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A Road Map Back to Profitability: Rebuilding a Distressed Dealership

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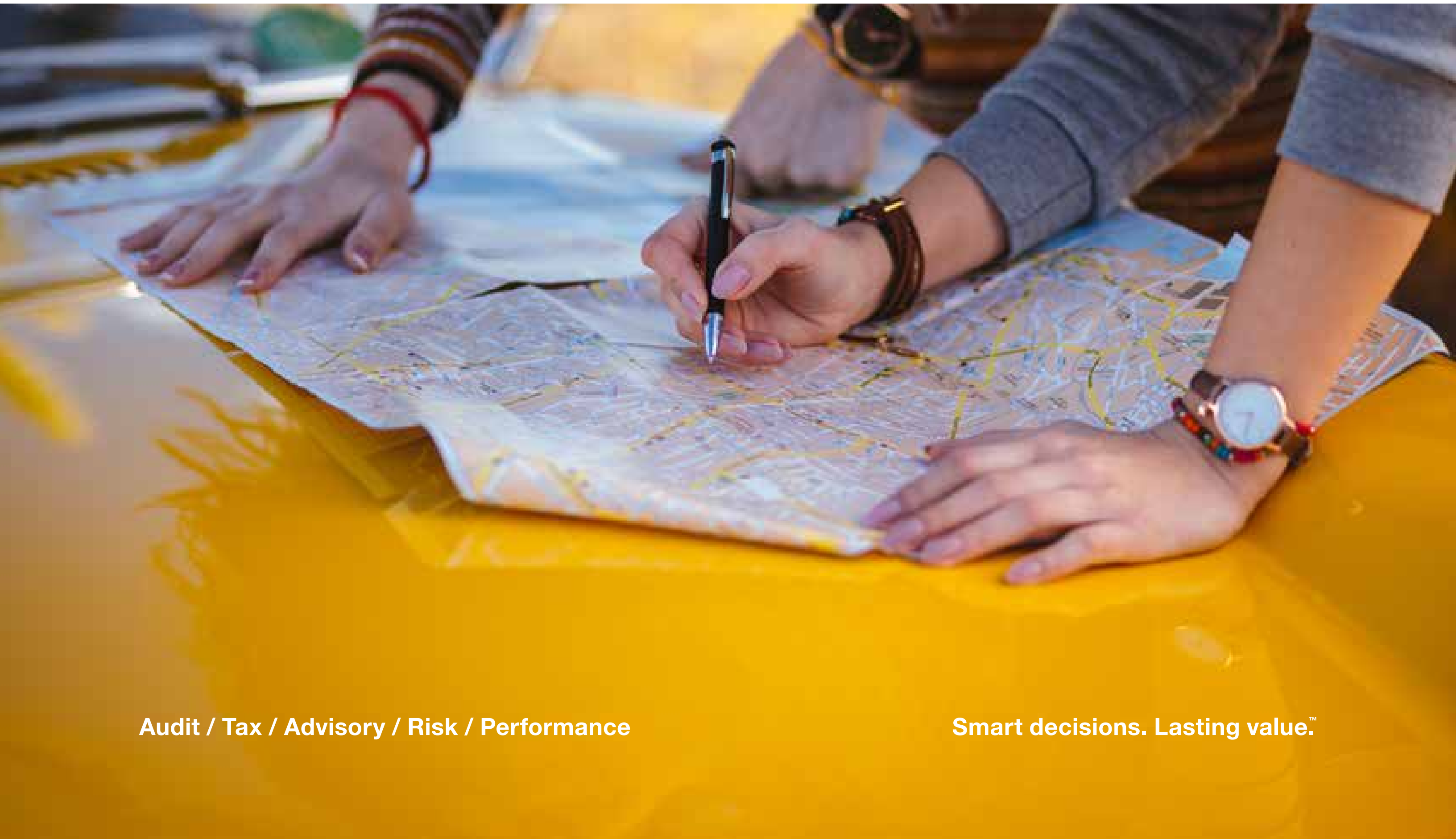

With the retail dealership industry in a period of stagnation, lenders must keep an eye out for signs of distress and plan ahead to help borrowers return to a position of stability.

After a long bull market starting in 2010, the auto industry is showing signs of decline. U.S. new vehicle sales in February 2018 fell 2.4 percent compared to February 2017 as manufacturers pulled back on incentives and interest rates began to creep higher.[1] Analysts expect annual sales this year to lag behind both 2017 and the record-breaking 2016 pace of 17.6 million vehicles sold.[2]

Such conditions are bound to lead many dealerships to experience varying degrees of distress, which should, in turn, cause their bankers to be concerned. Yet lenders – including those that provide financing for acquisition of a dealership, floor plan financing, or capital loans – are increasingly blindsided by dealerships that suddenly find themselves in hot financial water after appearing stable.

Current Conditions

Until recently, the auto industry has been booming, with dealer profits hitting all-time highs. But all good things must come to an end, and a seismic shift in how dealerships operate and make their profits has happened at the same time that the seasonally adjusted annual rate of sales has flattened.

Most dealerships these days are overly reliant on volume growth bonuses, also known as stair-step incentives, which manufacturers award when dealerships exceed certain sales goals. Under such programs, bonuses grow as unit sales grow. Dealerships often pursue the bonuses at the cost of taking losses on vehicle sales, thereby forfeiting immediate profits in hopes of making up for them at month-end. The dependence on bonuses is reflected by the fact that, as of September 2017, "other income," where factory money typically is classed, accounted for approximately 130 percent of net income at the median dealership.[3]

The manufacturers' bonus thresholds continue to go higher, though, making it more and more difficult for dealerships to achieve them. A dealership that has run its business with the expectation of bonuses can find itself facing significant financial distress if it misses its goals for a few consecutive months.

At the same time profits are down, expenses are climbing, partly due to poor control of expenses. It's common for dealerships that are seeing more than $1 million in annual profits to become somewhat lax in their controls because they are concentrating on dollars, not pennies. But pennies can begin to make a difference to the bottom line when dollars become scarce.

Dealing With Increased Leveraging

Dealerships generally are more leveraged today than they were during the previous economic downturn. While beginning to trend up, interest rates remain near historical lows, and plenty of credit is available. Whereas dealers in the not-so-distant past turned to floor plan financing only for new vehicles – with a typical target of no more than 70 to 90 percent of their inventory – the low rates have prompted them to expand such financing for used vehicles. After all, they reason, why have any equity in the inventory when debt is available and that equity could earn better returns invested elsewhere?

This approach might make sense from a dealership's perspective, but it is troubling for its lenders. Dealerships might now have zero equity in their inventory, where before they could usually at least turn to the "equity of last resort," the ability to sell used vehicles at auction to obtain cash.

Many bankers believe the recent fully leveraged nature of dealerships is not a concern because dealers have a large net worth. What these bankers overlook, though, is that dealers having money in the bank is not the same as dealerships having money in the bank. For this reason, bankers should request documentation to determine if the dealer's finances are linked to the dealership's (for example, by personal guarantees or other joint liability). When such links exist, banks must regularly track the dealer's checking and savings accounts to verify those personal funds are not diverted to make them unavailable for dealership debt.

Offsetting Risk of Outstanding Floor Plan Debt

According to various sources, the average dealership is running about a 1-1 ratio of floor plan financing to new inventory value, in part due to the lack of equity in new vehicles. In addition, a buyer's financing company can take up to two weeks to deliver the cash on a sale, meaning floor plan debt is not paid off immediately, further pushing up the amount of outstanding floor plan debt compared with actual vehicles on the lot.

Bankers can pre-emptively offset the risk this presents with escalated curtailments of 90 days. For example, a bank might notice that a car it financed for $30,000 is still unsold 90 days after the vehicle arrived on the lot. At that point, it can tell the dealership that it will continue to finance only $27,000 of the vehicle and the dealership must pay $3,000.

Until recently, bankers have tended to use curtailments conservatively, generally just as a way to stay on the dealership's radar. But in a time when a dealership can go under within a matter of months, bankers should employ curtailments more defensively. A bank that implements curtailments to reduce a floor plan ratio might cut its risk profile significantly. In cases where the ratio is high, banks should regularly revisit curtailments and check monthly factory statements for early warning signs of trouble (for example, discrepancies between the bank's records and the dealership's actual inventory).

Bankers also might consider offering floor plan financing to dealerships that do not have it for their used vehicles. Extending such credit immediately for a few used cars would give the dealership greater flexibility during financial crunches, as they can floor plan additional used vehicles to free up equity to fund operations. The line of credit presumably would be fully collateralized, so the bank could claim the used inventory if necessary to recoup the debt. In the long run, banks usually find it cheaper to offer the line of credit and help the dealership stay afloat.

It is advisable, as well, to institute daily floor plan audits and cash reconciliations to verify the amount of collateral at the store. The odds of sales out of trust – where a dealer sells a floor plan-financed vehicle but fails to repay the associated advance within the contract deadline – are substantially higher when profits are tight. Banks need to confirm that no cash or cars are leaving the lot without being accounted for.

Preserving Blue Sky Values

The intangible value of a dealership, expressed as a multiple of its adjusted pretax profit, is known as its blue sky value. During softening economic conditions, these values start to trend down in correlation with declines in cash flow, potentially triggering covenants on "air ball" loans that hinge in part on a borrower's business value or cash flow.

During times of dropping sales, expense management is crucial to survival. Bankers should develop a crisis management plan for these circumstances before they arrive to reduce the likelihood of losing money on their dealership loans. In addition to requiring daily cash reconciliations and floor plan audits, banks should have specialists on the ground at dealerships to review management decisions and expenses.

They also should see that the dealership executes the following crisis management steps:

1. **Develop a detailed 13-week cash forecast.** Once a bank realizes its borrower dealership needs help and corrective action is required, it must work with the dealership to determine the dealership's sources and uses of cash. How much cash is necessary to pay employees and creditors and satisfy the dealership's other operating expenses for the next one to three months? How can the dealership maximize its cash inflows and minimize its cash outflows? If the analysis shows that the dealership will not be able to at least break even, it might as well liquidate immediately to avoid incurring additional expenses merely to stay on life support.
2. **Perform an operational analysis of staff.** This step goes hand in hand with the first step. It requires an analysis of the dealership's head count to look at the existing employees and what is needed. For example, does the dealership fully utilize its service department employees, or can the staff be trimmed by boosting utilization?
3. **Minimize discretionary expenses.** Bankers might be surprised by how much a dealership can spend on discretionary expenses. Some dealers, for instance, are very liberal when it comes to company cars; company vehicle expenses can reach into the six figures if not controlled. Or, a dealership might provide free lunches to staff members who work on weekends. This seemingly inexpensive generosity can add up.
4. **Control owner compensation and distributions.** Bankers must take measures to see that dealership money does not disappear – especially if the dealer has a good chunk of cash sitting in the business. They should closely monitor the compensation and distributions account, take possession of dealership checkbooks, and obtain access to financial and accounting software.

5. **Analyze working capital and the accounts receivable and accounts payable processes.** This step includes determining the parties that must be paid and in what priority. For example, a dealership probably cannot stay in business if it does not pay its utility bills on a timely basis, but it might be able to extend other payables. Ideally, the dealership should pay those bills necessary to keep the doors open but not until the due date. The idea is for the dealership to improve its cash flow by collecting accounts receivable faster than it pays accounts payable.
6. **Monitor vehicle aging.** Careful scrutiny of aging is paramount. If used vehicles are on the lot longer than 60 or 90 days, it generally is best to consider sending them to auction. It's better to take a smaller loss sooner than a big loss later.
7. **Monitor parts aging and shrinkage.** Is the dealership getting rid of parts on a timely basis and voluntarily, as opposed to through theft? If the parts aging report shows parts older than 180 or 360 days, there could be a problem – at that point, parts generally are either worthless or missing. Pad-to-general ledger reconciliations will uncover any meaningful differences that indicate a breakdown in controls and the need for a physical inventory or statistical sampling.
8. **Investigate unusual control numbers.** Control numbers or text descriptions that are out of the ordinary require further investigation to determine the inflows and outflows to these accounts. They might be a sign of fraud or under-the-table transactions.

The purpose of these actions is not to establish a long-term plan but rather to stabilize the situation while a long-term solution is formulated. If the reason for the dealership's distress is not readily apparent, a fraud investigation could be warranted.

In situations of extreme distress, it will be hard for the dealer to secure new floor plan financing, meaning that the only real option for the bank to recover its investments is an eventual sale of the store. Stable operations will produce better blue sky values in the market. Often, stable but underperforming stores receive above-average blue sky multiples on the auction block because buyers see the upside potential. Without the stability, the buyer will not see a clear path to success. The buyer's view also will be obscured by a lack of documentation of the reasons behind the distress. The bank should develop documentation that honestly explains the situation.

Don't Delay

The risk of loss on dealership loans is real, and it is never too early to engage in the necessary discussions with borrowers. When a crisis presents itself, the time for coming up with a plan has already come and gone. The best time to establish a proper recovery plan is before it is needed.

Learn More

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[2] Nathan Bomey, "Plummeting Interest in Passenger Cars Drags Down U.S. Auto Sales," USA Today, March 1, 2018, https://www.usatoday.com/story/money/cars/2018/03/01/february-2018-u-s-auto-sales/384210002/

[3] Crowe Portfolio Analyzer™ solution peer data as of September 2017.

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