

Chapter 2: Analyzing a Dealership's Financial Statements & Operations

To analyze a dealership's operations, a close look must be taken at the day to day operations as well as examining the dealership's financial history. Usually more emphasis is placed on financial ratio analysis. However, financial statements offer only figures. Many times more insight can be gained by simply walking through the dealership.

Overview

Competition acts to drive profit margins and the returns on investment down to a free market minimum level. In other words, competition translates into lower prices. Therefore, in the long run, the analysis of profit margins (which is a component of return on equity) will depend upon the analysis of a firm's competitive position as well as the competitive position of the industry in which it operates.

Two factors determine the choice of a competitive strategy:

- (1) The long-term profit outlook for the auto-dealership industry.
- (2) A firm's competitive position within the auto-dealership industry.

Both are important. A firm can be in a profitable industry and still do poorly because of a bad competitive strategy, or it may have a good competitive strategy and do poorly because the industry is mature.

In order to forecast the profit margin of a company, and its return on equity, one needs to review the basic competitive forces that exist in an industry and assess the strength of each. There are five basic competitive forces as put forward by Michael Porter in his book *Competitive Strategy: Techniques for Analyzing Industries and Competitors*.¹

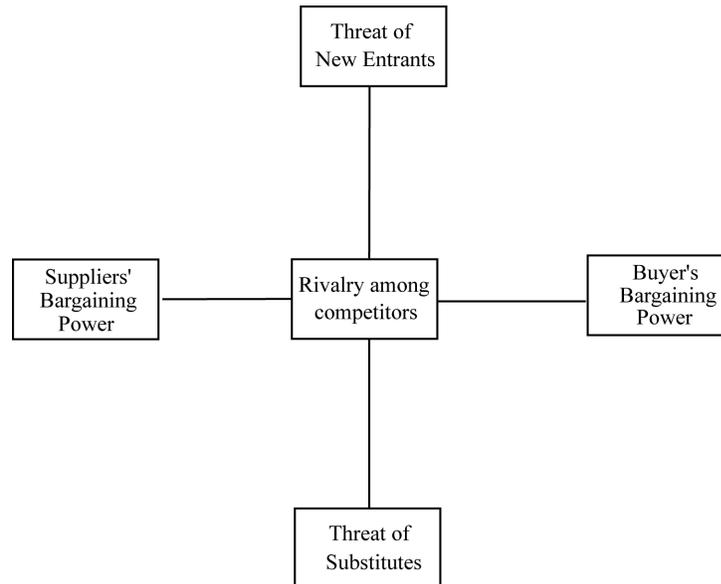
- (1) Ease of entry and exit
- (2) Rivalry between existing competitors
- (3) Pressure from substitute products

1. Porter, Michael E. 1980. *Competitive Strategy: Techniques for Analyzing Industries and Competitors*. New York: Free Press.

- (4) Bargaining power of buyers
- (5) Bargaining power of suppliers

These pressures are presented in Figure 2-1.

Figure 2-1: Five Basic Competitive Forces Facing an Auto Dealership



First, with respect to ease of entry, the following factors affect the decision of a dealership to enter a given market: capital requirements, economies of scale, secure distribution channels, strong brand identification, government policy, technological differences, expected retaliation, and absolute cost advantages.

Second, rivalry between existing competitors involves such variables as the number of competitors, the relative strength of the competitors, the strength of their competitor's relationship with car/truck distributors and manufacturers, the industry growth potential, the amount of fixed costs needed, service differences, and quality of cars available.

Third, pressure from substitute products can hurt the auto industry. The auto industry faces competition not only from within, but also from other forms of transportation such as trains, subways, bicycles, metro transits and others. One needs to focus on substitute products and the minimum switching costs for potential customers, and high profit earning industries which can afford to reduce margins in order to broaden their market into the seller's market.

Fourth, with respect to their bargaining power, buyers can bargain for price cuts, better quality, and more services. Such actions by buyers tend to lower profit margins for sellers. The buyers' power depends on their bargaining leverage, their sensitivity to the price of the product being sold, and the relative availability of substitutes. These variables are: the volume of purchases by the buyer

as a percentage of the seller's sales, the profitability of the buyer, the percentage of buyer cost that is represented by the product, buyer information, whether the buyer could duplicate the product from the seller, the product's impact upon the buyer's business, switching costs, and the seller's ability to influence the buyer. Overall, the internet has greatly increased the bargaining power of buyers

Finally, the bargaining power of suppliers (car manufacturers) can reduce a firm's profit margins by raising costs or reducing quality. The conditions that give bargaining power to suppliers are: the relative size of suppliers versus buyers, the importance of the buyer to the seller, the switching costs, whether the supplier can penetrate the buyer's market, the degree of organization of the supplier, the supply of the supplier's product, and whether the government can control the supplies of certain products.

If economic forces are strong enough to create a competitive market, then they will place downward pressure on rates of return so as to equal the return to assets used plus a business risk premium. If an industry is earning above average returns, then capital will flow into it causing an expansion of supply and therefore placing downward pressure upon margins. If the industry is earning below average returns, then capital will exit and there will be upward pressure upon margins.

It is the degree of competition produced by these competitive forces that determines the ability of dealerships within the industry to generate attractive rates of return. If these five factors are favorable, then many dealerships can earn attractive returns; if they are unfavorable and lead to intense competition, then few auto dealers can do well despite good management. The automotive dealership industry profitability is directly related to the industry structure and not the auto product in which the industry sells.

An Auto Dealership Owner's Business Strategy

For most dealership owners, growth has been primarily through the acquisition of new and more popular automobiles, the expansion of servicing and parts supplies, and creating advantageous franchising agreements with manufacturers.

Most dealership owners have built strong franchising agreements with vehicle manufacturers. A dealership will have a separate agreement with each manufacturer. These agreements help the manufacturer govern everything from minimum working capital requirements, lines of credit, net worth, to personnel, ownership and management. In return for this, the dealerships are given rights to sell the branded vehicles as well as display trademarks and slogans or logos that are agreed upon. Larger dealerships wield more bargaining power over manufacturers than smaller firms.

An auto dealership owner relies upon advertising to help sell cars off the lots. While conventional forms of advertising such as word of mouth, television and radio ads as well as flyers and print advertisements were once much more prominent, the industry trends show that consumers are now more responsive to the Internet based advertisements. Dealerships often team up with independent automotive search engines to help refine searches with a more extensive set of researching features that include safety ratings, insurance quotes, extended warranties and many other options.

Besides the sale of new and used cars, dealership owners can generate revenues through the sales of parts and repair of old cars and parts.

Operating Revenue From Dealerships

Dealerships generate their revenue primarily from the sale of new and used vehicles, which they require from the vehicle manufacturers.

Dealership Revenue

Dealership revenues are directly related to:

1. Auto sales, including the sale of new vehicles that are delivered from manufacturers, the sale of used vehicles, and trade-ins.
2. The content and quality of parts that are stocked in the dealership's service department warehouse,
3. The quality of customer service that is provided,
4. The quality of the body work and other auto-repairs performed by the service departments, and
5. The reliability and reputation of the dealership.

Revenue Recognition

For most dealerships, revenues are recorded when vehicles are delivered and title has passed to the customer, when vehicle service or repair work is performed and when parts are delivered to the customers. Sales promotions that a dealership will offer to customers are accounted for as a reduction of sales at the time of sale. Rebates and other incentives offered to the dealerships by manufacturers are recognized as "earned."

Additionally, significant estimates are typically made by a dealership in their Consolidated Financial Statements including:

- Allowances for doubtful accounts
- Accruals for charge backs against revenue recognized from the sale of finance, insurance and other protection products
- Certain assumptions related to goodwill and other intangible long-lived assets and accruals related to self-insurance programs
- Certain legal proceedings

- Estimated tax liabilities
- Estimated losses from disposals of discontinued operations, and
- Certain assumptions related to determining stock option compensation.

The sale of vehicles can be facilitated in several different ways. New vehicles can be financed either through traditional means or consumer automobile leasing sources. Most dealerships favor lease-financing, because they believe that it presents the opportunity to obtain repeat business from customers. New vehicle revenues are highly dependent on manufacturer incentives, which vary from cash-back incentives to low interest rate financing. New vehicle revenues are also dependent on manufacturers for adequate vehicle allocations to meet customer demands.

Auto Sales

Used vehicles are mostly obtained from auctions, open exclusively to authorized vehicle dealers, public auctions and trade-ins that are associated with lease termination. Used cars obtained from lease terminations are attractive, because they often have low mileage and are more recent models. Used vehicle revenues are directly affected by the level of manufacturer incentives on new vehicles, the number and quality of trade-ins and lease turn-ins, and the availability of consumer credit. In addition, various manufacturers provide franchised dealers the opportunity to “certify” pre-owned vehicles based on criteria established by the manufacturer. This certification process extends the standard manufacturers warranty.

Often times vehicles that are acquired through trade-ins or were originally intended for sale in used vehicle operations are eventually sold via auction. The ability to utilize closed-bid auctions, that attract many dealers and wholesalers, allows a dealership to increase operating efficiency through achieving optimal inventory levels.

Dealers have several different opportunities to pursue various streams of revenue after the sale of a new or used vehicle. Each sale provides the dealer with the option of providing different forms of assistance for financing the sale. The dealer can also derive revenues from offering the customer a third party extended service contract or insurance policy. Most dealerships will offer their salespeople different training programs to increase their knowledge on after-market revenue options.

After Market Revenues

Also, each sale allows the dealer to sell aftermarket products, such as entertainment systems, security systems, satellite radio and protective coatings. The consumer demand for customization of communication devices and other entertainment systems has skyrocketed in the automobile industry. Freedonia Group, an industry research firm, projects that by the year 2010 electronics could account for up to 40% of the total value of the average vehicle.

After selling a vehicle, auto dealerships will sell credit contracts to various financial institutions on a non-recourse basis to mitigate the risk of default. The dealership will receive a commission from the lender equal to either the differ-

Finance and Insurance Sales