To most human beings “Blue Sky” is what we see on a clear and sunny day, but for dealers it is something quite different. Automotive News defined Blue Sky as the value of a dealership, including goodwill and other intangibles such as customer lists and marketing materials and is expressed as a multiple of adjusted pretax income. Others call it the amount asked by the seller of a business that is beyond the book value that isn’t economically justified. However it is defined, it has always been a hard thing to attach a price to and often was little more than what the market would bear.

But today’s market has changed dramatically in the past 15 years. Many new buyers such as private equity firms, “family offices” and ever expanding auto groups to name a few are competing in the market and with that have come changes in how dealerships and “Blue Sky” values are determined.

On November 19th, 2015 Steve Schumacher, CPA, ASA and Stuart McCallum of Crowe Horwath LLP joined us for an online workshop to share their thoughts about how sophisticated dealership valuation techniques are becoming the norm and how savvy sellers position themselves for maximum return. Between them they have valued more than 350 franchises for mergers & acquisitions, strategic consulting, estate planning and litigation support.

Crowe Horwath LLP (www.crowehorwath.com) is one of the largest public accounting, consulting, and technology firms in the United States. Under its core purpose of “Building Value with Values,” Crowe uses its deep industry expertise to provide audit services to public and private entities while also helping clients reach their goals with tax, advisory, risk and performance services.

This report is a summary of Steve and Stuart’s comments and suggestions.

…see their Contact Details on the last page.

In this workshop Steve and Stuart explore how the business of business valuation is changing and what savvy buyers and sellers are looking for.
Today’s take-aways are:

- How to employ forecasts in dealership valuation.
- Discover the new “market multiples.”
- Explore income statement and balance sheet adjustments.
- Consider the impact of “market level compensation.”

Historically fair market value was calculated by applying intangible “Blue Sky” multiples to net asset value to arrive at a total selling price.

However this has up approximately 15 years ago this changed dramatically as non-traditional buyers such as public dealerships and other “wall street” class investors have become interested in the dealership market. These entities use a range of valuation methods of which the four most common are:

- Projected earnings focused on cashflow.
- Public company and Private market multiples derived from earnings.
- Traditional Blue Sky plus net asset models.

**THE PROJECTED EARNINGS VALUATION METHODOLOGY**

It is common to employ an income based approach when assigning a value to a business and that starts by knowing what, on a normalized basis, its’ true cash flow generating capability is. This cash flow methodology “sanitizes” the income statement by removing transactions that are not specific to the operation but rather reflect how the owner chose to operate. Some common income adjustments are:

- Owner compensation - to differentiate how much is derived from actual work and how much is a revenue pass through.
- Management compensation - to normalize compensation plans against the market.
- Management/Owner perks - such as cars, sports tickets, vacations, etc.
- Building & out-lot rents that are paid to a dealer owned entity - to ensure that it represents a market level rent factor.
- Management fees & corporate overhead – determines if the costs are necessary to operate the dealership and if cost is in line with the market.
- Aircraft operating expenses and depreciation.
- Intercompany income and expenses.
- Nonrecurring expenses – litigation, business interruption, image compliance, etc.
- LIFO (Last In First Out) reserve – and other tax strategies. The goal is to convert dealership financials to a FIFO (First In First Out).
- Rebates/Overrides/Incentives – when not flowed through the business.
- Captive insurance companies and other related party entities.

The result is a cash flow that fairly represents the dealership from a pure operations standpoint. This normalized information is used to build a projected income statement that reflects the current value of future earnings.
The future pre-tax income for each year of the projected income statement is used to calculate each year's value in today's dollars.

- The Debt-free net income (1) for each year is adjusted to account for such items as depreciation, capital expenditures and addition or subtraction to the working capital investment to yield a Debt-free net cash flow (2).
- To reflect the present value of the projected future income a discount rate is applied, in this case 14% to yield a PV (present value) discount factor (3).
- The PV discount factor is applied to the Debt-free net cash flow to determine the PV of debt-free net cash flow (4).

The key factor in this calculation is the discount rate and it's too complex to discuss in detail in this workshop.

Since the projected income statement forecast only spans six years, how do we account for earnings beyond that discrete point? A common method for determining this is to use a “Terminal Value” calculation. The Terminal Value calculation can be based on the discount rate or a multiple. Multiples are commonly used by investment bankers and private equity groups because they are easy to explain. In this example the Sum
of Interim Cash Flows of $5,169,000 is added to the product from the final year earnings multiplied by an “Exit Multiple” to yield a dealership operating value of $10,776,000.

**Working Capital Analysis**

Minimum working capital requirements are typically determined by a manufacturer formula found on dealer financial statements, however dealer specific structures such as a significant wholesale parts business or other add-ons may dictate that more is required. In these cases other data sources for working capital should be considered such as:

- Comparable publicly traded companies.
- The dealership's historic average and/or median.
- Discussions with management.

In some cases excess working capital may be identified which is added into the operating value of the dealership. In this example $1,375,000 is added to the value.

**THE MARKET MULTIPLE VALUATION METHODOLOGY**

Multiples can be either for public or private dealerships or groups, and are heavily relied upon by sophisticated buyers such as investment bankers, private equity groups and family offices.

They are typically based on revenue or EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization).

Some sources for multiples are:

- **Public Multiples** such as AutoNation, Sonic, Asbury, etc. have the advantage of being readily available and are updated constantly. However because they are diversified their use may not be appropriate when comparing single point dealerships. Additionally they are subject to market “noise” and are easily affected by factors unrelated to cash flow such as quarterly guidance, analyst estimates, etc.

- **Private Multiples** can be specific to a brand, location and size, however they are not readily available since most transactions are not published. The best bet is to contact industry professionals like Crowe Horwath or Alan Haig with Haig Partners.
When applying multiples, be sure that:

อก The numbers being used have been adjusted.
อก They are correctly applied i.e EBITDA multiples to the EBITDA, etc. otherwise valuations could be over/understated.
อก The data is meaningful and current. For example the value of VW six months ago is not what it is today.
อก The multiples are consistant with the dealership structure such as whether real estate is included/excluded, etc.

This example illustrates how different multiples can yield different results.

**THE BLUE SKY PLUS NET ASSET VALUE METHODOLOGY**

Blue sky is calculated as such:

\[ \text{Net assets} + \text{Franchise value} = \text{Dealerhip value} \]

It is still the most popular way to compare values and is what dealers hear in their 20 groups and NADA.

The Net Asset Value (NAV) method relies on the balance sheet which has been adjusted to reflect fair market values for both assets and liabilities. Some common adjustments are:

อก Buildings and out-lots.
อก LIFO reserve which tends to understate value.
  • Tax liability related to the liquidation of a LIFO reserve.
อก Prepaid intercompany expenses.
อก Vacation homes.
อก Antiques, cars, airplanes, etc.
อก Insurance cash surrender value.
อก Off-statement assets and liabilities.

Net Asset Value is the market value of assets less liabilities. For example the NAV (stock holders’ equity) is $58,060,000.

Blue Sky multiples are a combination of qualitative and quantitative factors surrounding a particular dealership and include:

อก Brands offered.
อก Profitability.
อก Location.
อก Quality of the real estate included.
Franchise type plays a big roll and typically trades within a range as illustrated.

“Blue Sky” is a value derived from a trailing 12 months earning multiple and reflects the premium at which a dealership trades over its net asset value. In this example the Adjusted net asset value of $58,060,000 is added to the Blue Sky multiple of $175,000,000 for a total indicated value of equity of $233,100,000.

In closing there is no “right” method for valuing a dealership because of the fragmentation of the market and each dealership’s specific circumstances.

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