JULY/AUGUST 2016

Dealer Insights

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Could auto industry trends affect your dealership?

Sometimes, you can get so busy in the day-to-day job of running your dealership that you neglect to take a step back and look at the big picture. Researching macro trends impacting the automotive industry is a valuable strategic planning exercise.

By pinpointing and understanding these trends, you may be able to uncover new opportunities and avoid potential problems. And this could lead to increased sales and profits down the road.

Safety is in focus

A prevalent trend over the past couple of years has been a sharper focus on vehicle safety features. Lane-keeping assist technology, forward-collision warning systems and backup cameras are a few examples of recent safety features that are becoming more common in vehicles.

This trend is being driven by both consumers and regulatory authorities. Families buying cars for teenagers are especially interested in such features, because fatal crash rates are three times higher among 16- to 19-year-old drivers than among other drivers, according to the National Highway Traffic Safety Administration (NHTSA). On the regulatory side, backup cameras will be required in all new vehicles starting in May 2018.

Adding these kinds of safety features will, of course, kick up the total vehicle price. For example, adding a backup camera will cost between $40 and $140 per vehicle, according to NHTSA estimates. With rising costs squeezing already tight margins on new vehicles, you may need to rely even more on your parts and service department to drive future profits.

CAFE standards are rising

Regulators enforce Corporate Average Fuel Economy (CAFE) standards that require vehicles to meet specific targets for fuel efficiency. The NHTSA has set standards to boost CAFE levels rapidly in the coming years.

Specifically, the final passenger car and light truck CAFE standards for vehicle model years 2017–2021 will require an average combined fleetwide fuel economy of 40.3 to 41 miles per gallon by model year 2021. Like required safety features, mandated higher fuel efficiency standards also increase vehicle costs and could crimp your profit margins going forward.

Gas prices remain low

The plunge in gas prices that began in the summer of 2014 is changing the kinds of vehicles that Americans purchase. For example, sales of pickup trucks and SUVs rose 10% last year, according to sales tracker Autodata, which was almost twice the increase in overall vehicle sales.

Meanwhile, sales of some fuel-efficient vehicles fell by double digits. This includes the Toyota Prius hybrid, which saw sales fall by 12% last year, and the Chevrolet Volt plug-in electric car, which saw sales fall by 23% last year.

One positive development for dealerships of this trend is that some consumers are putting part of the money they're saving at the pump toward the purchase of a more expensive new vehicle. This could increase your dealership's revenue and profits if the trend continues.

While oil and gas prices can be volatile, most analysts don't expect them to rise sharply in the near future. Therefore, you might want to take these sales trends into consideration as you plan strategies for what kinds of vehicles to stock going forward.

Customers are more informed

Thanks to the plethora of information available online and via mobile devices, many customers walking into dealerships today are more informed about vehicle choices, features and prices than they were a few years ago. What's more, this is likely to continue, with car buyers becoming even more knowledgeable in the future.

This trend affects dealerships in many ways. For example, it can be harder to maintain profit levels when customers know the dealer cost of a vehicle, giving them an edge in negotiations. Also, many customers today say they prefer a faster and more hassle-free car-buying experience. Consider these factors in your future vehicle pricing and salesperson training procedures.

Capitalize on trends

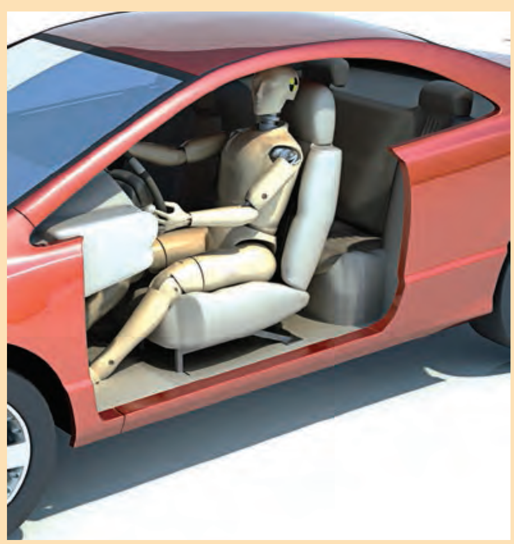
Now would be a good time to think about how these macro trends could impact your dealership in the future. As you do, make plans for how you can capitalize on them going forward.

New vehicle safety technology unveiled

The National Highway Traffic Safety Administration (NHTSA) issues Federal Motor Vehicle Safety Standards and Regulations to which vehicle manufacturers must conform. In its *Priority Plan for Vehicle Safety and Fuel Economy, 2015 to 2017*, the NHTSA describes some of the broader changes taking place in vehicle technology that are designed to increase safety.

Among these changes are in-vehicle crash avoidance systems and vehicle-to-vehicle (V2V) communications that employ crash-avoidance applications. According to the plan, the NHTSA intends to require V2V capabilities in new vehicles at some time in the future.

Other NHTSA vehicle safety priorities are the Driver Alcohol Detection System for Safety, which prevents vehicles from being driven by drunk drivers, and seatbelt interlock technology. This technology would prevent a vehicle from being driven if the driver and passengers aren't safely buckled in.



Using an earnout provision to advance a store purchase

Buying or selling a dealership can be stressful — it may be the largest financial transaction you'll ever make. And when you have an interested buyer (or seller), but are nowhere near settling on the purchase price, the situation can become disappointing. Before tossing in the proverbial chips, you might want to consider an earnout provision. It may spur you on to closing the deal.

Come up with an alternative

An earnout provision is contractual language that commits the buyer to make additional payments to the seller if the business achieves agreed-upon financial targets after the sale. Sometimes earnouts are called "payouts" or "contingent payments."

Earnout arrangements can be the answer when the seller and the buyer disagree on the purchase price, and the seller believes that the business will do well. An earnout also can be useful when the buyer can't come up with the full purchase price, and the deal will collapse without seller participation.

Accept a lower payment up front

In an earnout agreement, the seller typically accepts a payment lower than the asking price and maintains an interest in the business. As mentioned, if the agreed-upon financial targets are met during a specified period, the seller will receive additional remuneration. Some earnout provisions give the seller the right to claim company assets if the buyer fails to meet the payment schedule.

Say an auto dealer is firm with a $2.5 million asking price for his business based on projected earnings. But the buyer is only able to pay or finance $2 million. The two parties could agree on an earnout provision whereby the seller will be paid $1.75 million at closing and receive payments totaling $250,000 over the next three years. These payments would hinge on the dealership achieving, for instance, $20 million in gross annual sales for each of those years.

Develop financial milestones

A crucial part of an earnout provision is developing the financial targets or milestones. As noted, these will entitle the seller to be paid the balance of the purchase price. Set targets carefully, making sure that the new owner will likely achieve them.

The targets might involve gross sales, as in the example above, or some other metric, such as the number of new and used retail units sold or gross profit percentages by department. A different metric: A buyer might agree to pay the seller, for instance, 20% of annual earnings that exceed the previous year's earnings by a certain amount. Your CPA can help develop or assess ideal targets in an earnout arrangement.

Understand the dangers

During the life of the agreement, various factors might affect the buyer's ability to meet financial targets. Thus, the length of time in which post-closing payments will be made can be a risk factor. Three years is generally the longest term covered by an earnout provision.

Other examples of risk: The new owner might decide to take on the costs of an expensive renovation project or relocate the dealership. If the buyer decides to write off a portion of the renovation project's expenses or the move, the resulting change could lower earnings, causing the seller to lose out on one or more earnout payments.

To guard against this scenario, both parties need to identify any contingencies — the "what ifs" — that could affect the buyer's ability to meet the financial targets. Moreover, they must build in some protective measures so that the seller is adequately paid. Such measures could include restrictions on owner salary and compensation or on rent increases, or ceilings on the amount of capital expenditures allowed per year.

A keen understanding of every risk facing the dealership is essential to crafting the right targets and identifying the contingencies to attach to each.

Tread carefully

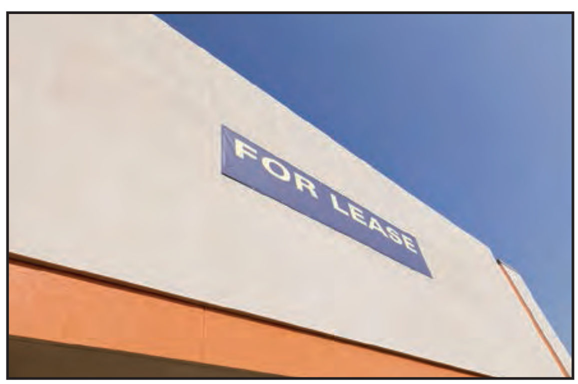
If you're considering an earnout provision in the sale of your dealership (or the purchase of another store), consult your attorney and your CPA. Many legal and financial issues need to be ironed out before entering such an agreement.

New lease accounting standards arrive

How this long-awaited guidance might affect your dealership

In 2006, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) launched a joint project designed to change the way leases are accounted for under U.S. Generally Accepted Accounting Principles (GAAP).

A decade later, the FASB has finally issued new guidance for lease accounting. Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*, will require dealerships that lease real estate, vehicles, equipment and other assets for more than one year to report lease obligations as fixed-asset liabilities on their balance sheets. Most lease obligations today aren't listed on the balance sheet — in fact, financial transactions are often structured to achieve off-balance-sheet treatment, because this improves ratios and



strengthens the bottom line, making it easier to obtain financing.

The effective date for the new standard for non-public entities doesn't kick in for a few years, but early adoption is permitted.

Lease classifications

From an accounting standpoint, leases are classified as either capital leases or operating leases. Historically, dealerships have only been required to recognize capital leases on their balance sheets. Operating leases, including long-term leases of your dealership's real estate, could be listed as a footnote in the financial statements detailing the terms of the lease agreement, and payments were recorded as rent expense.

The new lease accounting standard will change the accounting treatment of leases that are longer than one year in duration. Your dealership must recognize on the balance sheet assets and liabilities for all such leases, regardless of whether they're classified as capital or operating leases. Under the new standard, you'll report a right-to-use asset and corresponding liability for the obligation to make lease payments, discounted to their present value.

The new standard will classify leases as either finance leases or operating leases. The differentiating criteria will be similar to the criteria used to distinguish between capital and operating leases. Finance leases will be similar to capital leases under U.S. GAAP — in fact, most current capital leases will be considered finance leases under the new standard. The recognition, measurement and presentation of expenses and cash flows arising from a lease will continue to depend mainly on the capital (or finance) vs. operating lease distinction.

For *capital* leases, your dealership will amortize the right-to-use assets separately from interest on the lease liability on the statement of comprehensive income. You'll classify repayments of the principal portion of the lease liability within financing activities, and you'll classify interest payments on the lease liability and variable lease payments within operating activities in the statement of cash flows.

For *operating* leases, you'll recognize a single total lease cost that is calculated so that the cost is allocated over the lease term on a generally straight-line basis. All cash payments, meanwhile, will be classified within operating activities in the statement of cash flows.

Impact on dealerships

There are several ways the new lease accounting standard could impact your dealership:

- The addition of more debt and leverage to your balance sheet could affect key financial ratios, so you should communicate with lenders, investors and other stakeholders in advance to let them know about these upcoming changes.
- Similarly, changes in financial ratios could impact debt covenants with current lenders, or make it more difficult or expensive to qualify for financing in the future — something you'll want to discuss with your lenders ahead of time so they'll be prepared.
- You may incur additional costs to train employees in the proper application of the new standard.

Finally, the new lease accounting standard could significantly impact your future lease vs. buy decisions. The ability to structure off-balance-sheet financing under U.S. GAAP is one of the main benefits of leasing. With this benefit curtailed, buying certain assets might become more attractive.

Effective dates and deadlines

Privately owned dealerships must adopt the new lease accounting standard for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years starting after December 15, 2020. If your dealership is public, the standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

For more guidance on how the new lease accounting standards could affect your dealership, contact your CPA.

Save dollars by switching to LED lighting

Utilities represent a large variable expense for most dealerships. To lower these costs, a growing number of stores are switching to light-emitting diode (LED) lighting, both inside the dealership and in the parking lot. A change to energy-saving LED lighting also may save your business tax dollars with a deduction that's scheduled to expire this year.

What are the benefits?

LED lights offer many potential advantages when compared to standard lighting. For example, they:

- Reduce energy costs significantly — by at least 75%, according to the U.S. Energy Department,
- Have a much longer life than standard lights, requiring little maintenance for the first 10 years,
- Provide more natural-looking lighting, enabling you to better showcase car colors, and
- Can be focused more narrowly, making it easier to spotlight specific vehicles.

LED lighting also offers a security advantage: They can be synchronized with motion sensors and turned on or off immediately in your parking lot.

Additionally, LED lighting can yield tax benefits. Through the end of this year, Section 179D offers a deduction of up to $1.80 per square foot for the installation of high-efficiency indoor lighting that reduces total energy and power costs by 50% or more.

Does it make financial sense?

The best way to determine if switching to LED lighting makes financial sense for you is to perform a cost-benefit analysis. Say that the total one-time cost of switching to LED lights for a midsize dealership is $65,000. This includes $58,000 in light fixtures and controls and $7,000 in installation costs.

Then assume that the lights will save the dealership $18,000 annually in energy costs and $2,000 annually in maintenance costs. In this scenario, the dealership would recoup its initial investment in a little over three years via the annual savings in energy and maintenance costs. The investment will pay off sooner when you factor in the tax break.

Talk to an expert

Consult with your CPA for more details on the potential tax benefits of switching to LED lighting at your dealership.