and quality of dealership personnel.
- Facility conditions and compliance with factory image standards.
- Lease agreements.
- Site control agreements, and other agreements or contracts.
- Corporate or limited liability company legal information (formation, bylaws, articles, shareholder agreement, operating agreement).
- Insurance policies.
- Historical financial statements and relevant supporting schedules.

A valuation specialist, broker, or buyer needs to understand the economic prospects in the subject dealership's market and surrounding area. Having demographic data may be helpful in forecasting future demand for the automobile dealership's product mix. The location of the store may not be optimal, and/or the manufacturer may require some structural or cosmetic changes. Ascertaining the dealership's marketing strategy and effectiveness in connecting to customers and prospects is important. The dealership's 20 Group data, CSI and SSI reports, and other factory performance reporting can be of assistance in this regard.

II. FOUNDATIONAL MATERIAL

A. Industry Trends and Analysis

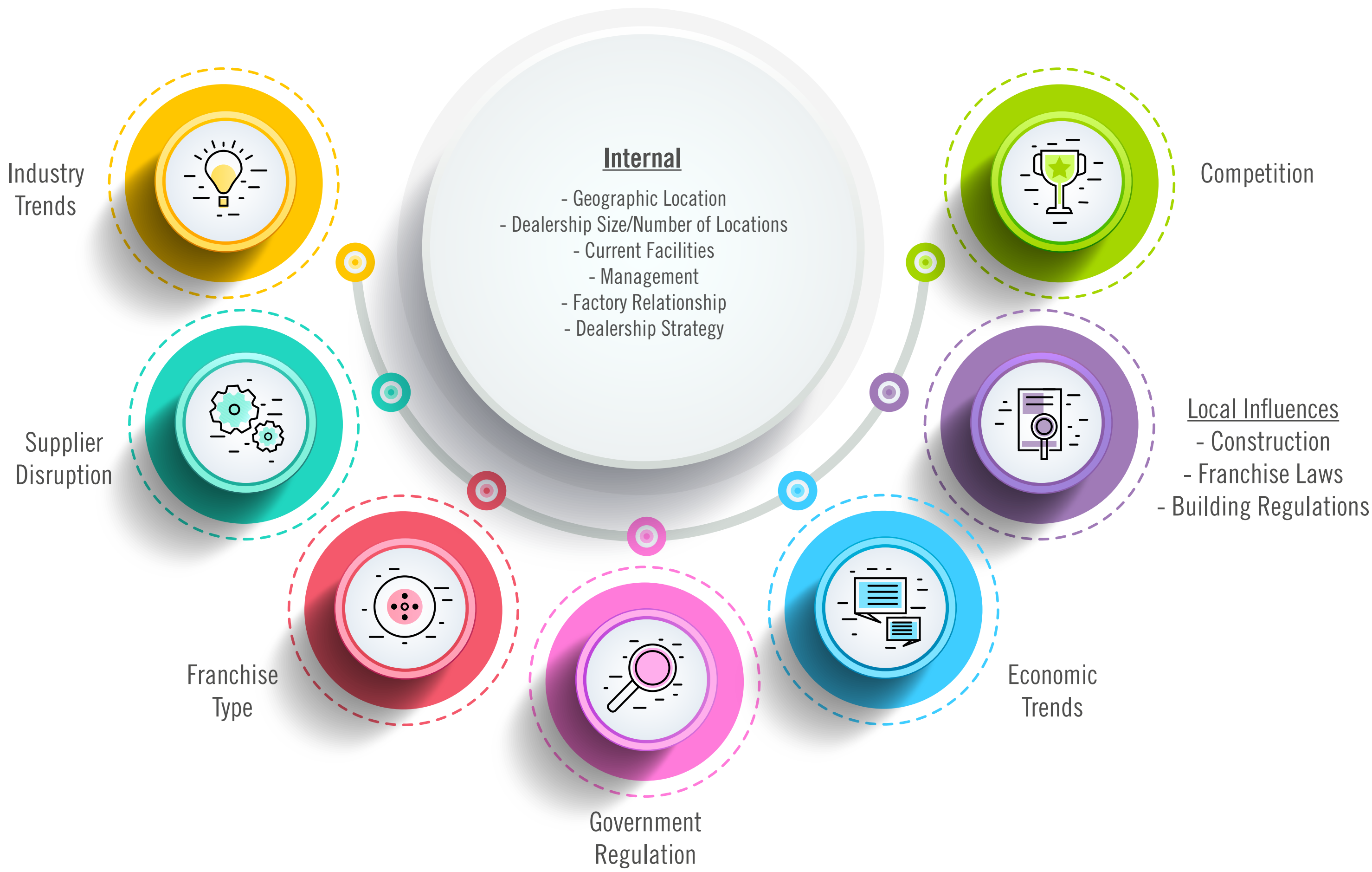
Industry. Current factors within the industry can affect individual dealerships. What is the overall demand for new vehicles in the industry? Is the industry producing an adequate level of desirable inventory? Are product redesigns or replacements occurring with reasonable frequency? What changes are manufacturers requiring of dealers? How are material costs, supplier parts, and supplier capacity affecting vehicle prices? Is there an adequate supply of used vehicles? Have there been factory recalls that affected dealership warranty volume? What is the average age of vehicles on the road?

Over the last decade, automobile and heavy-truck dealerships have recovered from the devastating effects of the Great Recession. Additionally, investment returns in the light- and heavy-duty vehicle segments have attracted new kinds of buyers such as family offices, private-equity-backed groups, and high-net-worth investors. Finally, the current high level of consolidation is expected to continue, with dealers retiring or leaving the industry, and groups adjusting their dealership portfolios or partnering with new investors.

The auto retail and heavy-truck public companies move in and out of acquisition mode, depending on the dealerships or groups available for sale and their prices weighed against their current stock market pricing and their ability to integrate or absorb new stores. Large consolidators and regional dealer groups compete when the stores for sale require a more significant level of capital to close the deal, but these buyers are competing with newer entrants as noted above. These newer buyers are enticed by the investment returns generated by the industry.

On the auto side, new and better technology, tools and procedures to streamline the consumer buying process and track consumer interactions with the dealership, coupled with one-person, one-price sales approaches and other strategies, are driving innovation at light-duty stores. While real estate values may be increasing fixed expenses at many dealerships, owners are carefully

Influences on Value - Internal and External



evaluating their expense structure relative to gross profit volume in order to right-size as volume levels out.

Heavy-duty truck dealerships have different requirements for facilities, and emphasize fixed operations, leasing, and financing activities. Accordingly, both the timing and pace of the slowdown expected in this segment affect truck dealerships differently. Heavy-truck new-unit volume is tied to demand for trucking and expected production cost increases that ultimately result in price increases for commercial truck buyers.

Factory incentives vary among auto franchises over time, causing difficulty in planning and implementing a store's retail strategies. Similarly, the OEM's auto facility image design programs and support ebb and flow, which causes dealerships to weigh whether to invest in their hard assets or exit due to insufficient expected returns on the funds needed for deployment. Ultimately, buyers of auto and truck dealerships evaluate the throughput of the target store(s) relative to the franchise average and its profitability relative to comparable dealerships.

Government/Regulation. Regulation, government programs, and taxes can affect any business. For dealerships the value of the dealership can be affected by numerous government agencies due to the global nature of the dealership, manufacturer, and supplier relationships. Recent governmental issues include tax reform, healthcare reform, dealership franchise laws, tax credits for electric vehicles, CAFE standards, new proposed regulations for emissions, and tariffs.

EPA emission standards have created pre-buying cycles in advance of new regulations for heavy-truck dealers. This has created a boom and bust situation. So assessing the timing of the current cycle is important for truck dealership valuations.

NADA's annual *Regulatory Maze* covers major federal regulations affecting auto and truck dealers.

B. Economic Analysis and Trends

Economic Analysis. The prognosis for the local or regional economy affects the dealership's prospects and should be carefully considered within any valuation. The following are some key local factors affecting the retail auto segment:

- Employment and unemployment rates.
- Per capita income.
- Strength of the housing market.
- Consumer sentiment.

For heavy-truck dealerships, the regional and national economic environment plays a greater role. Following are some regional and national factors:

- Federal regulations.
- Regional population growth.
- Strength of regional business environment (regional growth of GDP may be one indicator).
- Strength of the producer price index.
- Expected strength in the regional construction and manufacturing sectors.

Dealerships are also affected by national and international factors, as was evidenced during the Great Recession, which affected the entire dealership network from manufacturers to consumers. Two important macroeconomic factors include gross domestic product and interest rates.

Demographic Trends and Industry Evolution. Much discussion has focused on whether the younger generations will own vehicles versus using ride-sharing services and public transit, though a NADA-commissioned national study found that Americans, including younger consumers, overwhelmingly prefer to own their own personal cars. Subscription models and high-tech changes in vehicles also factor into these discussions. The outcome could have a long-term impact on auto industry volume, although prognosticators vary on how they see these changes unfolding.

Gas prices can influence the type of vehicle a customer buys, as can incentives for alternative-energy units. Truck dealers are affected by gas prices as well but government regulations are a much greater influence.

C. Other Influences on Value

Factors that influenced the historical financial results could easily shift projected results. Many additional factors may be in play, among which are the following:

1. Internal Factors

Geographic Location. The location of a dealership and the demographics of the surrounding area affect dealership valuations in several ways. First, the size of the surrounding market drives the overall sales potential for the dealership. Dealerships in larger markets may have greater overall sales and vehicle service potential, but there are other considerations. Dealerships in large urban areas often face higher rent, higher taxes, and reduced space for inventory, and it can be difficult to attract customers from the surrounding suburbs. Geographic location also drives demand for specific types of light-duty vehicles. Rural areas may have a greater demand for trucks and all-wheel drive vehicles, while smaller, more efficient vehicles sell better near urban areas, where space is limited and commuting is more common. However, recent sales results evidencing consumer preference for SUVs have upended the typical auto purchasing trends. Heavy-truck dealerships tend to be situated for easy access to the freeway to facilitate customer visits.

Dealership Size/Multiple Locations. Larger dealerships and multiple locations can create efficiencies and increase profits, but require more effective management to be successful. Determining the value of a larger dealership group with multiple locations can also pose its own issues, especially when opining on the value of a single dealership owned by the dealership group. The overlap of management functions, additional overhead, and the allocation of expenses can influence the earnings for any specific dealership.

Current Facilities. Dealership facilities are very expensive, particularly for automobile dealers, and continual improvements are needed to attract customers and meet manufacturer requirements. Deferred maintenance and the timing of any improvements need to be considered to value a dealership. Is the dealership of adequate size to meet future needs? Is the sales or service volume constrained by the size of the facility? Conversely, does the dealership have space that is not being used? Has the facility undergone a construction project that temporarily disrupted sales and service activities? Each of these situations can affect value and should be analyzed in the appraisal.

Management. The quality of management is a key consideration for an investor. Experienced managers who have performed well in the past give an investor confidence in achieving favorable projected results. Management succession is a concern as well, especially if many of the team members are nearing retirement and their replacements have not been identified and trained. The tenure and effectiveness of the employees are examined in more detail in a third-party sale transaction.

Factory Relationship. Having a strong and cooperative relationship with the dealership's OEM(s) is a benefit for an investor. Good relationships facilitate required facility and equipment upgrades and sometimes improve inventory allocation, among other benefits.

Dealership Strategy. How the store addresses its marketplace, customers, employees, community, technology, and related concerns can affect the business's culture and success. A focus on having strong service operations and higher fixed absorption helps stabilize cash flows and augments the value of a store. Embracing change, whether from industry trends, brand-specific concerns, local competition, or other issues, appears to be a key operating strength needed to remain successful in the auto and truck dealership environment.

2. External Factors

Franchise Type. The brand obviously has a significant impact on a dealership's value, and all brands experience high and low cycles. For auto dealerships, is luxury or economy "in"? Has the factory come out with fresh new models or has its product gone stale and lost market appeal? What's hot and what's not affect the value of a dealership at any given point in time. A dealership can overcome low cycles for its brands if it has strategically positioned itself to emphasize used and fixed operations to balance out the lower-volume periods. Truck dealerships operate in this setting day in and day out, and augment their operations with leasing and financing businesses to service their business customers.

Electrification and OEM strategy for future products could have a longer-term impact on dealership value if these are accepted by the auto-buying public and heavy-truck operators.

Competition. The proximity, strength, and approach taken by the nearest competitors affect the volume and growth prospects for a dealership. Further, if the local competition consists of publicly owned or large regional or national dealerships that have cost advantages due to their size, there may be significant challenges to a single-point dealership's opportunities for growth or long-term viability. Competitive advantages and disadvantages of a dealership need to be understood for the valuation.

Supplier Disruption. Past, current, and future financial performance can be severely affected by lack of inventory due to supply issues, labor disruptions, and similar events whose duration may be difficult to ascertain at the time of the valuation.

Road Construction. A retail auto business or heavy-truck store can face ingress and egress challenges caused by road construction nearby. Such issues can have a temporary or permanent impact on the business, depending on the nature of the roadwork.

Local Franchise Laws. During the recovery years following the Great Recession, many states implemented stronger franchise laws designed to protect dealerships from over-burdensome provisions or requests by OEMs.

Local Building Permit Regulations. Obtaining approval to expand or construct facilities or signage can become an obstacle for dealerships, despite the major economic benefits municipalities derive from property tax, sales tax, and other transactional tax revenues.

III. HISTORICAL FINANCIAL RESULTS

A. Review of Historical Balance Sheets

Balance sheet adjustments do not always have an impact on the dealership's earnings. For example, assets that are not used in the operations of the business should be classified as non-operating assets and analyzed separately. Other balance sheet considerations include inventory reporting choices and working capital (current assets less current liabilities) levels. The expenses related to these balance sheet items may affect the dealership's earnings and cash flow.

1. Non-operating Assets

Certain assets are considered to be non-operating items for purposes of valuation. Generally, these assets could be liquidated without impairing the company's operations. Such assets are not necessary for the dealership's operations. The assets may be obvious, such as a vacant piece of land that previously stored vehicles but is no longer used, or marketable securities held within the business. Others may be less obvious, such as excess cash held by the company beyond what is needed for operations or receivables from affiliated parties.

In removing the non-operating assets from the balance sheet any income or expenses related to the non-operating asset should be removed from the results of the income statement. This will affect the dealership's earnings and cash flow. Common income includes gain from marketable securities as well as interest and dividend income. Expenses related to non-operating assets can be more varied, but can include maintenance on non-operating assets, and related operating costs, or even depreciation of the asset. Once these income and expenses have been removed, the adjusted pretax earnings can be tax-affected to reach operating after-tax earnings. A similar analysis should be conducted for non-operating liabilities.

After estimating the value of the dealership using either the Income or Market Approach, it is often appropriate to add the value of any non-operating assets to the value of the operating dealership. For the Asset-Based Approach, no further adjustment would be necessary if the adjusted book value includes both operating and non-operating assets. If the valuation is to exclude all non-operating assets such as in an instance where the purpose is a sale of the entire dealership not including the non-operating assets, then the non-operating assets should be excluded from all three approaches.

When the ownership interest being appraised is a minority interest in the dealership, it may be appropriate to apply a discount for lack of control and a discount for lack of marketability to the non-operating assets. Each discount is discussed in depth in a subsequent section of this guide. The reason for these discounts is that a minority ownership interest investor cannot force the dealership to sell these non-operating assets or convert them to cash and compel payout to the owners.

2. Review/Normalize Historical Working Capital

Working capital, defined as current assets less current liabilities, can be a key point in the determination of the value of an automobile or truck dealership. Because working capital is used to fund the daily operations of the company, a business often requires a higher base dollar amount of working capital as it grows. The level of working capital needed, as well as increases in working capital as the company grows, decreases cash available as a return to an investor.

Determining the required level of working capital can be a difficult task. Typically, the manufacturer has a formula for the required level, but may not update the level often enough. Or, the OEM-required level of working capital may be less than what is actually needed to operate the business. If working capital is insufficient for the business needs, the value of the business may be decreased, because an investor would need to make an additional investment in working capital for the business to continue operations. The more common issue is that the business holds excess working capital. Excess working capital can come in several forms: excess cash, high inventory levels, or as the result of not flooring inventory, which reduces the current liabilities of the dealership. Regardless of the cause, excess working capital could be a non-operating asset that is not necessary for the operations of the business, and should be treated as such within the valuation.

The Risk Management Association's *Annual Statement Studies* publication shows working capital components as a percentage of total assets, and ratios as a percentage of sales. In practice, determining the appropriate level of historical working capital to use as a proxy for the ongoing level may be accomplished using the level as a percentage of sales or asset turn ratios. If the dealership uses LIFO (last in, first out) inventory accounting, the LIFO reserve should be excluded from both the historical analysis and the ongoing required level in the valuation. (See detailed information in "LIFO Adjustments," below.) In practice, we express the expected working capital level as a percentage of annual sales to facilitate aligning the expected level with future expected sales revenue.

3. LIFO Adjustments

<u>*Balance Sheet Adjustments*</u>

LIFO is a method of inventory accounting wherein the cost of the most recently recorded inventory is recorded as sold versus the first recorded inventory (first in, first out, or FIFO). LIFO and FIFO are the most commonly used inventory methods. The use of LIFO versus FIFO most often results in an understatement of the cash value of inventories on the balance sheet equaling the accumulated LIFO reserve. The accumulated LIFO reserve should therefore be added back to inventory in order to more accurately reflect its realizable value.

In addition, the built-in income tax liability associated with the LIFO reserve should also be taken into account, and such liability should either be subtracted from the inventory or added to the liabilities. In other words, the inventory should be increased by the LIFO reserve, minus the associated income tax liability. This tax adjustment is considered in the Asset-Based Approach but not typically incorporated into the estimate of ongoing working capital computed as a percentage of sales. Such liability is triggered when a dealership converts off LIFO inventory accounting, which is considered a contingent liability for valuation purposes. When a dealership converts off LIFO inventory a tax expert should be consulted to assess the tax consequences.

Income Statement Adjustments

Because LIFO inventory accounting can produce unusual historical (and noncash-related) results as far as earnings are concerned, earnings must be adjusted. When the value of inventory increases over time, as is often the case, the use of LIFO will result in the cost of goods sold (COGS) being greater than it would be using FIFO and results in a LIFO expense recorded on the income statement. The higher COGS results in lower gross profit and net income and thus a lower tax liability. The opposite is true when the value of inventory is declining over time, which results in LIFO income, higher net income, and a higher tax liability versus the FIFO method of inventory accounting. In a specific historical accounting period the COGS should be adjusted by the LIFO expense or income in order to assess the typical level of cash earnings for the dealership.

Cash flow is often used in determining value rather than earnings, and to the extent that the dealership pays less income tax due to LIFO accounting, both cash flow and value will be enhanced. Therefore, even though LIFO-based earnings are most often lower, cash flow and the overall value result are higher.

4. Built-in Gains

These gains result from the appreciation of the dealership's tangible assets above their book value and are taxable at capital gains rates upon sale of the appreciated asset. Dealerships that are C corporations, or have been S corporations for fewer than five years, are exposed to a double taxation scenario: Their gains would be taxable at both the corporate and personal levels.

When the purpose of the valuation is for a sale of the dealership, the double level of taxation may be avoided in a few ways. First, the sale of the dealership could be structured as a sale of the dealership's stock rather than its assets. However, because this has a negative tax implication for the buyer, the buyer will require additional compensation so the sale price will be reduced. Second, the sale transaction could be structured to include a personal goodwill component, which is outlined in a subsequent section of this guide. These and other techniques require consulting a qualified CPA or transaction advisor.

B. Review of Historical Income Statements

Financial statements the dealership prepares and submits to the factory provide unique information not contained in the company's tax returns or other prepared financial statements. When they're available, 13th-period internally prepared statements, used along with tax returns or other financial statements, will be useful to the person conducting the valuation. The CPA's year-end adjusting journal entries and/or trial balance can be helpful as well.

1. Earnings Adjustments

The historical financial results of a dealership often provide the basis for determining future cash flows. Note, however, that the value of the dealership is based on future cash flows, which may or may not be similar to historical results. During the valuation process, the appraiser, seller, broker, or potential acquirer reviews the subject dealership's historical income statement and balance sheet to determine whether they accurately represent what can be expected in the future. Removing one-time income and expenses may be necessary to reach historical normalized levels of cash flows that can be expected in the future. In addition, removing discretionary expenses that are at the control of a majority owner may be necessary to arrive at controlling cash flows.

Examples of adjustments to historical revenues include one-time manufacturer payments, the sale of assets, income from one-time events, or income from discontinued programs. While adjustments to revenue may be necessary, adjustments to expenses are much more common in developing adjusted historical financial information relevant to the valuation process. Examples include non-recurring expenses; expenses that should have been paid by the business but were paid by the owner or related entity, or foregone altogether; and expenses related to non-operating assets or operations. The following are examples of valuation-related historical income statement adjustments:

Extraordinary bad debt. A one-time write-off of a bad debt may be considered non-recurring and should be adjusted (as should any non-recurring expense) to forecast recurring earnings.

Gains/losses on the sale of assets. These are typically not regarded as a part of the operations, and may be removed as non-operating income or expense. An exception may be those gains or losses attributable to company or rental vehicles if the dealership maintains a portfolio of such vehicles.

Excessive salary or bonuses to owners and family members. What constitutes excessive salary is a subjective judgment, but salary surveys can be helpful here. In its publication *Annual Statement Studies*, The Risk Management Association refers to owner's compensation as a percent of sales. This number has consistently ranged between 0.3% and 1.1% of sales depending on the size of the automobile dealership, with the average at about 0.5% of sales.

NADA's Dealership Workforce Study can provide insight into appropriate compensation for various positions by region, dealership type (luxury versus non-luxury) and dealership size based on new-unit volume. The Workforce Study also includes data for heavy-truck dealerships. State or regional automobile dealer associations sometimes conduct compensation studies, as well.

Rent paid to related-party owners of the dealership's real estate. This can include third-party rents if the situation allows this change in the lease rate. As of February 2019, market rent usually fell between 7.5% to 9% of the market value of the real estate on an annual basis (triple net), but this can vary greatly, depending on the specific market conditions. A real estate appraisal or local real estate broker can usually help calculate market rent for the area.

Income, rent, or taxes on property not used by the dealership. Property not used by the dealership, and not required in the foreseeable future, should be considered a non-operating asset. As with any non-operating asset, if the property is not being employed to generate revenue for the dealership's operations, then income and expenses related to the property are also not related to dealership operations. As a result, the income and expenses need to be removed from the dealership's historical and future financial results.

Fringe benefits. Expenses related to personal vehicles, boats, country club memberships, airplanes, etc., may need to be adjusted.

Life insurance. Expenses related to life insurance of key individuals need to be adjusted if they are personal in nature and not associated with a company obligation. For example, if the company is the beneficiary of a life insurance policy on an equity owner of the business and the company's operating agreement includes a buy-back provision of the equity owner's interest in the event of the death of the owner, then the life insurance policy is not a non-operating asset but rather a necessary asset to account for the liability the company would incur in the event of the equity owner's death. Absent this liability the life insurance policy may be considered a non-operating asset and the expenses related to it should be removed.

Demos provided to non-working individuals. Expenses related to these may need to be adjusted for auto dealerships.

Non-essential travel expense. Travel of a spouse or family member to conferences and the personal portion of work-related conferences may all be non-operating or discretionary and thus require adjustment.

Non-business-related legal or professional expenses. Occasionally legal or professional expenses for matters that are more personal than business-related find their way onto the corporate books; these expenses may need to be adjusted.

Interest income from excess working capital. While dealerships must have cash on hand to fund operations, the level of cash (or cash equivalent) held by a dealership can exceed the operating needs of the dealership. This is discussed further in the section "Review/Normalize Historical Working Capital," above. Any income generated from excess working capital held by the company would also be treated as non-operating and may require adjustment.

LIFO income or expense recorded by the dealership. This must be removed, as it is a noncash item. For more details, see the section on "LIFO Adjustments" above.

The key determinants for adjusting historical earnings are:

1) Is the income/expense expected to continue in the future (i.e., is it recurring?); and

2) Is the income/expense necessary for operations and normal for the industry (i.e., is it non-discretionary)?

When a minority or a non-controlling ownership interest is being appraised, making discretionary adjustments may result in a controlling level of value and a discount for lack of control may need to be applied to arrive at the appropriate minority level of value.

2. Review/Normalize Historical Capital Expenditures

Capital expenditures do not show up when determining the company's net income, but they affect the value of the dealership. Often companies do not make capital improvements at a consistent level year over year, so it's important to consider a typical historical level of capital expenditures. For this reason, historical capital expenditures need to be analyzed when this item is used to forecast future capital expenditures. A discussion with dealership owners or a review of their capital budgeting plans for the future may also assist with the forward expectations.

Depreciation may also need to be adjusted to reflect the economic life of the assets, and not tax depreciation. The Tax Cuts and Jobs Act (TCJA) has made this even more apparent given the temporary bonus depreciation and increase in Section 179 limits. The TCJA is further discussed in a subsequent section of this guide.

3. Adjustments and the Level of Value

The appraiser may decide to include or exclude historical adjustments depending on the characteristics of the ownership being appraised, minority versus controlling. To illustrate, we'll use an example involving owner's compensation. Let's say that Dealership A is being appraised, and the owner/dealer principal is paid $700,000 annually in compensation. For the same dealership, it's determined that market compensation for the same position is $300,000.

For a controlling interest valuation, it's clear that a $400,000 adjustment should be made to decrease expenses, remove the non-operating (excess) compensation being paid historically, and properly represent the ongoing future cash flows to a controlling interest owner of the dealership.

For a minority interest valuation, however, should this same adjustment be made? Dealership A has a history of paying this level of compensation to the dealer principal, and there is no indication that compensation will decrease as the result of a transfer of a minority ownership interest in the company. Further, it is likely that the minority interest owner cannot force a change in the level of compensation being paid. As a result, adjusting the level of historical expenses would create an increase in the value of Dealership A that a minority interest owner would not receive.

The appraiser has some discretion as to how this situation is treated in the valuation (no adjustment to compensation; adjustment to compensation and the inclusion of a possible minority interest discount; full adjustment to compensation, with the belief that a minority interest owner could force a compensation change), but this illustrates that the appraiser must consider the type of interest being appraised when determining such financial statement adjustments.

You can use the worksheet in Appendix C to complete this historical earnings adjustment step for your dealership.

C. Review and Importance of Cash Flow

Realizing an appropriate return on investment is the key driver for any investment, and dealerships are no different. The value of a dealership is based on the future cash flows that an investor could expect to receive through investment in the dealership. For valuation purposes, we define net cash flow as follows:

	Earnings Before Non-Flooring Interest & Taxes (EBIT)
–	**Income Taxes on EBIT***
+	**Noncash Expenses (depreciation and amortization)**
–	**Increase** in Required Working Capital (funds needed for daily operations)**
–	**Required Capital Expenditures (equipment and facility improvement needs)**
=	**Net Cash Flows to Total Capital**

* This is a step generally done by business appraisers who develop the rate of return, using an approach that is based on after-tax returns.
** Decrease if sales are expected to contract for a period and produce positive cash flow.

Net cash flow is cash flow available for retention in the business, distribution to owners, and/or to reduce non-flooring debt. This cash flow is available to both non-flooring debt and equity investors, and is used to compute the total capital (or enterprise) value for a business. Owner-supplied debt may be used for flooring, and may need to be treated differently from other non-flooring debt.

As the cash flows of the dealership are being estimated, it's essential to consider the interest being valued. It is possible that the level of cash flow to a minority interest investor may differ from what a controlling interest investor could expect to receive. A controlling interest owner is able to make decisions regarding the dealership's use of debt financing, staffing levels, inventory levels, the day-to-day operations of the dealership, future capital improvements, and distributions to owners, among other items. Each of these decisions can have an effect on the dealership's projected cash flows and resulting value. Minority interest owners are typically not able to make business decisions, and are subject to the decisions of the controlling interest owners. As a result, cash flows to a controlling interest owner and a minority interest owner can differ.

As a minority interest investor, would you invest in a dealership that does not generate any earnings due to above-market compensation to owner-employees and

above-market rent to a related entity? Probably not. In this example, no cash flow could be passed on to the minority interest investor, and if the majority interest owner of the dealership has no plans to sell in the near future, there may be no return on your investment for the foreseeable future. What if you could acquire a controlling interest in the same dealership? An investment might be much more logical, assuming you could implement compensation and rent changes so as to generate an appropriate return on investment.

When determining the value of a dealership, it's important to look at the cash flows resulting from the dealership operations. Operating cash flows can be different from the total dealership cash flows, due to either revenue or expenses not related to operations (more commonly known as non-operating assets). Typical non-operating assets and related income or expenses need to be adjusted for valuation purposes and should be identified clearly in the summary of a dealership's value results.

D. Forecasting Future Cash Flows

After the historical income statements and balance sheets have been adjusted to accurately depict the expected recurring financial results of the dealership, they can be used to provide information regarding the health and direction of the company. The two basic types of financial analysis that can be completed are trend analysis and comparative analysis.

Trend analysis, the simpler of the two methods, is done to evaluate trends in the subject dealership's financial results over time, and more importantly, to link the trends to a specific cause. If the historical trend of the dealership's revenue, for example, is a decrease from 20X1 to 20X3, coincident with a decline in the industry or local or regional economy, that can easily be explained. However, if revenue declined from 20X4 to 20X6 and both the economy and brands represented were doing well, this trend would need to be examined in the company valuation. Similarly, if the adjusted gross profit or net income (without LIFO) has slowly contracted over the historical period reviewed, it is important to determine if it will continue to decline, stay at the same level, or increase to the level seen in earlier historical periods. Making these assumptions can have a significant effect on value, but it is important to know why the results of the dealership have declined in the first place to properly project the future results.

The other method of historical financial analysis is comparative analysis, where financial ratios are compared against industry metrics. Industry information can come from *Annual Statement Studies*, NADA and ATD 20 Group, *NADA DATA*, NADA Average Dealership Profiles, manufacturer-prepared composite statistics, and publicly traded dealership groups. Comparisons can be made to find areas where the subject dealership is strong and others where the dealership could improve. With any comparative analysis, the appraiser should determine why any differences between the dealership results and the guideline data exist, and how these differences affect projected future results. If a dealership's profit is below that of its peers, the cause for the lower profit should be identified. Additionally, the appraiser needs to determine whether it is reasonable to project that any issues can be resolved and dealership financial results can improve.

Comparative financial analysis typically includes a common-size step in which income statement items are expressed as a percentage of sales or gross profit and balance sheet items are presented as a percentage of total assets. This methodology allows comparison across groups of various sizes. Also addressed are traditional financial ratios measuring profitability, liquidity, solvency, and efficiency. The industry has numerous turn and efficiency ratios that are reported by 20 Groups, manufacturers, and others. NADA and ATD "Slide Guides" provide the formulas for many of these ratios.

Every fully documented valuation report should contain a comprehensive financial analysis, which can take a variety of forms, ranging from exhibits showing historical financial results and financial ratios measuring different aspects of the business, to a detailed discussion of the financial statements of the company, to pictorial charts and graphs. The financial analysis section details that an appraiser understands the financial statements of the dealership, and is the basis for any projections. Simply put, if the appraiser, broker, or buyer does not understand the business, including the historical financial results, then how can he or she determine its value?

Once the valuator understands the dealership's historical financial results, the next step is to develop a forecast for the company. Management can provide this information or discuss the relevant assumptions with the appraiser. Creating a forecast is a crucial step in determining the value of a company, because an investor is concerned primarily with the future financial performance of the business.

Within the Income and Market Approaches, expected financial results are presumed: A discounted cash flow model allows for a discrete forecast of the cash flow that would be available to an investor. When applying a market multiple or Blue Sky multiple, typical earnings or cash flow is utilized. These latter methods are referred to as capitalization methods; they presume that the dealership's earnings or cash flow figure will grow at a constant level into perpetuity and are presumed to be a proxy for future and ongoing cash flow. These valuation approaches are described in detail in the section titled "Estimating Value."

The following are factors in developing a top-down forecast:

1. Economic Forecast

While external factors affect the financial results of any business, they also need to be considered when forecasting future results. Though the value of a dealership is primarily affected by the surrounding economy, it is also influenced by national and international economic factors. Extraordinary weather events, government regulation and programs, tax law changes, political elections, population growth, labor issues, globalization, and employment trends are all examples of economic influences that can affect a dealership's performance. When making a forecast for any business, it is often most effective to start at the macroeconomic level (national and perhaps global economic factors), and then narrow the scope to microeconomic level (state, metropolitan statistical area, county, or city-level forecast). Federal, state, municipal, and private agencies and universities prepare and publish this data.

The past several years have shown many clear examples of how global and national economic factors affect dealerships. On a global level, wars, issues resulting from significant weather events, banking/financial problems, and international governments are just a few of the factors that we have seen influence the global economy and have a trickle-down effect on dealerships in the U.S.

2. Industry Forecast

The forecast for the overall new-car and -truck industry is closely related to the economic forecast, and NADA/ATD, along with many other industry analysts, provides estimates of future new-unit volume for one or more years forward. Additionally, the manufacturers calculate volume estimates that support their production plans, and issue associated sales requirements for dealerships. Thus, sales prospects vary from brand to brand. The availability of used-vehicle supply that is demanded by the dealership's customers must be considered when developing the expected sales mix for a forecast. The quality of vehicles produced has improved over the years, causing revenues from warranty work and customer-pay repairs to decline. However, dealerships continue to see growth in the fixed operations departments. The pace of this growth is likely different from that of the other departments, absent special marketing, sales programs, or techniques employed by a particular store to attract new customers. Fixed operations volume growth is a critical component for both auto and truck dealerships.

The ability of a dealership to sell vehicles and generate cash flows is dependent on the manufacturer's ability to provide an inventory of vehicles that are in demand. This seems like a simple premise, but is a constant concern for manufacturers and dealers alike. The reason for this is that there are numerous factors, both within and outside the manufacturers' control, that go into manufacturing and providing inventory to dealerships. As consumer preferences change over time, manufacturers are constantly adapting to offer desirable product. This process can lag behind consumer demand.

In the past, as gas prices increased, demand for smaller, more economical cars increased. Conversely, demand for larger vehicles decreased, hurting manufacturers focused on trucks and SUVs. Over time, auto consumers have adapted their expectations to higher gas prices, and demand has returned for larger vehicles. Also, manufacturers must continually redesign light-duty vehicles to remain desirable to customers and meet current customer trends, as well as meet ever-increasing fuel economy standards. Truck dealers experience similar influences with their buyers.

Brand reputation also influences the industry forecast, especially as it pertains to specific manufacturers. In recent years we have seen vehicle recalls for safety and performance issues, the restatement of mileage-per-gallon claims, and financial woes of some manufacturers. Incidents like these, which can influence brand reputations, should be considered in any forecast, and especially those with near-term implications.

Natural disasters and other global events can also have a significant impact on the industry forecast. After Hurricane Sandy hit New Jersey and New York, the impact not only affected local dealers, but led to an overall increase in used-vehicle prices nationwide to meet demand in the area. In 2011, a severe earthquake and tsunami devastated much of Japan. The disaster directly affected some Japanese manufacturers, but the impact was felt across all manufacturers as many suppliers were also affected. Severe inventory constraints, which resulted in depleted inventories of Japanese-manufacturer vehicles, hit U.S. sales volumes of these brands hard.

Events such as international conflicts, foreign policy changes, and government regulation can also affect the forecasts for specific brands.

3. Company-Specific Forecast

Taking a top-down approach, once the economic and industry forecasts are understood, a company-specific forecast can be developed for the dealership. Management can prepare this forecast or budget using the worksheet in Appendix D. It is a dealership best practice to prepare an annual forecast, budget, or goal so the year's results can be properly measured against the plan. Dealerships that engage in this process regularly, including monitoring and feedback to managers and staff, often are more successful financially because they are providing clear expectations for their team. Moreover, the plan can be developed by the various departments so they "own" the plan and are more aligned with achieving the results and generating the personal rewards associated with attaining the objectives.

If management does not prepare a forecast or budget, the appraiser and management can work together to determine the expectations for the dealership, how those expectations are to be met, and what the risks involved in meeting the expectations are. To be valuable, this needs to be an exercise that considers all of the factors above, and is not simply a matter of adding a small amount of growth to the latest financial results.

Apart from the economic and industry factors described above, a forecast should take into account the following:

- Management's expectations.
- Potential for the surrounding area and manufacturer planning.
- The dealership's revenue mix of new, used, service, parts, other.
- Management and staffing of the dealership.
- Facility needs and planned improvements.
- Manufacturer issues (new models, inventory constraints).
- Changes in profitability (areas that can be improved, areas where expenses will increase).
- The effect on growth of working capital needs.
- Local consumer trends.
- Competition, including any changes in the local market.

Suppose Dealership A is projecting revenue to increase 10% next year, while profitability remains the same, resulting in a 10% increase in earnings. First, is the projection of 10% growth realistic? Does this line up with industry and regional or local economic expectations? What is driving the revenue growth?

Next, should profitability remain level, or will it decrease in order to increase overall revenue due to changes in its sales mix among departments? Next, is it accurate to assume that operating costs will remain the same? Do advertising or staffing costs need to increase to provide for growth? Will the dealership need to floor a higher level of inventory? Or should the operating profitability increase, because the company has adequate resources to allow for growth and operating expenses will remain level in dollar terms? These are just some of the possible scenarios and issues that need to be considered when preparing or reviewing a forecast for the business.

While preparing forecasts can be difficult and time-consuming, the result is better information for use in the valuation, as well as a better understanding of the dealership's operations.

IV. ESTIMATING VALUE

Three primary approaches are used for the valuation of a business ownership interest:

- Income Approach.
- Market Approach.
- Asset-Based or Cost Approach.

The Income Approach uses estimated future returns, which are discounted to present value at an appropriate rate of return for the investment. In the Market Approach, valuation ratios or multiples derived from the publicly traded auto and truck retailer stock transactions or those derived from dealership sale transactions (including rules of thumb) may be applied to the subject dealership's single annual period of earnings, cash flow, or other amount to determine value. The Asset-Based Approach analyzes the assets and liabilities of the business and restates them from historical book value to market value. More detail about all three approaches follows. An examination of the balance sheet may indicate the presence of assets that are not required for operations (discussed in a previous section), and require special treatment. Please refer to "Special Valuation Considerations" below for a discussion of how to treat these special assets.

A. Income Approach

The Income Approach can take several forms, but the concept is simple: to show the profits and cash flow that can be achieved from investing in the dealership, and to define the return required for making an investment in the dealership.

1. Earnings versus Cash Flow

In determining the value of a company, earnings, net income, and cash flow are often used as measures of return to the investor. But various definitions of earnings may be used. The following are examples of when each measure of earnings may be appropriate:

Current Earnings. Earnings have been stable over the most recent years, and are projected to continue to be stable in the near future.

Average Earnings. Earnings have varied both up and down over the period without a clear trend in either direction. Average earnings over the period should be used in conjunction with forecasted earnings.

Forecasted Earnings. Earnings are projected to vary from the historical results, and a reasonable forecast is provided by management or developed in concert with the appraiser. Forecasted earnings can be used either for a single period in a capitalization of earnings method, or in a multi-period discounted cash flow model. (Both are discussed below.)

While earnings may be used in determining the value of a company, they often do not fully capture the return to an investor. Additional working capital needs to fund growth and necessary investment for equipment or facility upgrades often result in the overstatement of the profits returned to an investor if earnings are used. On the other hand, noncash charges such as depreciation and amortization could lead to the understatement of cash flows returned to an investor. For this reason, cash flow is the preferred measure of an investor's return. Net cash flow (which includes the effects of working capital and capital expenditures) measures the total cash returned from the business to an investor. As discussed in "Review and Importance of Cash Flow" above, net cash flow is calculated as follows:

	Earnings Before Non-Flooring Interest & Taxes (EBIT)
–	**Income Taxes on EBIT***
+	**Noncash Expenses (depreciation and amortization)**
–	**Increase** in Required Working Capital (funds needed for daily operations)**
–	**Required Capital Expenditures (equipment and facility improvement needs)**
=	**Net Cash Flows to Total Capital**

* This is a step generally done by business appraisers who develop the rate of return, using an approach that is based on after-tax returns.
** Decrease if sales are expected to contract for a period, and produce positive cash flow.

2. Rate of Return

The rate of return, more commonly called the discount rate, measures the level of return that is required, based on the perceived risk of the investment. To illustrate this concept, let's look at two very different investments. Within this discussion, the discount rate and rate of return will be used interchangeably.

An investment in a bank savings account is nearly risk-free, and may pay an investor 1% or 2%. By contrast, an investor in a pre-revenue technology start-up company may recognize that there is a high probability of losing such an investment and thus require a 50% rate of return. To make an investment in a dealership, an investor may require a 20% rate of return, which is also the discount rate for the investment.

Determining an appropriate discount rate for an investment contains some subjective components, but at a minimum, the following factors should be considered:

- Return available on alternative investments.
- Volatility of the company's earnings.
- Company's competition.
- Size and age of the dealership.
- Condition of the economy.
- Brands sold by the company.
- Management capabilities.
- Historical and projected growth rates in sales and cash flow.

Appraisers typically use two methods to calculate the return on equity portion of the discount rate: the build-up method and the modified capital asset pricing model (CAPM). The modified CAPM starts with the original CAPM, and adds adjustments for size and subject company risk. In each instance, the result is the rate of return applicable to an equity investor.

Build-Up Method:

	Risk-Free Rate
+	**Equity Risk Premium**
+	**Size Premium**
+	**Industry Premium**
+	**Company-Specific Premium**
=	**Equity Discount Rate**

Modified Capital Asset Pricing Model:

	Risk-Free Rate
+	**(Beta × Equity Risk Premium)**
+	**Size Premium**
+	**Subject Company Risk Premium**
=	**Equity Discount Rate**

While appraisers may dispute which method is better, in most instances the rate of return developed for valuation of a dealership will range from 15% to 20% based on data available at publication date. Lower risk (and lower return) is assumed for larger, more profitable and stable dealerships. Conversely, a higher rate of return is appropriate for smaller, less profitable, and less stable dealerships.

3. Long-Term Sustainable Growth Rate

For either Income Approach method an additional input is necessary—the long-term sustainable growth rate. This is the growth rate expected in perpetuity for the dealership's cash flows. In Method 1 (below) of determining the capitalization rate, the Capitalized Cash Flow Method, the assumption is that the dealership has already achieved a stable level of cash flow and long-term sustainable growth and thus a single period projection is all that is required to derive a value estimate. In Method 2, the Discounted Cash Flow Method, the long-term sustainable growth rate is reached in the residual period.

The capitalization rate is equal to the discount rate minus the expected long-term sustainable growth rate of cash flows for the dealership. If the business is projected to have no long-term growth (though this would be rare, as normal inflation causes some growth), then the discount rate and capitalization rate would be equal. Inflationary growth is a typical starting point for estimating the long-term sustainable growth rate. In addition, the long-term sustainable growth rate should not be greater than the overall economy in which the dealership is located as this would imply that the dealership would eventually outgrow the economy.

Capitalization Rate =
Discount Rate – Long-Term Sustainable Growth Rate

<u>Method 1: Capitalized Cash Flow</u>

A capitalized cash flow model is one of the simplest Income Approach models, in that the value is determined based on a single period of cash flows, which should be indicative of projected future results. Once

the cash flows have been adjusted and the capitalization rate has been selected, the formula for determining value is as follows:

Value = Cash Flow ÷ Capitalization Rate

As noted above, many different definitions of earnings can be used in determining which cash flow is most applicable. Earnings do not always equal cash flow to an investor, and thus it is appropriate to adjust for this difference in a capitalized cash flow model.

Luckily, the adjustment is fairly easy. From the expected level of earnings, a reduction should be taken for the annual level of increased working capital that is necessary to provide for growth in the dealership. This typically can be estimated as the long-term growth rate times the required working capital level. No adjustment is typically necessary for capital expenditures in the capitalization of cash flow method, as the cash flow adjustment to add back typical depreciation and the reduction of typical capital expenditures are frequently simplified to be offsetting calculations (in periods of growth, capital expenditures should exceed depreciation by the long-term growth rate at a minimum). The following is an example of a capitalized cash flow model:

Expected Annual Net Income	**$800,000**
Less Working Capital Adjustment	**50,000**
Residual Net Cash Flow	**750,000**
Capitalization Rate	**÷ 15%**
Capitalized Value	**$5,000,000**

Method 2: Discounted Cash Flow

A discounted cash flow model is often the preferred valuation method for determining the value of a dealership, because it analyzes the actual cash flows to an investor, and allows for flexibility in changing future income statement or balance sheet expectations, as well as future one-time income or expense items, during any forecast period. In theory, the value of a dealership depends on expected future returns in the form of cash flow that will accrue to it. Such returns are discounted back to present value using an appropriate discount rate. In other words, the basic concept is to project the dealership's expected future cash flow and bring it back to today's dollars while accounting for the risk of the investment. Discounting is the mathematical opposite of compounding.

A typical cash flow model projects five years of expected cash flows, although the period only needs to be long enough to reach a level of normal, stabilized cash flows, and then a terminal period or residual cash flow level. The residual period captures the value after the forecast period into perpetuity. The ability to project discrete annual cash flows is necessary when a sustainable level of cash flow or growth has not yet been achieved. This can be because of internal factors, such as a new point that is expected to have unusually high growth for the first three to five years, or because of external factors such as an expected near-term slow growth or negative growth period in the industry.

The discounted cash flow model is a forward-looking model, and relies on projected financial information prepared by management and/or the appraiser. With the exception of an extraordinary circumstance, adjusted historical earnings typically become a starting point in the process of building a forecast. As we've discussed, an accurate valuation depends on building a forecast that includes as much information as possible. Economic factors, industry factors, and local competition, as well as dealership-specific issues such as facility improvements and working capital needs, should all be considered within the forecast. But, as the saying goes, "garbage in, garbage out"—any assumptions used in the model should be reasonable expectations for the business. The discounted cash flow model is the most flexible, and that's why it's most often the preferred approach to estimating value. Follow a forecast example in Appendix E and replicate it for multiple future years to estimate expected financial performance until a stabilized level of cash flow is expected.

An example of a future expected cash flow model is shown on the next page.

Once the annual and residual expected cash flows have been estimated, the residual value can be determined. Residual value is calculated in the same manner as the capitalization of cash flow. So, the residual cash flow is converted to the value at the end of Year 5 by applying the capitalization rate ($1,163,000 ÷ 0.15 = $7,753,000, rounded). Because this is the future value of all cash flows after Year 5, it must be converted to present value. All of the other expected future annual cash flows must also be converted to present value.

The discounting process can be simplified by calculating a present value factor to apply to each discrete period's forecast. The discounting formula is the inverse of the interest-compounding formula.

Future Expected Cash Flow Model Example
Dollar amounts in thousands

	Year 1	Year 2	Year 3	Year 4	Year 5	Residual
Expected Net Income	$800	$950	$1,050	$1,100	$1,150	$1,185
Plus Depreciation	150	150	140	160	165	170
Less Working Capital Changes*	50	75	50	25	25	17
Less Capital Expenditures	100	500	100	120	150	175
Net Cash Flow	$800	$525	$1,040	$1,115	$1,140	$1,163

*Working capital changes are estimated as a percentage of sales. Accordingly, the growth is proportionate to sales increases. Note that in Year 2 an unusually large level of reinvestment is expected in the form of higher capital expenditures.

Compounding

$(1 + \text{discount rate})^n$ = where discount rate equals the interest rate or return received *and* where n = number of periods until the cash flow is received.

Present Value

Calculate the inverse of the compounding formula, as follows:

$$\frac{1}{(1 + \text{discount rate})^n}$$

Using an 18.0% discount rate, the formula becomes $1 \div (1.18)^n$. A typical discounting convention is to assume that the cash flow is received at the end of the period or year, or n = 1 for Year 1 cash flow. However, in the case of a dealership, as in many businesses, profitability and cash flow occur throughout the year, so this assumption may not be appropriate. If we assume future cash flow is received midway through each year of the forecast period, the model may more closely follow economic reality. The calculation for Year 1 cash flow present value factor becomes:

$$\frac{1}{(1.18)^{0.5}} = \frac{1}{1.0863} = 0.920575$$

Similarly, the computation for Year 2 cash flow present value factor is:

$$\frac{1}{(1.18)^{1.5}} = \frac{1}{1.2818} = 0.780148$$

This computation is repeated for each of the five periods. The residual period's present value factor is equal to that of the preceding period (Year 5 in this example). As with the capitalization of cash flow, the residual period captures all future cash flow value from a specific time into perpetuity. So in this example, the value of the company at the end of Year 5 (using the same assumptions shown above) would be $7,753,000, equal to the residual value. The cash flow from each period is then discounted to present value, using the above equations.

See below for an example of the discounted cash flow model.

Summing the present value for the discrete annual cash flow periods and the residual value produces a total present value of $6,681,000. As noted earlier, the discounted cash flow model is often the preferred valuation method, because one can more readily estimate the uneven expected cash flows an investor would

Discounted Cash Flow Model Example
Dollar amounts in thousands

	Year 1	Year 2	Year 3	Year 4	Year 5	Residual
Net Cash Flow	$800	$525	$1,040	$1,115	$1,140	$7,753
Present Value Factor	× 0.9206	× 0.7801	× 0.6611	× 0.5603	× 0.4748	× 0.4748
Present Value of Cash Flows	$736	$410	$688	$625	$541	$3,681

expect the business to generate due to varying reinvestment requirements. This method specifically allows for changes in the business, capital expenditures, or other unusual income or expense to be incorporated into the expected cash flows. Further, discounted cash flow is the methodology used by the publicly traded companies and other sophisticated buyers in evaluating potential acquisitions. Refer to the worksheets in Appendix E to prepare a discounted cash flow analysis for your dealership.

4. Income Taxes

Dealerships can be organized in different ways, each of which will influence the manner in which earnings are taxed. Generally, earnings are taxed at the corporate level or, in the case of a pass-through entity (PTE) such as an S corporation or limited liability company, the earnings are passed along to the owners, who then claim them as regular income and pay taxes at their personal income tax rates. In any case, income taxes should be deducted in estimating net income. Because the rate of return is typically based on market data for companies that are taxed at the corporate level, a consistent assumption of after-tax cash flow or earnings is important to properly align the market data with the dealership being appraised.

The IRS has found, in some instances, that income taxes should not be deducted in the valuation of a PTE for estate tax issues. This is a topic of discussion for appraisers but suffice it to say, income taxes are a reality for investors and a consideration for buyers and sellers.

B. Market Approach

The Market Approach determines the value of a dealership based on a comparison to similar companies that are publicly traded (public company method) or that have been sold (merger and acquisition method). Additionally, any prior transactions in the dealership's stock or ownership units should be considered. Finally, a rule of thumb method, also known as a Blue Sky multiple, may be employed. Each of these methods or techniques is described below. It is notable that each method capitalizes a single period of cash flow, earnings, or other figure. Matching the time period for which the multiple is computed and the time period to which the multiple is applied is an important technique. It is possible to make appropriate adjustments to historical multiples to apply them to projected earnings, but this is a technical discussion for appraisers.

1. Public Company Method

This method examines the multiples being paid for the publicly traded shares of similar businesses. Because comparable companies fit this description for dealerships, appraisals made for IRS or dispute purposes routinely consider this methodology. It is also referred to as a guideline public company method.

To estimate the value of a dealership based on publicly traded comparable companies, follow these steps:

- Select similar guideline companies.
- Compute valuation ratios (or multiples).
- Adjust the market-derived valuation ratios for size, expected growth differences, and subjective adjustments relative to the dealership being appraised.
- Compute values and summarize.

Valuation ratios are computed from publicly traded guideline companies that are similar in nature to the dealership. However, these public companies differ in several key ways from most dealerships in that they are significantly larger, more diversified than the dealership being appraised, and typically have better access to capital than private dealerships. These differences typically warrant adjustments to the observed valuation multiples before applying them to the subject dealership or dealership group.

The most commonly known public company ratio or multiple is price-earnings, or P/E, ratio. From the financial data available, various observed P/E ratios can be computed, each with a different definition of earnings or cash flow:

- Equity price to forecasted earnings (can be projected one to two years forward).
- Equity price to pretax income.
- Equity price to net income after tax.
- Equity price to cash flow.

Besides price-earnings valuation ratios, you can consider several other ratios. Valuation ratios of total capital (all debt and equity) to revenue, gross profit, and EBITDA (earnings before interest, taxes, depreciation, and amortization) are other examples of valuation ratios that you can use. These multiples use the returns available to all classes of capital, so they are computed with a different numerator than the equity price valuation multiples.

Adjustments to observed valuation ratios may be made for differences in projected earnings growth, size, and any other factors that might be unique to the company being appraised. In most instances, because the publicly traded company dealerships have access to the public markets and the ability to acquire and open new dealerships, it's likely that the publicly traded companies have higher earnings growth expectations than private dealerships. Again, these publicly traded companies are often substantially larger than the dealership being valued, which reduces the level of risk to an investor (and results in a higher multiple).

Further, an appraiser may adjust for the subject company's risk factors that don't apply to the public companies. You may want to consider differences in:

- Experience of management.
- Labor relations (union concerns).
- Diversification of brands.
- Prospects for the local or regional economy.
- Dependence on localized customers.
- Manufacturer relations.
- Overall financial performance.
- Contingent liabilities.

After you make the appropriate adjustments to the observed valuation ratios, multiply the adjusted ratios by the subject dealership's corresponding earnings, cash flow, or other figure to reach an indication of value. Equity price multiples produce an equity value, while total capital valuation ratios require deducting total debt (including flooring debt) to estimate equity value. Following are two examples that demonstrate this method:

Example 1: Equity Multiple

Public Company Projected Price-Earnings Multiple	**12.0**
Less Growth Adjustment @ 10%	**× 90%**
Less Size Adjustment @ 30%	**× 70%**
Less Subject Company Risk Adjustment @ 5%	**× 95%**
Adjusted Price-Earnings Multiple	**7.18**
Times Projected Year 1 Earnings	**× $800,000**
Indicated Equity Value of Operations	**$5,744,000**

Note that the resulting value is an equity value for the company. That's because the financial metric used is earnings, which are available to equity investors.

Example 2: Total Capital Multiple

Public Company Total Capital to Projected EBITDA Multiple	**9.0**
Less Growth Adjustment @ 10%	**× 90%**
Less Size Adjustment @ 30%	**× 70%**
Less Subject Company Risk Adjustment @ 5%	**× 95%**
Adjusted Total Capital Value to EBITDA Multiple	**5.39**
Times Projected Year 1 EBITDA	**× $1,460,000**
Indicated Total Capital Value of Operations	**$7,869,000**
Less All Debt (Flooring and Non-Flooring)	**–$3,000,000**
Indicated Equity Value of Operations	**$4,869,000**

In Example 2, an EBITDA multiple is used to compute the total capital value for the dealership. Because EBITDA is a financial metric available to all financial interest holders (both debt and equity investors), the value derived is total capital value. All debt is deducted from total capital value to estimate equity value.

Estimate the growth adjustment by substituting the subject company's expected growth rate for that of the publicly traded company. The difference in value yields the difference in value attributable to growth. The size adjustment is calculated using logarithmic equations based on annual studies conducted by valuation industry professionals.

Precise computation of these components is primarily for appraisers. In most instances, the aggregate growth and size adjustments for the valuation of a dealership will be within the range of 30% to 60%, depending on the relative size and earnings growth expectations. Lower risk (and a smaller adjustment) is appropriate for larger, more profitable, growing businesses while a larger adjustment is appropriate for smaller, less profitable dealerships that are not experiencing growth.

2. Merger and Acquisition (M&A) Method

This method employs merger and acquisition transactions involving automobile or truck dealerships. In order to estimate the value of a dealership based on M&A transactions, follow the steps detailed above for the publicly traded comparable company method.

On the surface, this method seems fairly straightforward. However, the difficulty with this transaction data is that it is typically very limited and often inconsis-

tent. The sources that report data on M&A transactions do not always use the same definitions, so care must be taken to evaluate the data and ensure that the definitions of earnings, the transaction price, and any other financial metric are clearly understood. A specific example: If earnings are not presented on a FIFO-inventory basis or cannot be adjusted to FIFO, then these transactions cannot be easily used in a valuation computation.

The valuation ratios for the M&A method are computed similarly to the public company approach. One difference is that, because the transaction data gives no information on the acquired company's projected results, only historical information is reported. As discussed earlier, investors are interested in future results, and differences in projected growth between the subject dealership and acquisition data can lead to significant differences in the resulting value. Below are the ratios typically used in the M&A method:

- Equity price to pretax income.
- Equity price to net income.
- Equity price to cash flow.
- Equity price to book value.

In addition, total capital value to revenue, total capital value to EBITDA, and total capital value to EBIT may be applicable.

Note that M&A transactions may not reflect "fair market value." If a buyer anticipates that there will be some synergies with its existing dealership operations, the buyer may be willing to pay more for the dealership. If the transaction price contains this buyer's synergies, the price reflects "investment value" rather than "fair market value," which by definition does not include anticipated synergies. You may need to adjust the valuation ratios derived from such transactions downward, therefore, in order to convert the valuation ratios to a fair market value equivalent.

Adjustments for differences in size and for any differences unique to the subject company may also be required. The information available is often very limited, making comparisons difficult. An adjustment for growth is not applicable, due to the fact that there is no information available on projected growth rates for the dealerships acquired in M&A transactions.

Valuation ratios derived from M&A transactions are considered majority interest ratios because they involve the sale of entire companies or controlling interests in companies. To compute the value of a minority interest ownership, you'll need to apply discounts. These are described in "Special Valuation Considerations."

3. Prior Transaction Method

A prior transaction in the dealership's ownership or a franchise may provide a relevant indication of fair market value, because it involves the sale of the actual dealership or dealership interest. However, as with any transaction, it's important to carefully evaluate the transaction, the parties involved, and the price. Analyzing past franchise acquisitions or divestitures made by your dealership to determine the multiples that were paid is a part of this method. When evaluating a past transaction, you'll need to determine whether the transaction represented fair market value. This definition of value typically requires an arm's length transaction that was negotiated between a willing buyer and seller, with neither party acting under the compulsion to buy or sell. For appraisals made for IRS or dispute purposes, this method should be considered if such prior transactions occurred.

4. Rule of Thumb (Blue Sky) Method

Rules of thumb are mechanical and simplistic, and may not represent sound economic or valuation theory. They are a valuation shortcut, and may or may not produce a value that makes any sense from an economic standpoint. In some cases, rules of thumb provide a reasonable starting point, and the actual facts about the dealership determine why the value is higher or lower than the rule of thumb method.

If you are a seller and the rule of thumb method produces a high value, then this is not a matter of great concern. You may be able to use the rule of thumb method to your advantage and entice a buyer to pay more than the economic value of your dealership. However, if you are a buyer, you are well-advised to work through the valuation process as outlined in this guide, and make your purchase decision on an informed basis.

For dealerships, a rule of thumb method is sometimes used to value Blue Sky. Blue Sky, or goodwill, is the value of a business that is over and above fair market value of the physical assets. Here's an example of the rule of thumb method for valuing the Blue Sky of dealerships:

Blue Sky =
Adjusted Pretax Earnings × Blue Sky Multiple

The automobile segment multiple ranges fluctuate over time, and were reported as 2 to 9 during 2018, depending on the brand, with luxury at the high end, mid-line imports in the middle, and domestics near the lower end. The adjustments to historical pretax earnings are described in "Forecasting Cash Flow," and may or may not be consistent with the adjustments made by buyers of a dealership applying this multiple.

To estimate the total equity value of the dealership, add the amount calculated for Blue Sky to the adjusted book value (which represents fair market value of the assets less liabilities, as discussed in the "Asset-Based Approach" section below). Blue Sky multiples are published by several sources, but may only provide a general sense of value based on average data; the actual value for a specific dealership can vary significantly.

The value of the dealership using the rule of thumb method is as follows:

Blue Sky + Fair Market Value of Assets
– Fair Market Value of Liabilities = Total Equity Value

Note that the "purchase price" in a transaction of 100% of a dealership or franchise is usually not the same as the "equity value" of the dealership. The asset transaction "purchase price" consists of the Blue Sky (as determined above) plus some or all of the tangible assets (e.g., parts, equipment, furniture, special tools, and new- and used-vehicle inventory) at values agreed upon by the buyer and the seller. Assets such as cash, contracts-in-transit, and accounts receivable are typically not included, and neither are the liabilities of the dealership.

Blue Sky is properly calculated as follows:

Blue Sky =
Earnings Value – Adjusted Book Value

If a dealership is consistently generating $800,000 per year in after-tax cash flow and the capitalization rate is 15%, the earnings value would be $5,333,000 ($800,000 ÷ 0.15, rounded). If the adjusted book value is $4,000,000 (fair market value of assets less liabilities), then the company has Blue Sky of $1,333,000 ($5,333,000 – $4,000,000). Blue Sky, or goodwill, therefore, is a result of an earnings value in excess of the net asset value.

Someone would pay $5,333,000 for assets that are only worth $4,000,000 in tangible asset value because the historical earnings have shown that the company is able to generate a satisfactory return that produces a value for the business in excess of the value of the company's assets and that level of earnings is expected to continue. Many factors can contribute to the higher value, including the results of past efforts by the dealer and staff, the right to operate a dealership franchise, and the value of the company's assembled employee base, to name a few.

So, what is the problem with rule of thumb method valuations?

Suppose that the appropriate capitalization rate is 20%. Remember, the capitalization rate, as well as the discount rate, is determined by the long-term risk of the business. An increase in the capitalization rate could result from changes to the dealership's operations that increase risk to an investor. Or it could be the result of market changes such as an increase in lending rates or greater industry volatility. In the scenario where there is an increase in the capitalization rate, the earnings value for the same dealership would be $4,000,000 (800,000 ÷ 0.20), and the Blue Sky would be zero, as follows:

Earnings Value	**$4,000,000**
Adjusted Book Value	**–4,000,000**
Blue Sky	**$0**

This example highlights just one of many factors that could cause a rule of thumb to produce an inaccurate value for a dealership. As we've noted, the value of a business is determined based on its *future* cash flow potential. Blue Sky multiples do not account for any uneven growth or changing profitability expectations, future capital expenditures or real estate issues, manufacturer-related issues, management or employee issues, or demographic or economic issues specific to the dealership. Any of these factors could greatly affect the future cash flows of the dealership, and the resulting value.

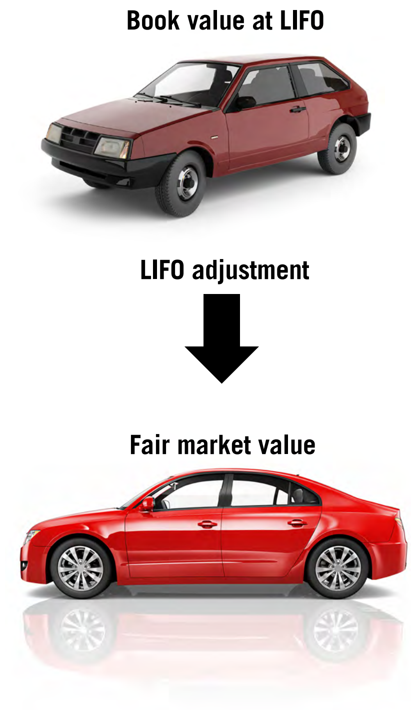
The rule of thumb method is a quick and easy way for a seller to determine roughly the amount of Blue Sky that might be paid for the dealership. It is not, however, grounded in recognized business valuation theory and practice as a robust means of valuing the intangibles of a business.

C. Asset-Based Approach

In the Asset-Based Approach, net asset value is estimated by restating the value of assets and liabilities from historical cost to fair market value. Assets and liabilities can be valued either individually or collectively. Like the overall business, individual assets and liabilities of a business can be appraised using the Cost, Market, and Income Approaches to asset valuation.

The simplest form of an Asset-Based Approach is book value. Book value is calculated by subtracting total liabilities from total assets based on the company's financials. It is the same as equity or net worth as stated on the balance sheet.

Book value has several problems as a determinant of a dealership's value. Assets such as real estate and equipment are stated on the books at cost less depreciation, and this may be quite different from the fair market value of these assets. In addition, LIFO-based inventory is understated from the fair market value of inventory



by the amount of the LIFO reserve. These are just some of the reasons why the book value of assets may not resemble the fair market value of the assets.

Thus, book value is seldom if ever a good indication of the fair market value of a dealership. But that does not mean it should be entirely ignored. It is always a good idea to compare the estimated dealership fair market value to book value as a "sanity" check. A large premium over book value or Blue Sky should be supported by either high earnings and cash flow or dependable evidence that assets have appreciated significantly over their depreciated cost.

Adjusted book value restates the assets and liabilities of the dealership at their fair market value rather than the value reflected on the balance sheet. Assets can be formally appraised or estimated by management, by a third-party appraiser, or in conjunction with a business appraiser. Land, buildings, and LIFO inventory are usually the assets with the greatest variance between book value and fair market value. Liabilities are often most accurately expressed by their book value, except for unbooked income tax-contingent liabilities for LIFO reserve or real estate gains.

Here's an example of a dealership balance sheet adjusted to reflect fair market value (dollar amounts are in thousands):

	Book Value	Adjustment	Adjusted Book Value	*Notes*
Cash & Equivalents	$200	$0	$200	*1*
Accounts Receivable	400	-20	380	*2*
Inventory	4,000	1,500	5,500	*3*
Other Receivables	150	0	150	*1*
Rental Vehicles	300	-30	270	*1*
Land & Buildings	2,000	1,200	3,200	*4*
Equipment	500	–100	400	*5*
Furniture & Fixtures	250	–150	100	*6*
Company Vehicles	100	–50	50	*1*
Other Assets	300	0	300	*1*
Accumulated Depreciation	–1,400	1,400	0	*7*
Total Assets	**$6,800**	**$3,750**	**$10,550**	
Total Liabilities	**$5,250**	**$567**	**$5,817**	*8, 9*
Asset-Based Approach Value	**$1,550**		**$4,382**	

Notes:

1. *Stated at book value. For the rental vehicles and company vehicles, the adjustment represents the reclassification of accumulated depreciation.*
2. *Reduced by 5% to account for uncollectible receivables.*
3. *The LIFO reserve was added to the inventory value to reach a market value estimate for the inventory.*
4. *Adjusted to market value per real estate appraisal.*
5. *Adjusted to market value per equipment appraisal.*
6. *Adjusted to estimated market value per management.*
7. *Accumulated depreciation was removed.*
8. *Income tax liability on the untaxed LIFO reserve (21% × $1,500).*
9. *Income tax liability on the untaxed real estate built-in gain (21% × $1,200). This gain tax is applicable to C corporations, or corporations that have converted to S corporations within the last five years.*

Sometimes, an additional downward adjustment for used-vehicle or parts inventory and prepaid expenses is warranted. Other adjustments should be made for unrecorded liabilities such as potential charge-backs of recourse finance contracts, other contingent liabilities, and environmental cleanup expenses.

Please note that the above estimates are by no means scientific and, with the exception of the real estate and equipment, are not based upon formal appraisals. In most instances, however, these types of estimates are satisfactory for determining adjusted book value. In an actual sale transaction, the purchaser may insist upon a more detailed and specific analysis, and the value of many assets may be negotiated if they are included in the transaction. Appendix B is a worksheet you can use to prepare this analysis for your dealership.

Adjusted book value, as we've seen, reflects assets less liabilities at their estimated fair market value on a going-concern basis rather than the value reflected on the balance sheet. However, any attempt to realize that value (i.e., sell the assets) will result in fees and selling costs. If a sale of the assets is either probable or contemplated, these additional expenses should be deducted from adjusted book value to arrive at what is called "liquidation value." Liquidation expenses will consist of such items as brokerage fees, possible depreciation recapture, capital gains taxes, and other operating costs that will be incurred during the liquidation process (e.g., salaries, rent, utilities, etc.). Further, the timing of the liquidation, especially if it is short or under duress, will often result in decreased realizable asset values.

Liquidation value is used as a determinant of value if the ownership interest being valued has sufficient control to cause liquidation (either 51% or 67%, in most states) *and* liquidation is probable or contemplated. Because there would be little reason for the owner to sell for less than the amount at which the assets of the business could be liquidated, liquidation value represents the minimum value of a controlling interest in a business.

D. Reconciliation of Value Indications

Once the appraiser has determined various estimates of value by applying the procedures and methods under the three approaches to value, the final step in a business valuation is to assign a weight to the values determined to arrive at the appraiser's conclusion of value. The first part of the weighting process is a review of the procedures taken under each of the approaches or methods employed. This will often help identify differences and the reasons for those differences.

When considering the various indications of value, it is important to understand the differences and similarities of the various methods. For instance, the Asset-Based Approach may employ elements of the Income Approach or the Market Approach in deriving a specific asset's value; this is frequently the case when determining goodwill value under the Asset-Based Approach. The Market Approach often utilizes an economic income of the underlying company, such as a net income multiple that is closely related to the variables utilized in the Income Approach. In addition, the Income Approach relies on market data and conditions in deriving an appropriate discount and capitalization rate.

While it is rational to expect that the indications of value from the various methods will produce different values, when the methods are employed using the same assumptions and with reliable data the differences should be reasonable in relation to one another. The appraiser will assign a weight to the indications of value based on his or her level of confidence in each method. This may be driven by the reliability of the data used in each of the methods or the purpose of the valuation.

The appraiser should explain the reasoning behind the final valuation conclusion, including the weighting employed.

V. SPECIAL VALUATION CONSIDERATIONS

A. Discounts and Premiums Overview

There are numerous discounts or premiums that may be necessary in any given appraisal assignment. These discounts and premiums may be broadly broken into two groups: those driven by unique factors of the subject company itself and those driven by the factors of the ownership interest being appraised. Some examples of discounts taken due to the specifics of the subject company include a key person discount, a discount for trapped-in capital gains tax, and deductions for known potential liabilities such as pending litigation. Some of the discounts that are driven by the ownership interest being appraised include the two most commonly applied discounts—a discount for lack of control and a discount for lack of marketability.

Subject company discounts are independent of the ownership interest being appraised—i.e., they are present if a controlling ownership interest or a minority ownership interest is being appraised. Ownership interest-specific discounts or premiums are directly related to the rights inherent in the ownership interest being appraised. The need for an ownership interest-specific discount or premium will be determined based on the procedures employed in the various approaches to value and the resulting value in relation to the level of value chart outlined in the section "Defining the Appraisal Assignment." For example, if a discounted cash flow method is employed under the Income Approach and controlling interest adjustments have been made, then the resulting value under this method will yield a controlling interest value. To determine a non-controlling interest in the company, the appraiser would investigate the applicability of discounts for the minority interest including a discount for lack of control and a discount for lack of marketability.

Discounts and premiums may be difficult to quantify and need to be considered on a case-by-case basis.

B. Discounts for Non-Controlling Interests

The size of the ownership interest is an important consideration when estimating the value of a specific interest. If an investor would pay $600,000 for a 60% stake in a company, would he or she pay $400,000 for 40%? Is a 10% interest in a dealership worth 10% of the controlling interest value of the company? The answer to each of these questions is, probably not. Minority interest owners don't exercise any real control over the business, and various studies in this area reflect that minority ownership interests typically suffer a discount from their pro rata share of the value of the company.

In addition to lack of control, an ownership interest in a privately held company may also suffer from lack of marketability. An investor holding a 1% interest in a public company could easily liquidate his or her shares through the open market because the shares are actively traded. However, selling an ownership interest in a private company, especially a minority interest, may be much tougher, as an active market does not exist for these ownership interests. For this reason, ownership interests in a closely held company are discounted to reflect their lack of a ready market to convert to cash, referred to by appraisers as "non-marketability."

It's important to note that if a discount for lack of control and a discount for lack of marketability are both applied, they should not be combined, but rather taken sequentially on a multiplicative basis, as shown below:

Estimated Value Controlling Interest	**$1,000,000**
Less Discount for Lack of Control @ 10%	**× 90%**
Fully Marketable Minority Interest Value	**900,000**
Less Discount for Lack of Marketability @ 30%	**× 70%**
Estimated Value Minority Non-marketable Interest	**$630,000**

The following discussion details some of the various discounts that may be applied to the value of a non-controlling interest in a dealership.

1. Discount for Lack of Control

A minority ownership interest in a company, unlike a majority interest, does not confer the right to make decisions affecting the operations of a company. A minority interest owner has minimal influence in affecting the day-to-day operations, corporate policies and strategies, and long-term plans of a company. Decisions relating to management selection, compensation, dividend distributions, benefit packages, and company bylaw amendments, for example, are left to those who hold a majority ownership interest in the company.

Minority ownership interests, then, are generally perceived to be worth less than their pro rata share of total company equity value. This value differential is known as a discount for lack of control, also known as a minority interest discount. Appraisers can refer to a number of studies or data sources to calculate an appropriate discount, including merger and acquisition pricing analyses before and after an acquisition, publicly traded asset-holding companies that trade at a discount from underlying net asset value, dual-class capitalization analyses (for price differences between voting and non-voting shares), and IRS court cases.

IRS Revenue Ruling 59-60 states, "Control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock."

The size of the minority ownership interest discount depends on:

- The present distribution of ownership and other factors that affect voting control.
- The nature of the assets to which the discount is being applied.

For illustrative purposes, non-operating cash may be afforded a discount of 5% or less, based on the relevant study data, while real estate may be discounted by 25%. These discounts must be properly supported based on appropriate discount study data and the specific facts and circumstances of the company being appraised, particularly for IRS purposes or dispute matters.

2. 50-50 Ownership Situations

Most automobile manufacturers do not allow 50-50 ownership unless one owner has an agreement to control the voting rights. To avoid the potential problems that arise with 50-50 ownership, agreements generally stipulate that one owner must have control of the dealership through a 51-49 ownership split. However, some older agreements may still reflect 50-50 ownership and, in such cases, it's important to understand the impact that such ownership structure has on valuation of the dealership.

A 50-50 ownership scenario can present the most difficult situation as far as discounts are concerned. That's because neither of the two owners is in a minority interest or a controlling interest situation, so the study observations about minority ownership interest discounts do not necessarily apply. But it doesn't mean that either owner has the ability to control the company. In most cases, it means that both owners must agree on all key decisions, and each has the power to veto decisions made unilaterally by the other. This lack of control by either owner is sure to cut into the marketability of each ownership interest.

Even though neither owner can unilaterally control the company, it's usually possible to seek legal redress for partitioning the assets if the owners become deadlocked. While this would eventually lead to achieving some sort of "marketability," legal redress can be time-consuming and expensive.

3. Discount for Lack of Marketability

The valuation approaches we've discussed are considered to indicate the value of the company as if it were publicly traded. But because closely held equity interests lack the inherent marketability of publicly traded securities, it is accepted valuation practice to discount the values indicated by these approaches to account for this inherent lack of marketability.

This position is affirmed in IRS Revenue Ruling 77-287, which states, "Whether the shares are privately held or publicly traded affects the worth of the shares to the holder. Securities traded on a public market generally are worth more to investors than those that are not traded on a public market."

In the following discussion we will see how marketability (or lack thereof) can affect the value of non-controlling or minority ownership interests.

As with lack of control discounts, appraisers may refer to various resources, or studies, to determine an appropriate discount for privately held shares, including:

- Letter stock (restricted stock pricing versus unrestricted).
- Pre-IPO stock (private transaction pricing versus subsequent publicly traded price).
- IRS court cases.
- Protective put analyses (the cost of purchasing a put option to protect against downward price changes).

The marketability discount applicable to a particular closely held equity interest depends on the facts and circumstances relating to that ownership interest.

In general, ownership interests that are regularly providing cash flow (beyond the income tax requirements for pass-through entities) would be expected to be afforded a smaller discount for lack of marketability. Other factors that influence the size of the discount are the size of the entity's total equity value, size of the ownership interest, company leverage ratio, company profitability, and company revenue size. Most commonly, discounts for lack of marketability range between 20% and 35%. Application of this discount must be well-supported for IRS purposes as study averages are considered unacceptable.

4. Discount for Non-Voting Interests

Non-voting stock by definition is non-controlling stock; thus, it likely warrants discounts for lack of control and non-marketability. However, in most instances, non-voting stock is less desirable than a minority ownership interest position in voting stock. Because the non-voting owner has no say on items put to a vote of the owners, it's common to discount non-voting stock by an additional 5%. This discount is supported by several empirical studies that look at the pricing differences of dual-class stock.

If the minority interest ownership value of the dealership was estimated at $2,000,000, including any minority interest and lack of marketability discounts, the value of non-voting stock might be estimated as shown below. Some appraisers incorporate this differential as voting rights within their analysis of the non-controlling discount:

Net Equity Value to Minority Interest Owner	**$2,000,000**
Less Non-Voting Discount @ 5%	**× 95%**
Net Equity Value to Non-Voting Minority Interest Owner	**$1,900,000**

C. Discounts for Controlling Interests

In the case of a controlling interest in an automobile or truck dealership, the inherent marketability of the underlying company may be considered in determining an appropriate non-marketability discount. Dealership franchise agreements are not readily transferable to a third party, and the universe of potential buyers is limited to those that are acceptable to the manufacturer. Because of these restrictions, which reduce the marketability of the company and potentially increase the time and expense needed to monetize such an investment, a discount for non-marketability may be warranted. Some IRS court cases provide discounts for poor marketability associated with controlling interests.

The time to completion of a sale of an entire dealership is another consideration in determining an appropriate marketability discount. This period can often extend from several months to more than six months after the initial contact with a broker or advisor to facilitate the sale. Negotiating, drafting, and executing lease or employment agreements can extend the time frame, as can resolving deferred facility or equipment maintenance items and operational issues.

The primary asset of a dealership is its ability to sell and service a certain brand of automobile or truck, and this asset usually resides not with the company, but with a prescribed individual named by the manufacturer. Thus, the ability to represent a certain vehicle brand is not technically a company asset that can be sold. Most dealer franchise agreements specify the owner of the dealership, and are thus inherently more difficult to sell because the manufacturer must approve any new owner not named in the agreement.

Application of this discount must be well-supported for IRS purposes and incorporate the relevant facts and circumstances of the subject dealership.

D. Valuation of Personal Goodwill

When planning for a dealership sale, owners typically focus on net sales proceeds (proceeds after paying all debts and taxes). The tax cost of a sale is negatively affected when a dealership is structured as a C corporation, or if it has been an S corporation for fewer than five years, according to current tax law. In these scenarios, a sale will generally trigger two levels of taxation: one at the corporate level and another at the individual owner's level.

With careful planning, a portion of the transaction could be structured as personal goodwill rather than business goodwill or a noncompete covenant. You should seek the advice of a tax professional to maximize your value if you're contemplating selling your dealership.

The following example illustrates the potential federal income tax savings that would accrue from the personal goodwill scenario:

XYZ Motors, a C corporation, sells its assets to National Auto Co. for $18 million, and then liquidates, distributing the proceeds to the shareholder. Of the $18 million, $8 million was Blue Sky (goodwill). XYZ Motors will pay 21% tax on the Blue Sky, or $1.68 million (plus state income tax where applicable). When the money is distributed to the shareholder, he or she will pay capital gains of 20% and Medicare tax of 3.8% on $6.32 million ($8 million minus $1.68 million), or an additional $1.5 million in taxes. That leaves $4,815,840 for the shareholder of the $8 million in Blue Sky (and over $3 million is paid in total tax).

On the other hand, if XYZ Motors sells its assets for $10 million, and the shareholder negotiates for and sells personal goodwill for $5.6 million, with the remaining $2.4 million of Blue Sky considered a corporate asset, the overall taxes paid on the transaction will be lower. None of the personal goodwill is taxed at the corporate level, resulting in tax savings of approximately $1.1 million as demonstrated below.

To value personal goodwill, you'll need to analyze several factors, including the percentages or dollar amounts of goodwill contributed by the dealer and the corporation. You should consider:

- Whether the dealer signed an employment contract or noncompete agreement with the selling dealership prior to the transaction.
- The number of years the dealer has been active in the dealership.
- The amount of personal identification of the dealer principal with the dealership (as reflected by the principal's involvement in media advertising, community events, or active community involvement).
- The franchise agreement terms (and whether it names the dealer principal and identifies the arrangement as a personal services contract).
- Personal customer relationships and personal sales.
- Other unique contributions of the dealer, including his or her reputation.

Case law has developed several criteria that personal goodwill must meet in order to satisfy IRS scrutiny. The portion that is properly allocated to the dealer would not be subject to double taxation. Further, the purchaser of personal goodwill would be entitled to a 15-year amortization of the goodwill purchase. The result is a tax savings for the buyer.

The personal goodwill concept needs to be evaluated carefully by your professional advisors. It's desirable

		Scenario 1	**Scenario 2**
		Value	Value
Tangible assets		10,000,000	10,000,000
Corporate Blue Sky/Goodwill		8,000,000	2,400,000
Personal Blue Sky/Goodwill		-	5,600,000
Total assets		18,000,000	18,000,000
Corporate federal taxes on Blue Sky	21.0%	(1,680,000)	(504,000)
Amount available to distribute to shareholder		6,320,000	1,896,000
Capital gains and Medicare taxes	23.8%	(1,504,160)	(451,248)
Shareholder cash flow after taxes		4,815,840	1,444,752
Corporate federal taxes on personal goodwill	0.0%	-	-
Amount available to distribute to shareholder		-	5,600,000
Capital gains taxes	20.0%	-	(1,120,000)
Shareholder cash flow after taxes		-	4,480,000
Total taxes paid		(3,184,160)	(2,075,248)
Difference in total taxes paid, Scenario 1 vs. 2			(1,108,912)

This example is for illustrative purposes only.

to have two buy-sell contracts: one for the corporate assets and one for the personal (shareholder's goodwill) assets. The potential tax savings can be very attractive.

Cash flows that support the foregoing components determine the allocation to personal or corporate goodwill or intangible assets. Valuations prepared in this setting should consider the relevant corporate goodwill components to ensure the resulting allocation is supportable. For example, the value of the dealership's assembled workforce is a primary corporate intangible asset that is generally developed. A favorable lease is another example of a corporate intangible asset to the extent that such asset would be included in the transaction.

Preparing a personal goodwill valuation close to the sale date is essential, as the seller will have limited access to the necessary information to do so after closing. Because structuring a transaction using personal goodwill provides significant tax savings, sellers should not short-circuit the process.

E. Valuation for Key Employee Ownerships

Any time a business is owned by multiple individuals, the possibility exists for disagreement about how the business should be run, and possibly about how the interests of an owner should be redeemed. Any dealership with more than one owner should have a buy-sell or similar agreement that stipulates what happens to the ownership interest in the event one of the following occurs:

- Death.
- Termination.
- Disability.
- Retirement.
- Divorce.
- Bankruptcy (owner).

With any such agreement, the details are critical, and it is important to have the agreement drafted by an attorney with extensive experience in this area. It's also a good idea to have a professional business appraiser review this document. Most agreements use one of three methods to value ownership interests—formula, mutual agreement, and appraisal. Let's look at each option.

Formula. A formula is the simplest choice, and the advantage of a formula is that it always works: It will always provide a value as of any given date. Examples of a formula range from a simple "book value" to a multiple of pretax or after-tax earnings, or some combination thereof. However, while a formula always works, this does not mean that it is fair to all owners or is an indication of fair market value. As noted above, the value of a business is based on future prospects for the company, but most formulas are based on historical figures.

If a formula is used, you are strongly advised to get professional advice from a business appraiser as to how the formula should be structured. Courts and the IRS have disallowed formulas that were arbitrarily set by owners without seeking professional advice. Remember that although formulas work in that they always provide a value, this value may not reflect the fair market value of the dealership or interest in the dealership.

Mutual Agreement. Each year the owners can sit down and agree on the value of the dealership for the coming year. This may not be a bad way to set the value, as long as owners remember to do it every year, and the basis for their assumptions makes sense. Otherwise, the value will become out-of-date and/or be economically unsound. It's also essential that all parties sign or initial the new value each year to eliminate any question of mutual agreement at a later date.

Unfortunately, while this approach makes sense in theory, it rarely works in practice. Typically, after the first few years the value is not set regularly, or owners do not know how to set the value, so they end up using a very basic formula to compute value. The result is a value that again does not approximate the fair market value of the dealership and may not stand up in litigation.

Appraisal. The third alternative is an appraisal of the company's ownership interests. This alternative will involve paying fees, but it provides a neutral third-party perspective to determine the value of the business, based on the dealership's financial results and future expectations. In the case of adverse situations, agreements can stipulate that both sides agree on the selection of an appraiser, but usually the agreement provides for each side to pick an appraiser. If the two appraisers cannot agree on value, the appraisers could select a third appraiser to mediate the final value, or they could take an average of the original two appraisals, or use the closest two of the three final appraisals completed.

While the number of appraisers to use and how to reconcile differences may vary, all scenarios allow each side to help select a neutral appraiser to determine value.

It is important that the appraiser's engagement agreement stipulate the following:

- The standard of value to be used in the appraisal.
- The effective date of value for the appraisal.
- Whether the ownership interest to be appraised is a controlling interest or a minority interest.
- Whether a buy-sell agreement stipulates the application of discounts.

Many dealers overlook the need for an owner buy-sell agreement, or have agreements that are either poorly drawn or out-of-date. Dealers ignore this area at their financial peril. A properly drawn agreement will avoid long, costly, and possibly acrimonious proceedings for buying out an owner.

F. Valuation for Federal Tax Matters

Overview

The most common purposes that may involve a business valuation in federal tax matters include estate taxes, gift taxes, capital gains taxes, charitable contributions, and transfer pricing. The procedures the valuation expert employs will be driven by the Internal Revenue Code, case law, and IRS interpretations such as Treasury regulations and revenue rulings.

The standard of value for federal tax matters is fair market value, which has been previously discussed. While many of the procedures the valuation expert will follow are settled in principle, there are still many decisions to be made in applying the procedures. For example, while a discount for lack of marketability is common practice in a valuation of a minority interest for gifting purposes, the magnitude of the discount is not strictly defined and will be selected by the appraiser by employing commonly accepted appraisal procedures.

1. Gifts of Property

If an appraisal is prepared for a transfer of property (ownership interests and the like) reported to the IRS as a gift to a family member, it is deemed adequately disclosed and will start the three-year statute of limitations for the IRS to review the gift reporting when the tax return is filed (with the appraisal attached). Even when a family ownership transfer is structured as a sale (perhaps with a note), it is advisable to document this transfer with an appraisal and file a no-tax gift tax return. This will also start the three-year statutory period, and can provide the same protection.

The appraisal must be prepared by someone who regularly performs appraisals; has the requisite experience; and is not the donor, donee, or a family member or employee of either donor or donee. The appraisal report must contain the required information regarding the subject of the appraisal and procedures employed. After the three-year period, the IRS may not question the value of the gift unless it has not been adequately disclosed.

When such gift transfers are not deemed adequately disclosed, the IRS may review them prior to or upon the death of the donee. It is very difficult to prepare appraisal reports many years after a gift is made, as obtaining business records and other necessary information to support the valuation exercise becomes problematic. In this instance, the IRS may calculate the value of the gift using current financial performance, which is likely very different from the dealership's actual earnings results and prospects many years before.

If the IRS rules are followed, the benefits planned by a dealership owner's advisors may come to fruition. Shortcuts, conversely, can diminish the benefits derived and may lead to costly outcomes for the owners in the event of an IRS review.

G. Valuation in Litigation

Some of the most common litigation matters where a business valuation expert may need to be employed include marital dissolution, shareholder and partner disputes, and economic damages. While the valuation expert will need to follow commonly accepted valuation procedures and methods—or his or her opinion will be excluded from consideration—the methods and procedures employed will be heavily influenced by case law precedence in the jurisdiction where the case is being litigated.

For example, as of the writing of this guide, in marital dissolution procedures in the state of North Carolina, it is case law precedence that any value attributed to personal goodwill in a company held by the marital parties will be considered in dividing the marital estate. However, in South Carolina any personal goodwill in a company held by the marital parties is not considered an asset of the marital estate. As one can imagine, the consideration of personal goodwill may greatly change the overall value that each of the marital parties ultimately receives.

While case law precedence influences the procedures employed by the valuation expert, the expert should not be giving legal opinions. It is important for the valuation expert to be aware of the case law that influences his or her procedures, but to take direction from the court and legal counsel in defining the assignment and understanding any unsettled matters. This may lead the expert to derive more than one estimate of value so that the trier of fact can understand the impact of decisions that will be made by the court.

It is important to understand that a valuation expert is independent—i.e., not an advocate for his or her client but rather for his or her work product and opinion.

It is equally important to understand that a valuation expert in a litigation matter involving a dealership should have prior experience not only in valuing dealerships, but also in the type of litigation. The valuator should also have one or more business valuation credentials.

H. Reviewing a Business Valuation

It is in your best interest to review a business valuation thoroughly. You should understand how the valuation was done—the approaches and methods used, among other things, and the reasoning behind the valuation expert's many decisions. We've provided a questionnaire for the review process in Appendix F.

I. The Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act (TCJA) was signed into law on December 22, 2017. It represents the first large-scale tax reform since 1986. The TCJA has many implications for corporations and individuals that affect business valuation. There has been and continues to be a great deal published concerning the implications of the TCJA. For more information, see NADA's *Driven* guide *A Dealer Guide to the Tax Cuts and Jobs Act of 2017* and Moss Adams. The following is a brief outline of some of the more impactful changes as they relate to business valuation and dealerships. ***For any specific tax situation, a tax expert should be consulted.***

- **Federal corporate income tax rate permanently changed to 21%.**
  – The majority of dealerships are pass-through entities and are not directly affected by the decline in corporate tax rates. However, for those entities that are affected, the decline in the corporate tax rate, other things held constant, would increase the value of the dealership as there would be more after-tax cash flow available for debt and equity owners.
- **Federal individual income tax rates temporarily changed until 2025**.
  – As the majority of dealerships are pass-through entities and thus their equity owners personally pay the taxes associated with the dealership's income, the decline in individual tax rates, all else held constant, would increase the value of the owner's interest in the dealership, as less tax would be due. However, any impact is highly dependent on the individual owner's tax situation.

  – As the benefit is temporary, the impact will be reduced as 2025 approaches and any benefit has already been realized.
- **Temporary qualified business income (QBI) deduction until 2025.**
  – The TCJA introduced a new deduction for certain owners of pass-through entities that is generally equal to 20% of QBI. QBI is generally defined as the net amount of qualified income, gain, deduction, and loss that is effectively connected with the conduct of a U.S. business and excludes certain items, including reasonable compensation paid to the owners of the business. The QBI deduction is subject to restrictions and a tax expert should be consulted when claiming this deduction.

  – All else being equal, the temporary reduction in taxes on the dealership's income will increase the dealership's value through increased expected cash flows. However, this is highly dependent on the individual owner's tax situation and will be reduced as 2025 approaches and any benefits have already been realized.
- **Changes to bonus depreciation and Section 179 limits.**
  – The TCJA introduced temporary changes to bonus depreciation to allow for 100% deductibility of qualifying property through 2023 with a phase-out through 2025. For dealerships, the 100% deductibility of qualifying property is generally limited to those businesses that have total business interest, including floor plan financing interest, that does not exceed the limitation of 30% of adjusted taxable income.

  – The TCJA increased the annual deduction and the annual phase-out threshold, and changed the definition of property eligible for Section 179 expensing.

– For those that utilize the higher depreciation and expensing limits the initial impact will be to reduce current taxes.

VI. MAXIMIZING VALUE

A. Strategic Planning and Building Value

Planning that begins well in advance of a dealership sale can maximize value for the seller. The following action items, completed within three to five years of a transaction, will help to enhance the value of the dealership.

1. Create a Plan

While it is always advisable to perform both short-term and long-term projections, it's even more important in the years before a sale. Though prospective buyers care primarily about the future earnings of the business, they also care about your ability to forecast, plan, and manage that future. The ability to demonstrate a strategic plan and how it was executed, and even explain why actual results differed from the strategic plan all show management strength and a level of predictability. Further, the plan and actual results should aim to maximize profits, even if this results in significantly higher taxes. Prior to a sale, the dealership should emphasize maximizing earnings, demonstrating greater profitability and the resulting higher value to the buyer.

In formulating your strategic plan, compare your financial performance with that of your peers. Celebrate successes, and recalibrate where you encountered below-average results. Identify tactics that address the uniqueness of your marketplace or customer base as well as gaps in past performance, and leverage the strengths of your team. Study your largest expense categories: people/people-related, advertising, and DMS. Increase the impact of your spending by ensuring employees have proper training, carefully measure the results of advertising, and hire a consultant to analyze DMS bills or contracts for redundancy or non-compliance with terms. Review your franchise portfolio from time to time. If some brands don't generate sufficient return to warrant the effort by your people, sell or terminate them.

2. Empower Your Team

Sometimes having long-tenured and experienced management and employees can lead to strong capability and effectiveness. If that is not the case for your dealership, it may be time to upgrade your human capital. Focus on people who have the energy, positive attitude, enthusiasm, and ultimately, the accountability to create positive financial results. Empower your team to accomplish your goals and provide support as needed. Successful dealers create processes that drive consistency with customers. Ensure your employees know that your business and their pay are dependent upon satisfied customers. Plan and prepare for management succession, ensure there is someone well-trained in advance of a known retirement and identify and train those who could step up their role after an unplanned exit.

3. Get a Good CPA

Because financial statements are a basis for a prospective buyer to review your dealership's performance, it is vital to have financial statements that are accurate and easy to interpret. In most cases, dealer statements are not adequate by themselves. While audited statements are always best, their cost is the highest, reflecting the complexity of procedures conducted. Reviewed financial statements from a reputable CPA, preferably one who works with dealers, are a good alternative to audited statements. This will cost extra, but will pay dividends in the sale process.

Due diligence prior to closing varies among buyers. However, having an independent advisor or CPA involved can lead to a successful closing. Additionally, reconciling the detailed financial schedules at closing to the benefit of the seller is most often best accomplished by an independent CPA experienced in this type of work for a dealer.

4. Clean Up the Financials

Over years of operations, it's common for financial statements to reflect items that are not needed for dealership operations. Non-operating assets, owner- or affiliated-entity loans, or obsolete assets are just a few of the items that should be removed before a sale. You want the buyer to be able to analyze financial statements that are representative of what they would be buying; any other information on the financial statements only confuses the process. Having schedules that properly document the balance sheet assets and liabilities will facilitate due diligence and the closing process.

5. Resolve Facility Issues

Because facility upgrades can be a significant expense, a dealership buyer will pay close attention to the dealership's condition and expenditures that may be required after acquisition. From the seller's perspective, it may be best to complete the improvements prior to sale. Just as new vehicles are presented in their best condition, it is important to present the physical dealership facility in the same way. This will lead to stronger interest in the dealership and the best starting price for negotiation. Also, when a buyer estimates the needed facility expenditures, he or she may add costs for unknown issues and the inconvenience that comes with improvements, which ultimately reduces value to the seller.

Further, it's a good idea to obtain or retain a confirming letter from the manufacturer stating that the facilities meet the current image standards and that the factory is not requesting further improvements. During the process of approving a new buyer for automobile dealerships, the manufacturer often asks for facility upgrades. Having this written approval prior to the transaction process helps protect the buyer, helps with approval, and ultimately helps the seller to complete the transaction.

B. Preparing for Exit (Sale to a Third Party)

Using your professional advisory team, develop a range of estimates for the potential sale price and compute the expected net after-tax cash proceeds. Doing this step well in advance of the sale process can avoid the challenges that may arise if the expected proceeds are less than desired.

Once the dealership is in an optimal position to be sold, identifying the best buyer becomes the next priority. To do this, the dealership owner must consider: Who are the potential buyers of the business? Will these buyers be able to meet the manufacturer's requirements? What steps are required of these buyers in the diligence process? Will the goals of the buyers align with those of the seller? Will the dealership be sold to a related party, member of management, new dealer, large dealership group, or private equity firm? Identifying the most likely prospective buyers is key to proper preparations for the sale, as well as the overall sales process. Typically, transaction brokers assist and guide owners and buyers through this process.

In the sale of a dealership, the saying that "one buyer is no buyer" holds true. To sell a dealership and have a positive outcome in terms of price, goals of the sale, and transition of the dealership, it is vital to have more than one potential buyer with whom to consider a sale. Ultimately, the best indicator of the true market value of any business is the sale proceeds. Unless the company is marketed to multiple buyers, and possibly multiple buyer types, it may be impossible to know the true market value of the dealership. Thus, it's best to familiarize multiple parties with the dealership during the sales process, and to entertain multiple offers, without, of course, pitting one potential buyer against another. In this way, you should be able to weed out those prospects who are not committed to the deal, and motivate the interested buyers to make better offers. Advisors can facilitate maintaining the transaction's confidentiality to mitigate the disruption to dealership employees prior to the successful closing of a transaction.

Selling your dealership may well be the biggest financial transaction of your lifetime. The reality is that you will probably only get one shot at getting it right. Know that selling your business is not your line of work, nor is it a "do-it-yourself" job. A knowledgeable dealership transaction attorney, accountant, transaction advisor or broker, and business appraiser can work together to help protect your interests, while ensuring the transaction process flows smoothly. This is not an inexpensive process, but if selected carefully, each of these professionals will bring a return on investment through the services they provide and additional value they create.

1. Potential Buyers

Large Dealership Groups. In many ways, a large dealership group may be the easiest potential buyer to work with because the transaction process is routine. Typically, large groups have a set transaction process in place, approval from the manufacturer is not an issue, and they have sufficient capital for the transaction and the knowledge to operate the dealership without continuing efforts on the part of the seller.

However, in a transaction with a large dealer group (public or private), the seller needs to verify that the long-term goals for the dealership align with the buyer's vision for the dealership once it is sold. Typical items of concern include the retention of management and employees, as well as community involvement activities and commitments post-closing. With all transactions, it's important to engage experienced advisors to look out for your best interest in the transaction. Just because the transaction process is going smoothly, don't assume that you don't need legal and financial advisors.

Private Equity Groups. This is a newer entrant into the buyer market, and the transaction issues are similar to those of large dealership groups, with a few exceptions. Private equity groups, family offices, and the like may have a more difficult time being approved by the manufacturer, because traditionally manufacturers have preferred to have a single person or family as the contact. Also, some of these groups may look to hold investments for only five to seven years, which does not align with the long-term operational goals of most manufacturers. Further, private equity groups and similar buyers may want the seller to remain involved in the business for a period of time to make the transition smoother. Sometimes sellers can retain a small portion of the equity when they stay involved in dealership operations post-closing.

Member of Management. Sometimes, the logical choice for a buyer is a member of the current dealership management team. This type of sale transitions the dealership to someone who knows the business and may operate it in the same manner as before the sale. This type of sale can be an incentive to management. Selling to a member of management is not without issues, though. You will have to consider, for example, whether management can afford to buy the dealership. Doing so obviously requires a lot of capital. The seller needs to be sure that the management buyer has sufficient capital not only to purchase the dealership, but also to operate it successfully. This can result in seller financing arrangements, which may or may not be desirable for the seller. There are, however, private equity partners who may be willing to assist with financing for such a buyer.

Employee Stock Ownership Plan. Although employee stock ownership plans (ESOPs) are not a common exit strategy in the industry, a small number of dealerships have implemented these benefit plans when they fit the seller's goals. Forming an ESOP and executing a transaction with an ESOP necessitates hiring advisors skilled in these transactions. Such transactions can be scrutinized by the Department of Labor post-closing because ESOPs are benefit plans under their purview and regulations.

New Dealer. Many individuals who have had success in other fields are looking to invest in automobile and heavy-truck dealerships. Typically, these buyers have sufficient capital and can meet the financial requirements for manufacturer approval. However, they may not have the dealership or management experience that the manufacturer is looking for, which could make approval difficult. Overall, the transaction process will be more difficult and require more patience and assistance from the seller because of the buyer's lack of prior experience with dealerships. Also, the buyer may require the seller to remain involved in the business to ensure a smooth transition.

2. New Investor Value Measurements

It is helpful to be aware of value measurement techniques that may be used by dealership acquirers. These are shortcut methods to either check the value results or ensure that the investment comports with their portfolio criteria.

A common method for investors is to define their rate of return, or ROI, for example 15%, to be applied to net cash flows to determine if the investment meets their threshold returns. Frequently, this approach results in using similar expected cash flow as outlined in the "Income Approach" section of the guide. However, the investor may look at income taxes differently, and may consider the benefit of post-transaction goodwill amortization in the cash flow analysis.

Sometimes investors evaluate the future expected cash flows to determine how long it will take to recoup the goodwill value in a transaction. This payback period computation is then compared with the desired time frame or expected time frame for similar investments, three to five years for example.

Some buyers may have acquisition goals and consider their required pretax earnings for the first year of operations along a continuum of expected growth and rate of return or Blue Sky multiple to evaluate a purchase. This might look like the table below.

Blue Sky Multiple				
Required Pretax ROI	Growth in Pretax Earnings Year 1			
	-3%	0%	3%	6%
10%	7.7×	8.0×	8.3×	8.6×
15%	4.5×	4.7×	4.9×	5.1×
20%	2.9×	3.0×	3.2×	3.3×

Other investors consider the EBITDA resulting from the value analysis. Because flooring interest is not viewed as a corporate finance decision, EBITDA includes the cost of vehicle flooring. As in the other calculation methods, the investor has a threshold criterion for the resulting EBITDA multiple from the transaction.

These methods allow investors to compare results across their portfolios, so they can manage and monitor each store or segment's fit with their specific investment criteria.

Two other value-related topics should be noted: Some dealership acquirers do not purchase 100% of the ownership, so sellers may continue to participate in the dealership being sold. Additionally, earnouts, which are more common in non-dealership transactions, are making their way into the industry in some transactions.

Earnouts are a way for dealership sellers to achieve additional benefits, which are contingent upon achieving specified results or target levels. These sweeteners can make it more challenging for sellers to evaluate the expected cash flow from a particular transaction; appraisers have techniques for estimating the value of earnouts.

Regardless of how the foregoing methods are applied, we find that some dealership investors or owners use the results of the appraiser's independent look at the operation, particularly its risks, strengths, and weaknesses, to build a stronger business. Appraisers analyze the dealership from an independent investor's perspective. It may be important to the owner to continue growing or improving the value of what may be his or her largest asset and retirement nest egg. An appraisal can help in this assessment.

C. Preparing for Exit (Sale to a Non-Third Party)

Preparing for a sale to an affiliated party or family members can require additional steps. These may involve estate or succession planning for the seller or dealership (see NADA's *Driven* guide *A Dealer Guide to Business Succession Planning*). The goal of this type of sale may not be to maximize value to the seller.

The advisors to this type of transaction are frequently different from those who assist third-party sales, and most commonly this transaction is completed as an equity rather than asset deal. The parties should still complete a number of the steps described above to ensure a clean slate for the new owners. Additionally, it is a best practice to prepare a no-tax gift tax filing for a family member transaction to trigger the three-year statute of limitations during which the IRS can review the transaction.

Appendices

Information Often Requested for Valuation

Company Background

- [ ] Entity type, formation date & state in which formed
- [ ] Key events in dealership's history
- [ ] Ownership by individual, total shares or units
- [ ] List of locations & activities at each site
- [ ] List of affiliated companies

Products/Market

- [ ] Brands sold & when acquired or awarded
- [ ] Primary brand competitors & their sales volume
- [ ] Description of market area & market share
- [ ] Planning potential or retail objective by brand
- [ ] Factory or 20 Group composite (comparison data)
- [ ] Recent CSI/SSI
- [ ] Dealer sales and service agreements

Operations

- [ ] Organizational chart
- [ ] Management: role, age, tenure, compensation
- [ ] Facilities: size, age, condition, capacity, image compliance status
- [ ] Facility real estate appraisal or value estimate
- [ ] Facilities lease agreements or summary of terms
- [ ] Description of employee benefit plans
- [ ] Date of last IRS audit & EPA inspection
- [ ] List of demonstrators provided
- [ ] Employment agreements or contracts

Legal

- [ ] Bylaws & articles of incorporation
- [ ] LLC operating agreement
- [ ] Shareholder or buy-sell agreements
- [ ] Board of directors minutes
- [ ] Union agreements
- [ ] List of litigation matters (5 years)
- [ ] Description of contingent liabilities
- [ ] Licenses and contracts

Insurance

- [ ] Description of current policies
- [ ] Description of owner's life insurance

Financial

- [ ] CPA financial statements (5 years)
- [ ] Dealer statements (5 years-13th period)
- [ ] Federal income tax returns (5 years)
- [ ] CPA year-end journal entries (5 years)
- [ ] CPA's trial balances (5 years)
- [ ] Interim dealer statement: current month
- [ ] Interim dealer statement: last year, same month
- [ ] Fixed asset listing/depreciation schedule
- [ ] Budget, forecast, or business plan
- [ ] Capital expenditure plans: cost, timing
- [ ] Owner's compensation (5 years)
- [ ] Unusual income or expense (5 years)
- [ ] Discretionary expenses (5 years)
- [ ] Non-operating income/expense (5 years)
- [ ] Description of owner loans-receivables: name, amount, terms
- [ ] Non-operating assets: list, value
- [ ] Debt: lender, amount, terms
- [ ] Owner distribution policy or plan
- [ ] Prior ownership transactions
- [ ] Franchise acquisitions/sales

Adjusted Book Value Worksheet

	Book Value as of ______	Adjustment	Adjusted Book Value	Notes
Cash and Equivalents	$	$	$	
Accounts Receivable	$	$	$	
Marketable Securities	$	$	$	
Other Receivables	$	$	$	
Prepaid Expenses	$	$	$	
Other Current Assets	$	$	$	
Inventories:	$	$	$	
New	$	$	$	
Used	$	$	$	
Parts	$	$	$	
Supplies	$	$	$	
Work in Process	$	$	$	
Other	$	$	$	
Lease/Rental Units	$	$	$	
Land	$	$	$	
Buildings	$	$	$	
Equipment	$	$	$	
Furniture/Fixtures	$	$	$	
Company Vehicles	$	$	$	
Leasehold Improvements	$	$	$	
Accumulated Depreciation	$	$	$	
Notes Receivable	$	$	$	
Other Assets	$	$	$	
TOTAL ASSETS	$	$	$	
Less Liabilities	$	$	$	
Adjusted Book Value of Equity			$	

Earnings Adjustments and Adjusted Earnings Worksheet

Year					
Sales	$	$	$	$	$
Gross Profit	$	$	$	$	$
Remove LIFO (+ expense or - income)	$	$	$	$	$
Adjusted Gross Profit	$	$	$	$	$
Pretax Earnings	$	$	$	$	$
Plus Non-recurring Expenses:					
	$	$	$	$	$
	$	$	$	$	$
	$	$	$	$	$
Less Non-recurring Income:					
	$	$	$	$	$
	$	$	$	$	$
	$	$	$	$	$
Plus Discretionary Expenses:					
	$	$	$	$	$
	$	$	$	$	$
	$	$	$	$	$
Less Non-operating Income:					
	$	$	$	$	$
	$	$	$	$	$
	$	$	$	$	$
Plus Non-operating Expenses:					
	$	$	$	$	$
	$	$	$	$	$
	$	$	$	$	$
Adjusted Pretax Earnings	$	$	$	$	$
Less Income Tax	$	$	$	$	$
Adjusted Net Income	$	$	$	$	$
Adjusted Net Income Percentages					
% of Sales	%	%	%	%	%
% of Gross Profit	%	%	%	%	%
State Tax Rate	%				
Federal Tax Rate	%				

Earnings Forecast Worksheet, Part 1—Sales and Gross Income Forecast Worksheet

	Unit Growth Rate[a]	Units	Gross Profit Per Unit[b]	Total Gross Profit	Gross Profit Percentage[c]	Average Sales Price[d]	Total Sales Revenue[e]
New Vehicles:							
Type 1	%	×	$ =	$	%	$ =	$
Type 2	%	×	$ =	$	%	$ =	$
F&I	%	×	$ =	$	%	$ =	$
Subtotal New				$	%		$

	Used/ New Ratio[f]	Units	Gross Profit Per Unit[b]	Total Gross Profit	Gross Profit Percentage[c]	Average Sales Price[d]	Total Sales Revenue[e]
Used Vehicles:							
Type 1		×	$ =	$	%	$ =	$
Type 2		×	$ =	$	%	$ =	$
F&I		×	$ =	$	%	$ =	$
	Wholesale Ratio[g]						
Wholesale	%	×	$ =	$	%	$ =	$
Subtotal Used				$	%		$

		Average Monthly Gross Profit[h]	Total Gross Profit	Gross Profit Percentage[i]	Total Sales Revenue[j]
Parts	12 ×	$ =	$	%	$
Service	12 ×	$ =	$	%	$
Body Shop	12 ×	$ =	$	%	$
Store Total			$		$

Assumptions/Notes:

[a] Based on industry or manufacturer's expectations.
[b] Based on recent historical or projected gross profit per unit.
[c] Gross profit per unit divided by average sales price.
[d] Based on recent historical average unit sales price or projected unit sales price.
[e] Average sales price times number of units.
[f] Used retail divided by new retail unit volume, based on historical average or projected ratio.
[g] Used wholesale divided by total used sales volume, based on historical average or projected ratio.
[h] Departmental average gross profit, based on recent historical volume or projected volume.
[i] Based on recent historical average departmental profit or projected profit.
[j] Total gross profit divided by gross profit percentage.

Earnings Forecast Worksheet, Part 2—Operating Expenses and Net Income Forecast Worksheet

	Monthly Average Amount	Percent of Dept'l Sales	Percent of Dept'l Gross Profit	Percent of Total Gross Profit	Percent of Total Sales	Per Vehicle Retail	Projected Annual Amount
Operating Expenses:							
Variable—New Vehicles	$	%	%	%	%	$	$
Variable—Used Vehicles	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
Total Operating Expenses	$	%	%	%	%	$	$
Operating Profit	$	%	%	%	%	$	$
Other Income/ Expense:							
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
	$	%	%	%	%	$	$
Pretax Profit	$	%	%	%	%	$	$
Income Tax							$
Net Income							$

Assumptions/Notes

Use historical trends that are most consistent for the expense or income category as a basis for projection, or forecast based on future expected level using guideline data.

Discounted Cash Flow Worksheet—Revenue Driven

Year	Prior Year						Residual
Total Revenue	$	$	$	$	$	$	$
Gross Profit	$	$	$	$	$	$	$
Less Operating (Expenses)	$	$	$	$	$	$	$
Plus/Less Other Income/(Expenses)	$	$	$	$	$	$	$
EBIT	$	$	$	$	$	$	$
Less Taxes on EBIT	$	$	$	$	$	$	$
Less Depreciation	$	$	$	$	$	$	$
Less Working Capital Changes*		$	$	$	$	$	$
Less Capital Expenditures	$	$	$	$	$	$	$
Future Expected Cash Flow		$	$	$	$	$	$
							Cap. Rate
				Capitalize Residual Value			÷
Future Cash Flow		$	$	$	$	$	$
Times Present Value Factor							
Annual Present Value		$	$	$	$	$	$
Discounted Cash Flow Value		$		*Sum of 5 years plus residual present value*			

Summary Assumptions:

Total Revenue Growth		%	%	%	%	%	%
Gross Profit % of Sales	%	%	%	%	%	%	%
Operating (Expenses) % of Sales	%	%	%	%	%	%	%
Other Income (Expenses) % of Sales	%	%	%	%	%	%	%
Depreciation % of Gross Sales	%	%	%	%	%	%	%
Working Capital % of Gross Sales	%	%	%	%	%	%	%
Working Capital - Value	$	$	$	$	$	$	$
Capital Expenditure % of Sales	%	%	%	%	%	%	%

Discount Rate	%	State Tax Rate	%
Long-Term Sustainable Growth Rate	%	Federal Tax Rate	%

Compute Present Value Factor	1	1	1	1	1	1
Insert discount rate	$(1.\_\_\_\_)^{0.5}$	$(1.\_\_\_\_)^{1.5}$	$(1.\_\_\_\_)^{2.5}$	$(1.\_\_\_\_)^{3.5}$	$(1.\_\_\_\_)^{4.5}$	$(1.\_\_\_\_)^{4.5}$
Equals Multiplier						

Present value factor formula: $\dfrac{1}{(1 + \text{discount rate})^{n}}$ Where: n = number of periods until the cash flow is received

Example with 18.0% discount rate: $\dfrac{1}{(1.18)^{0.5}} = \dfrac{1}{1.0863} = 0.9206$

*Working capital is computed without non-operating cash and without LIFO reserve.

Discounted Cash Flow Worksheet—Gross Profit Driven

Year	Prior Year						Residual
Gross Profit	$	$	$	$	$	$	$
Less Operating (Expenses)	$	$	$	$	$	$	$
Plus/Less Other Income/(Expense)	$	$	$	$	$	$	$
EBIT	$	$	$	$	$	$	$
Less Taxes on EBIT	$	$	$	$	$	$	$
Less Depreciation	$	$	$	$	$	$	$
Less Working Capital Changes*		$	$	$	$	$	$
Less Capital Expenditures	$	$	$	$	$	$	$
Future Expected Cash Flow		$	$	$	$	$	$
							Cap. Rate
					Capitalize Residual Value		÷
Future Cash Flow		$	$	$	$	$	$
Times Present Value Factor							
Annual Present Value		$	$	$	$	$	$
Discounted Cash Flow Value		$		*Sum of 5 years plus residual present value*			

Summary Assumptions:

Gross Profit Growth		%	%	%	%	%	%
Operating (Expenses) % of Gross Profit	%	%	%	%	%	%	%
Other Income (Expenses) % of Gross Profit	%	%	%	%	%	%	%
Depreciation % of Gross Profit	%	%	%	%	%	%	%
Working Capital % of Gross Profit		%	%	%	%	%	%
Working Capital - Value	$	$	$	$	$	$	$
Capital Expenditure % of Gross Profit		%	%	%	%	%	%

Discount Rate	%	State Tax Rate	%
Long-Term Sustainable Growth Rate	%	Federal Tax Rate	%

Compute Present Value Factor: *Insert discount rate*	$\frac{1}{(1.\_\_\_\_)^{0.5}}$	$\frac{1}{(1.\_\_\_\_)^{1.5}}$	$\frac{1}{(1.\_\_\_\_)^{2.5}}$	$\frac{1}{(1.\_\_\_\_)^{3.5}}$	$\frac{1}{(1.\_\_\_\_)^{4.5}}$	$\frac{1}{(1.\_\_\_\_)^{4.5}}$
Equals Multiplier:						

Present value factor formula: $\frac{1}{(1 + \text{discount rate})^{n}}$ Where n = number of periods until the cash flow is received

Example with 18.0% discount rate: $\frac{1}{(1.18)^{0.5}} = \frac{1}{1.0863} = 0.9206$

*Working capital is computed without non-operating cash and without LIFO reserve.

Questionnaire for Valuation Review

1. Were the five elements of the appraisal assignment identified—purpose of the valuation, date of the valuation, interest appraised, standard of value, premise of value?
2. Did the appraiser use the Income, Market, Asset-Based, or other approach?
3. If the Income Approach was used, was the method discounted cash flow or capitalization? Was the method used appropriate for the dealership's future prospects and assumptions properly explained?
4. If the Market Approach was utilized, which method(s) were used—the guideline public company, merger and acquisition, rule of thumb, and/or prior transaction? Were the inputs and assumptions properly explained?
5. What weighting was accorded each of the indications of value and did the appraiser outline the reasoning?
6. Was the impact of the local, regional, and national economic environments considered?
7. Were the unique aspects of the automobile or heavy-truck industry considered?
8. Was a financial analysis performed?
9. Did the appraiser make adjustments to the historical financial statements and if so, do they seem reasonable and appropriate given the assignment?
10. Were discounts or premiums applied and if so, are they supported and do they seem reasonable and appropriate given the assignment?
11. Were the steps taken in the appraisal process reasonable and appropriate given the assignment?
12. Were there any contradictions in the report?
13. Were there any mathematical errors?
14. Is the report documentation consistent with the assignment? (For example, a calculation assignment will be documented differently from a fully documented report.)

ACKNOWLEDGMENTS

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