PERSONAL INTRODUCTORY NOTES

BEHIND EVER SUCCESSFUL DEALER THERE IS A CONTROLLER

COMMON SENSE – Being a successful dealer is not rocket science. It requires discipline. Discipline to understand and act upon what the financial statement tells you. We will talk about that in a moment.

Remember this: **Great Discipline generates great strength** – and great stores.

PERSONAL BACKGROUND:

In 1972 there were 3 Lawyers in California that specialized heavily in automobile dealerships.

Back then, there was a lot more fun in the world of dealerships.

- An 18-year old kid could graduate high school, go to work for a car dealer and drive a new demo home to show mom and dad.
- At Saturday sales meetings the owner or manager would tape money under the chairs $5, $10, $20, a couple of $50s and a $100 bill. They would tell the crew that they were sitting on money and, as each person looked under their chair there was a cheer when the money was found. The bigger the bill, the larger the cheer.
- Then the IRS then decided that having demos was a benefit and small spiffs were income and they decided to tax the perks.

Back then the courts did not know much about the business. **In 1976** we had a dealership charged with 36-counts of misconduct by the San Mateo County District Attorney's office. In less than 60-days, with only a few depositions, the case was dismissed because the investigators really did not know the business or what they were charging. You can read the newspaper article on our website.

In 1980 I sold my law firm and moved to Aspen, Colorado. I soon found that the car business was as addictive as drugs.

A car person can understand how Daryl Strawberry paid people to stop him using cocaine – and still could not stop. Once hooked on the business, it is difficult to leave it.

To be a good CFO, you have to understand your dealer.

The best story I heard describing a dealer's thought process is the one about the dealer who died and was told by St. Peter that he could not enter Heaven because there were too many dealers. He was told that he would have to wait a few centuries for more non-dealers to die so that the ratio of dealers to populace would balance.

The dealer then asked Peter if he had a stool available. Peter asked why, and the dealer said just watch. The dealer then stood on the stool and announced: "They are selling Honda Civics for five grand back of invoice in hell." Immediately there was a rush to hell by the existing dealers. Peter, not believing his eyes, told the dealer he could now enter Heaven.

With that, the dealer paused and said: "Could I take a rain check for a couple of days?" Peter asked why, and the dealer said: "Well, I would like to go to hell for a while to check out those Hondas." Peter, in total amazement said: "But you were the one that made up the story so that there would be room in Heaven for you." Whereupon the dealer responded: "Yeah, but there might be some truth to the rumor."

If you can understand that story, you can understand how a dealer thinks.

In 1986, I worked my first transaction in Texas. My client was $3.5 million out of trust and a guy by the name of Walt Dathe was the Control Branch Manager of GMAC. One night while walking to the car after dinner, Walt said to me: "John, I trust you to take care of GMAC's shortfall on this deal." I reminded Walt that the dealer had paid me a retainer to represent him and, without a beat, Walt looked me in the eye and said: "He may have paid you a retainer, but he did it with my money." That's when I said to myself, "I love Texas and the way people think here. They see things so clearly."

In 1987 – I wrote Book on buying and selling car dealerships. That book became the basis of the Modern Buy-Sell Agreement. To this date it is the only book in the United States Library of Congress that addresses the subject and today, 25-years later, lawyers and dealers still call me to get copies.

So, before we start, let me say it again. **<u>Running a dealership is not rocket science – It is discipline!</u>**

Great Discipline generates great strength – and great stores.

I encourage each of you to become a Student of Industry.

Today's seminar is to get you on the right track.

As we continue, however, remember that I am condensing several 1-day lectures into one hour. The seminar is not meant to give all of the answers. It is meant to provide a building block to help you become a successful controller.

Assessing CFOs and Controllers during Mergers and Acquisitions

By: John Pico, BA, JD*

Introduction

To understand how we view CFOs and Controllers, you have to understand what we expect from them.

In our view, the CFOs and Controllers represent the heart and soul of the dealership.

They are the heart of the dealership because, aside from the rote functions of their job, they should be able to detect almost all of the weaknesses of the store. And, they are the soul of the dealership because they should also be able to detect illegitimate actions of the owner(s) and employees.

Take the factory financial statement, for example. A financial statement is to a dealership what a horizon indicator is to an airplane. It signals the direction of the store – up, down or steady. At the same time, it is reflects many of the immoral actions of management and employees.

The first thing we do with a financial statement is add the vehicle receivables to the contracts in transit and divide that number by 30,000. (In 2011, the average selling price of vehicles were $30,659, for new and $17,267 for used. Source: NADA 2012 State-of-the-Industry Report)

We would then take that number and divide it by the average monthly sales. For example, assuming the total vehicle related receivables were $2,400,000, a divisor of 30,000 would equal 80. If the dealership is selling around 80 or more vehicles per month, we would, without a formal audit, feel comfortable about the number.

On the other hand, if the dealership was selling only 30 vehicles per month, we would find it to believe that the store had not been paid on a contract for 2 ½ months – if we wanted to believe the statement.

[Noted: Another "quick check" would be to divide the number of vehicles in inventory by the average cost of a vehicle. For example, if the average dealer cost of a new Chevrolet is $30,000 and the statement shows 20 new vehicles in inventory, with a value of $3,000,000, more likely than not, the statement is plugged.]

The second thing we would look at is the prepaid expense total. Many times a dealer will place ordinary expenses into the "prepaid" account in order to inflate profits.

You would be amazed at the number of statements that reflect hundreds of thousands of dollars in prepaid expenses and two or three months of vehicle receivables.

The third thing we notice are the asset and liability accounts that have minus numbers. Any minus number on the balance sheet is investigated.

For example, we recently looked at a store where the accounts payable account was stated as a minus 253,000.

As we dig deeper, we compare percentages in each department against NADA or 20-Group averages and investigate all abnormalities.

> NOTE: Most CFOs and controllers do not understand that misstating numbers on financial statements is a crime. Comerica, Chase, Ally Financial, etc., are federal lending institutions, insured by the FDIC, and providing them with false financial statements is punishable by fine, imprisonment and restitution – or any combination thereof.
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> In addition, kiting checks is a federal crime. Perry Pressley (comptroller of an El Paso dealership) sentenced to jail and ordered to pay $1.5 million in restitution for conspiracy to commit bank fraud. Pressley argued that he lacked the specific intent to deceive or cheat the bank because he thought the dealer was wealthy and could cover the float. He also argued that he was only following orders. The court held that neither argument was relevant and affirmed his conviction and sentence. 990 F.2d 822

On the other hand, Melissa Vinson, a former comptroller, alleged in a lawsuit that she was fired for refusing her boss' request that she falsify financial data to a financial institution -- a criminal act.

She was awarded a judgment of $844,925 for wrongful termination.

In her suit, she alleged that the legal entity that controlled her store, took a substantial loss and that her boss was attempting to provide a statement to an unnamed financial institution to lower his interest rate on a loan.

In ordering Vinson to prepare that statement, she alleges her boss told her not to include expenses the company incurred in December, which had the effect of artificially inflating the company's bottom-line performance.

When she objected, she was told she was on "vacation" and not to return to the office until further notice. After continuing to refuse to make the change, Vinson was fired, according to the lawsuit. Source: Dallas Business Journal, February 14, 2005.

Places you can go for help:

For basic bookkeeping questions see sites such as:

1. For basic accounting questions (Ford and GM Accounting Manuals) http://advisingdealers.com/Automobile_Dealership_Accounting.html
2. For Audits: see http://www.advisingdealers.com/downloads/IRSAuditGuide2004.pdf

What we do when buying or selling a dealership

1. Visiting the facility is a must – before negotiating.
   a. The first thing we do is look at the cars as we approach the dealership. We work on **the clock method**. 12:00 o'clock means that the cars are lined-up, side by side, in a straight line with the front pointing toward the curb. As a dealership experiences financial problems, inventory drops and the space between the vehicles increases, until there is so much space that the vehicles begin to slant to 1:00 o'clock, then 2:00 o'clock and finally, there was a Chevrolet dealership in Brighton, Colorado that had them at 3:00 o'clock. It reminded us of John Wayne circling the wagons in an old western.
   b. The next thing is the **demeanor** of the employees. [If the employees are all in a group, smoking in front of the store, there is generally a management problem.]
   c. The next thing we notice is the **condition** of the facility and the furnishing;
   d. When we enter the store, we look at the **awards plaques**. In a number of instances we told dealers they had signs on the showroom floor stating when they ran out of money. For example, in one store the Salesperson of the month awards stopped being posted the previous October. That is when the dealer was more preoccupied with chasing money than recognizing his employees.

What we look for in the business office

We look for CFOs and Controllers:

a. **Not Posting Accessories & Adds** – makes grosses look good. For example, in a California dealership Chevrolet dealership the commercial truck manager was paid on a percentage of the gross. The business manager was not posting adds and truck manager was making over $300,000 per year.

b. **Service Department versus Parts Department** – The statement may show a profit in parts and a loss in Service, but that could be caused by having a strong parts manager and a weak service manager. Example in one Dallas area store – Parts manager was selling bed-liners to the service department to pre-install. The salesmen were giving them away when the customer would not buy one. The loss was posted back to the service department. Result: the service department looks bad, while parts department looks good.

c. **Used vehicles booked too high** – In a Chevrolet store there was a 1992 Dodge on the used car lot that was booked in at $142,000.

What we see in the current market place

1. Over Confidence in the market – Dealers' IQs fluctuate monthly with their balance sheet. We have an uptick in sales and profit and everyone is smart again and they are going to make millions. Well the world hasn't changed. Despite the uptick, the basic facts remain the same:

   - The national debt is increasing at an unsustainable rate;
   - Home mortgage defaults are being masked because of the election year;
   - Bank closures are being delayed because of the election year;
   - The Fed is printing money like candy; and
   - The interest rate has been suppressed for too long at an artificially reduced rate.

   The last time mortgage interest rates were this low was April 1956. I was in 6th grade and Elvis Presley scored his first number 1 single with "Heartbreak Hotel" in April 1956.

   Sooner or later, the dam has to burst. The 21st Century cannot continue at 1956 interest rates.

2. The IQ fallacy is causing Dealers that should sell to hold on. They don't understand that the Lord gave them a window to get out. It reminds me of the story of the lady sitting on her roof during Katrina. A boat came by and the guy told her to hop-in. She said "No Thanks. The Lord will take care of me. Then a helicopter came by and she told them the same thing. When she drowned and went to Heaven, she told the Lord "I thought you were going to take care of me" and the Lord answered, "You dummy, I sent a boat and a helicopter."
   The moral of the story is: When the house is on fire and the Lord opens a window – climb through.

3. Currently, there are lots of buyers for just about any store out there, and they are paying pretty decent prices. They are buying profitable deals, where the owners want to cash-out and either retire, or sit on the sidelines; and, they are buying insolvent deals where the dealer hung on too long and the ship sunk.

Multiples versus Concluded Earnings Values

Someday you will be asked your opinion as to the value of a store and, whatever you do, do not value it by a multiple of earnings.

A store is a business opportunity and a business opportunity is worth what an investor believes would be a reasonable return on the value of the investment – and that could be almost anything – ten percent, twenty percent, thirty percent.

If a store is losing money, or goes bust, and you believe you could make $2,000,000 a year in the store, would it be smart to walk away from the deal because the dealer wants $100,000 blue sky?

There are many considerations besides Return-On-Investment that go into determining the value of a dealership: Location, Upside, Personnel, Brand, Condition of Facility, and so forth.

Right now, if you invested in T-Bills, you could expect a 2% return.
But dealerships have risk factors.

Ibbotson says the risk factor of the auto industry is 5%.

An additional risk factor would be assigned to the particular store in question (using the other consideration I referred to above.) Assume you assign a risk factor of 3% to the store being valued. So what do we have?

T-Bill (an allegedly "safe" return)	= 2.94%
Equity Risk Factor of Industry	= 5.00%
Risk factor of this store	= 5.00%
Capitalization Rate would	= 12.94%
Subtract long-term growth rate	1.30%
The Net Concluded Capitalization Rate would	= 11.60%

We use a formula that applies the "Net Concluded Capitalization Rate" to our compilation of:

- Current earnings,
- average restated earnings; and
- weighted restated earnings

to arrive at a concluded earnings value, from which we subtract the book value of the dealership, to arrive at a number we believe the goodwill should be.

Doing it backwards, one can divide the potential earnings of the store by the amount of investment being made to determine the Return on Earnings. E.g., Invest 5,000,000 to get back 1,000,000 = a 20% ROI.

Obviously, in weighing the investment amount, consideration must be given to how much is cash, how much is borrowed, how much is real estate (and how you value that separately), etc.

**** Dr. Pico has represented over 1,000 automobile dealers since 1972. He has been a guest speaker at Stanford University School of Law, The University of California's Hastings College of Law, The California Department of Motor Vehicles, The San Mateo County Trial Lawyers Association, and numerous Legal, Accounting and 20 Groups.***

Available Links:

1. Factory Accounting Manuals see:
   http://advisingdealers.com/Automobile_Dealership_Accounting.html
2. Buyer's Takeover Checklist and Termination / Liquidation Checklist see:
   http://advisingdealers.com/Checklists_and_Factory_Notes.html
3. For IRS Audits see:
   http://www.advisingdealers.com/downloads/IRSAuditGuide2004.pdf

Note: To gain access to some of the handouts you will need a User ID and Password. We have issued the following, temporary User ID and Password. The User ID and password will work until December 31, 2012.

User ID: Supplied to attendees by LGT
Password: Supplied to attendees by LGT