

Chapter 4: Business Valuation: Auto/RV Dealerships

When valuing the business, the most difficult task is adjusting the income and expense statements as well as the balance sheets of the operation. This section focuses on the adjustments and nuances of making these adjustments, as well as the most typical techniques used to value a business. These techniques have been simplified for the reader.

Adjusted Balance Sheet (Business Valuation)

Overall, this valuation method is used to value a company as a going concern. However, it has a number of shortcomings in that it does not consider intangible assets such as: an assembled workforce, trademarks, customer lists, technical know how, etc. Most importantly, if a buyer were to “start the business from scratch,” then this buyer would probably purchase all of the assets at a liquidation value. In summary, this valuation methodology is most important to the insurance industry and financial lenders, and usually represents the floor value of a business. When the value indicated by the market and income approach is less than the adjusted balance sheet value, then the business is probably not a going concern.

Inventories need to be adjusted to some degree. Most adjustments are made pursuant to IRS Revenue Procedure 77-12, which governs the treatment of manufacturing and retail inventories.

Inventories

First, raw materials are valued at their most recent cost. If the inventory is a commodity, then it may be valued at its purchase cost. Second, “work-in process” inventory gets special treatment. It may be approached either from its cost (plus an allowance for the value that has been embedded by the manufacturer) or from its ultimate sale price. Third, the “finished-goods” inventory is typically valued by determining the amount that will be received from its sale in the ordinary course of business, less any normal discounts and allowances, less the cost that the new owner incurs in holding, transporting, and making the sale of the inventoried products, less any returns. Finally, the buyer’s share of the anticipated profit should be adjusted.

Table 4-1: Sample Adjusted Balance Sheet

	Book Value	Adjustment	Market Value
Assets			
Cash & Equivalents	1,278,553		1,278,553
Accounts Receivable	210,153		210,153
Inventory	3,060,605	1,625,000	4,685,605
Other Assets	198,044	4,645	202,689
Total Current Assets	4,747,355	1,629,645	6,377,000
Fixed Assets			
Furniture	83,552	(50,000)	33,552
Vehicles	108,016	(57,066)	50,950
Machinery & Equipment	173,003	(100,000)	73,003
Fixtures & Leasehold Improvements	57,082	(30,000)	27,082
Total Fixed Assets	421,653	(237,066)	184,587
Depreciation	(355,000)	355,000	-
Net Fixed Assets	66,653	117,934	184,587
Other Assets	461,627	(385,000)	76,627
Total Assets	5,275,635	1,362,579	6,638,214
Liabilities			
Current Liabilities			
Accounts Payable	\$ 361,484		\$ 361,484
Accrued Liabilities	223,850		223,850
Notes Payable (Current)	2,345,541		2,345,541
Current Portion Long Term Debt	-		-
Other Current Liabilities	133,350		133,350
Total Current Liabilities	3,064,225		3,064,225
Long Term Debt			
Real Estate	-		-
Operations	40,000		40,000
Total LTD (Real Estate + Operations)	40,000		40,000
Note Payable-Stockholder	-		-
Capital Lease Obligations	-		-
Total Liabilities	3,104,225		3,104,225
Stockholder's Equity	2,171,410	1,362,579	3,533,989
Total Equity & Liabilities	5,275,635	1,362,579	6,638,214

If the company is using the FIFO (first in, first out) method of inventory, then one may utilize the book value as a proxy for the fair value. If the company is using the LIFO (last in, first out) method of inventory, then one *must* add the LIFO reserve to conclude at a rough approximation of the FIFO value. This

method is often used when valuing auto and truck dealerships for the auto or truck inventory as well as for RV dealers. Note that LIFO can understate the value of the existing inventory when the cost per unit is increasing over time. An example of the extent to which LIFO can affect the value on a balance sheet can be seen in Table 4-1.

Table 4-1: Example of Auto Dealership Relative to LIFO Reserve

Line Item	Amount
Existing Net Book Value	\$3,060,605
LIFO Reserve	1,625,000
Adjusted Net Book Value	<u>\$4,685,605</u>

With the adjusted balance sheet method, goodwill should also be factored in. Most companies sell for their adjusted book value plus a premium of zero to two times EBITDA. For our subject company, this would result in a premium (goodwill value) of the EBITDA of \$868,771 multiplied by two, to equal an additional \$1,737,542 of value. Total invested capital would equal \$7,657,072 and after subtracting out the \$2,385,541 of interest bearing debt, the equity value would be \$5,271,531.

Goodwill

Table 4-2: Concluded Values (Adjusted Balance Sheet)

Line Item	Amount
Adjusted Equity Value	\$3,533,989
Plus: LTD (Long Term Debt)	\$40,000
Plus: Notes Payable	\$2,345,541
Total Invested Capital (not including Goodwill)	\$5,919,530
Plus: Goodwill	\$1,737,542
Total Invested Capital (including Goodwill)	\$7,657,072
Less: LTD & Current Portion	(2,385,541)
Equity Value (including Goodwill)	<u>\$5,271,531</u>

As an example of an adjusted book methodology, look at Table 4-1 and compare the adjusted book value to the values concluded by the market approach (see Table 4-10 on page 93 and Table 4-11 on page 94), and the concluded value of the income approach in Table 4-14 on page 97. It must be noted that not all companies indicate such a range in values. A summary of all of the concluded values can be seen in Table 4-16 on page 98.

Market Approach (Guideline Company Approach)

Before applying the market multiples we need to adjust the cash flow of the subject dealership, stripping out the value of the real estate so as to provide a leasehold value of the business. This would allow us to compare apples with apples when comparing our subject dealership with the other public company dealerships that operate predominately under leases.

Adjustments of Cash Flow

Table 4-3 shows a summary of the adjustments needed to be made to the cash flows, which are taken from the example in Table 2-5 on page 53 of our subject dealership.

Table 4-3: Adjustments to the Income Statement of Subject Dealership

	2007	2006
Income Before Taxes*	\$833,034	\$775,996
Depreciation & Amortization (Equip)	18,216	22,839
Interest Expense (Operations)*	17,521	1,000
Unadjusted EBITDA	868,771	799,835
Plus: Discretionary Expenses	125,000	125,000
Plus: Actual Rent Paid	400,000	400,000
Less: Fair Market Rent**	(480,000)	(480,000)
Adjusted EBITDA (leasehold cash flow)	\$913,771	\$844,835
Unadjusted Cash Flow	\$932,196	\$878,800
Plus: Discretionary Expenses	125,000	125,000
Plus: Actual Rent Paid	400,000	400,000
Less: Fair Market Rent**	(480,000)	(480,000)
Adjusted Cash Flow (leasehold cash flow)	\$977,196	\$923,800
Unadjusted EBITDA	\$868,771	\$799,835
Plus: Discretionary Expenses	125,000	125,000
Plus: Actual Rent Paid	400,000	400,000
Adjusted EBITDA (fee simple cash flow)	\$1,393,771	\$1,324,835
Unadjusted Cash Flow	\$932,196	\$878,800
Plus: Discretionary Expenses	125,000	125,000
Plus: Actual Rent	400,000	400,000
Adjusted Cash Flow (fee simple)	\$1,457,196	\$1,403,800

* Figures are taken from the balance sheet and income statements found in Table 2-4 on page 52 and Table 2-5 on page 53 (2007 EBT= \$850,555 EBIT - \$17,251 interest expense).

** Fair Mkt Rent = RE Value (6,000,000) x Capitalization Rate (0.0800) = \$480,000. The value of \$6,000,000 includes two locations.

As can be seen from the table above, we need to adjust the cash flow for the fair market rent of the real estate. We used a capitalization rate to calculate market rent of our subject dealership. A full real estate valuation was completed

in “Asset Valuation For RV and Auto Dealerships (Real Estate)” on page 101. The dealership owns two locations. One of the locations was purchased 12 months prior from the lessor (seller) for \$2,560,000. The second was appraised for a concluded value of \$3,440,000 as shown on page 116. For this reason, the \$6,000,000 real estate value is a total of \$2,560,000 and \$3,440,000.

Using publicly traded information and comparing this to our sample company, whose balance sheet and income statements are in Table 2-4 on page 52, and in Table 2-5 on page 53, shown earlier, we can contrast differences between the subject company and the market comparables. The subject company is a new and used car dealership company with several locations. It must be noted that the comparables have not been adjusted for items such as differences in inventory practices, intangible assets or off balance sheet financing, depreciation or capital structure.

Publicly Traded Information

Table 4-4: Comparative Ratios as a Percentage of Assets & Income (Unadjusted) (\$000's)

	Subject	Company 1 (AutoNation)	Company 2 (Penske Automotive Group)	Company 3 (Lithia Motors)	Company 4 (CarMax)	Company 5 (Group 1 Automotive)	Company 6 (Sonic Automotive)	Median Comparable
<i>Balance Sheet</i>								
Total Assets (%)	100%	100%	100%	100%	100%	100%	100%	
Cash & Equivalents	24.2	0.6	0.3	1.7	1.0	1.9	0.4	0.5
Accounts Receivable	4.0	9.5	10.5	4.0	14.5	13.4	12.3	11.4
Inventory	58.0	27.4	34.0	39.7	44.3	39.3	37.7	38.5
Current Assets	90.0	39.3	51.2	49.4	61.0	55.7	51.6	51.4
Net Fixed Assets	1.3	60.7	48.8	26.4	34.6	10.9	7.1	30.5
Current Liabilities	58.1	35.2	39.2	39.9	27.2	44.5	45.8	39.6
Long Term Debt	0.8	18.1	26.1	18.8	1.8	20.3	19.2	19.0
Net Worth	41.2	43.1	29.0	31.2	66.2	32.8	28.9	32.0
Working Capital	31.9	4.1	11.9	10.5	41.9	11.3	5.8	10.9
Total Assets (\$000)	\$5,275.6	\$8,607,000	\$4,469,802	1,579,357	\$1,885,573	\$2,113,955	\$3,124,764	\$2,619,360
<i>Income Statement</i>								
Revenue (%)								
Working Capital	6.4	1.9	4.7	4.7	8.6	3.9	2.3	4.35
Debt-Free Working Capital	15.3	1.9	15.3	5.2	10.6	3.9	2.3	4.6
Pretax Income	3.5	2.9	1.8	2.1	4.3	2.3	2.1	2.2
Net Income	3.5	1.7	1.1	1.3	2.7	1.5	1.2	1.45
EBITDA	3.3	4.6	3.1	4.2	4.8	3.7	3.7	3.95
Revenue (\$000)	\$26,265	\$18,989,000	\$11,242,313	\$3,172,894	\$7,465,656	\$6,083,484	\$7,972,074	\$7,718,865

Source: www.sec.gov

Table 4-7 shows the breakdown of the various components of the company which make up the returns on equity (ROE), based upon a DuPont analysis. The reader will recall that this overview is critical for understanding which component drives the equity return. These ratios are more fully described earlier -See “DuPont Model” on page 60.