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DEALER INSIGHTS

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Dealer Digest

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ACCOUNTANTS & ADVISORS

Is a subprime auto loan bubble ready to burst?

Automobile lending in the U.S. is booming, recently reaching the highest level since well before the Great Recession. According to the Federal Reserve Bank of New York's August 2014 *Household Debt and Credit Report*, auto loan originations recently reached the highest level in eight years, while auto loan balances increased for the thirteenth straight quarter.

This is generally good news for dealerships, as more auto loans translates into more automobile sales. But digging deeper into the numbers reveals one potentially disturbing trend: a sharp rise in the number of *subprime* auto loans being made — especially among auto finance companies.

Subprime borrowers active

About one-quarter of all auto loans are now made to subprime borrowers, which are generally defined as borrowers with credit scores below 620. Since bottoming out in late 2009, auto loan originations and balances have rebounded among all borrowers, but this growth has been most pronounced among borrowers with the lowest credit scores.

For example, the dollar value of auto loans to borrowers with credit scores lower than 620 has nearly doubled since 2010, while the value of auto loans to borrowers with credit scores above 720 has increased by only about one-third. The total volume of subprime auto loans in the U.S. exceeds $145 billion, according to credit rating firm Experian.

Some economists believe that this surge in subprime auto lending is eerily similar to the boom in subprime mortgages that preceded the financial crisis. For one thing, many large banks and private equity firms are investing billions of dollars in subprime auto lenders. Also, like mortgage loans, some subprime auto loans are being bundled together to be packaged as complex securities and sold to investors.

So is the subprime auto loan market a bubble that is ready to burst? The U.S. Justice Department is concerned enough that it launched an investigation into subprime auto lending last August. It's in the process of investigating the subprime lending practices of General Motors Financial to determine whether any of these practices are unethical or illegal. And some banking analysts and credit rating agencies are warning investors about the potential for severe losses if subprime borrowers fall behind or stop making their loan payments.

For example, a Standard & Poor's report issued last summer warned investors they should be prepared to withstand "higher losses" on packaged subprime loan securities. And the Office of the Comptroller of the Currency noted in a report issued

How to avoid subprime lending problems

It's important to make sure your dealership doesn't cross over the line that separates legitimate subprime lending from predatory lending practices. Here are a few tips to consider:

- ❏ Verify that all the income and employment information on borrowers' credit applications is accurate and complete.
- ❏ Be upfront and clear with customers about the loan's interest rate and any additional fees so they can see the total cost of buying the automobile.
- ❏ Don't use hardball sales tactics on subprime loan customers when discussing financing, such as unnecessarily making them wait for hours for a financing decision.

last June that signs of easing terms and increasing risk in auto loans are "noteworthy."

Fears may be overblown

However, other economists and experts believe that fears of a bursting subprime auto loan bubble are greatly overblown. They point out that the total subprime auto loan market is a fraction of the size of the total mortgage loan market. So the ripple effects of a burst subprime auto loan bubble (assuming a bubble exists) on the overall economy would be much less significant than those of the burst mortgage loan bubble.

While subprime lending and predatory lending are often closely associated with each other, they *aren't* the same thing.

An Equifax report, *Not Yesterday's Subprime Auto Loan*, describes the importance of a fair and functioning second-chance market for those with low credit scores who need financing to buy an automobile. Without subprime auto loans, the report states, many people would be unable to obtain a vehicle and, thus, unable to obtain and maintain employment.

The report also notes that, while subprime lending and predatory lending are often closely associated with each other, they *aren't* the same thing. Predatory lending encompasses practices designed to take advantage of consumers. These practices are often unethical and even illegal, such as falsifying income and employment information on borrowers' loan applications.

Conversely, legitimate subprime auto lending provides credit that enables consumers with low credit scores to buy used vehicles. Some lenders point out that, while subprime loans feature higher interest rates, this is necessary to compensate for the increased risk of making the loan.

Loan performance appears adequate

Finally, the Equifax report notes that there's been no evidence yet suggesting higher delinquency rates or increased charge-offs in the subprime auto loan sector. "The results thus far do not indicate that recently originated subprime auto loans are exhibiting decreased performance," stated the report.

Only time will tell whether there's indeed a subprime auto loan bubble. Given the current environment, though, dealerships would be wise to exercise prudence when it comes to financing customers with lower credit scores. ■

6 steps for choosing the right DMS system

Your dealership management software (DMS) system is critical to successfully running your business. It's the engine that helps you efficiently manage inventory, accounting, customer relationship management, sales, financing and back office functions. Thus, it's vital to choose the right one.

Wide-ranging DMS options

There are many DMS solutions from which to choose. These range from expensive high-end systems with dynamic and complex functionality to less robust and less costly ones that are adequate for many smaller dealerships. Here are six steps to help you choose the right product:

1. Create a cross-functional team to evaluate and choose your system. This team should include you (and your fellow owners, if any), general manager, department managers, and controller or CFO. Getting input from these staff members and others will help you make a more informed decision while also helping ensure buy-in to your decision across different departments.

2. Decide what kind of functionality your dealership requires. Which DMS functions are most important to *your* dealership? There's no sense buying an expensive DMS system with fancy functions your business will rarely, if ever, use.

Work with your team to draft a requirements document that details the specific functionality each department in your dealership requires. One practical use would be the ability to download data from the system for analysis. And make sure to choose a DMS solution that includes the functions that will increase efficiency across your dealership.

3. Determine what complementary services your dealership needs. Most DMS vendors offer a wide range of complementary services in addition to their core software — such as consulting, data analytics, office forms and supplies, and advanced training. Ask potential vendors about their complementary services and discuss with your team which ones might add value to your dealership by helping you operate more efficiently.

4. Ask vendors about the DMS implementation process and the levels of training and support they provide. Choosing the right DMS solution is just the first step — you also need to make sure your system is implemented properly. Ask potential vendors detailed questions about how implementation will work at your dealership, including a projected timeline with key dates and operational responsibilities.

Adequate training and support also are critical to a successful DMS implementation. Be sure to ask vendors what kinds of training and support programs they offer. For example, do they offer on-site training for your employees, or is training done via computer? And is technical support offered in person or via the phone, Internet or e-mail?

5. Look at the total cost of DMS implementation, not only the software sticker price. There's much more to a DMS system than just software. Full implementation also typically includes hardware, maintenance, database configuration, training, and software and hardware support. Ask vendors for a total implementation price, and then make your decision based on the package that delivers the most value for your dealership.

6. Get opinions from other dealers who're currently using the DMS system you're considering. What issues are they having with the system, and what do they like — and dislike — most about it? Did their conversion to the new DMS system go smoothly? What were some of the bumps in the road they experienced?

No "one-size-fits-all" approach

Every dealership is different, so there's no one-size-fits-all approach to choosing a DMS system. By following these steps, you'll boost your chances of selecting the right solution for your dealership — one that delivers the functionality and services you need, without all of the bells and whistles that you don't need and shouldn't pay for. ■

Accounting considerations

Getting your arms around goodwill

Goodwill — also known as "blue sky" — is an intangible asset, a commodity that isn't easily quantified. Goodwill typically appears on a balance sheet following a merger or acquisition when one company acquires another company for a price higher than the fair value of its assets. With so many dealers consolidating their businesses over the last year, now is a good time to revisit the nature and accounting treatment of goodwill.

What is "goodwill"?

Think of goodwill as the "it factor" that differentiates you from other dealers. It comes from years of cultivating relationships with repeat buyers and a reputation for offering fair prices and reliable, friendly customer service. You can't touch goodwill, but it's potentially valuable.

Accountants have a more formal definition, of course. The Financial Accounting Standards Board (FASB) defines goodwill as "an asset representing the future economic benefits arising from other assets acquired in a business combination […] that are not individually identified and separately recognized."

How do you account for it?

Generally Accepted Accounting Principles (GAAP) require buyers of a business to allocate the purchase price of assets acquired and liabilities assumed based on their fair values. It's straightforward for most working capital and debt accounts. You simply transfer book value from the seller's balance sheet to the buyer's balance sheet. But other assets — such as used vehicle inventory, customer lists and franchise agreements — may require outside appraisals.

Any purchase price that's not assigned to identifiable assets and liabilities is booked as goodwill. GAAP requires goodwill to be tested for impairment after the deal closes at least annually (or more frequently if certain conditions exist).

Goodwill impairment happens when the fair value of the company or reporting unit falls below its book value. If goodwill is determined to be impaired, its book value is reduced on the balance sheet and an impairment loss is reported on the income statement. This could, theoretically, send up a red flag with investors and lenders.

What about privately held dealerships?

FASB's Accounting Standards Update (ASU) No. 2014-02, *Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill*, offers privately held companies an alternative goodwill measurement method. That's because — after soliciting feedback from private company lenders, owners and accountants — FASB learned that many stakeholders disregard goodwill and impairment losses when assessing operating performance.

Private dealers now have the option to amortize existing and newly acquired goodwill on a straight-line basis over a 10-year period (or less, if you can justify a shorter useful life). By electing to use the alternative method, you'll lower the carrying value of the goodwill, which makes taking an impairment loss less likely. Also, you'll no longer be required to perform impairment testing annually.

When might impairment take place?

Goodwill impairment is more likely to happen under certain conditions. So FASB does require private dealerships to test for impairment when "triggering events" take place. Examples of triggering events include:

- Unanticipated competition,
- The loss of a key person, and
- The issuance of a new regulation that has a significant adverse effect on auto dealerships.

Goodwill impairment equals the excess of the carrying amount of the entity over its fair value. This measurement standard is simpler than GAAP for nonprivate entities, because private businesses aren't required to hypothetically reallocate fair value to all of the entity's identifiable assets and liabilities.

In addition, private companies can measure impairment at the entity level. So, if you have multiple franchises that are doing well overall but an acquired franchise is underperforming, the modified rules give you extra time to turn things around before reporting an impairment loss.

Who can help?

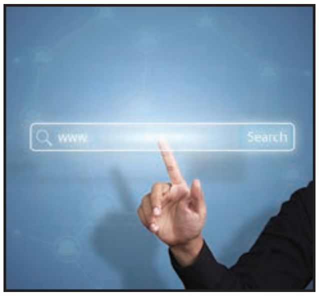
Dealerships today are able to spend less time and money on goodwill testing than in past years, because of the 2014 accounting changes mentioned above. If you have questions about goodwill and goodwill impairment, contact your CPA — he or she can help you better understand these complex factors as you prepare to buy or sell a dealership. ■

DEALER DIGEST

Use SEO to get e-head

Savvy dealerships have begun using search engine optimization (SEO) to boost their search engine rankings, generate more online leads and increase sales. Here are four tips for optimizing your dealership's website:

1. **Concentrate on your local presence.** Register your dealership with the major search engines' local services, such as Yahoo Local and Google Places. Also claim your listing on area-focused websites like Citysearch and Yelp.
2. **Update your site regularly with keyword-rich, high-quality content.** Do some research to determine the best keywords and keyword phrases for your dealership. Then consistently post quality content such as blogs, research articles and vehicle reviews.



3. **Optimize all your website assets.** All the images, videos, inventory and other assets on your website should be "crawlable" for the major search engines.
4. **Actively participate in social media.** Building social networks on Facebook and Twitter is key to raising SEO. Take the time to interact regularly with these online communities by sharing valuable content with your followers. ■

Is CFPB methodology flawed?

Two years ago, the Consumer Financial Protection Bureau (CFPB) began regulating the automobile finance industry. At that time, it stated that finance companies offering auto loans through dealerships would be held responsible for interest rate markups based on a borrower's race or ethnicity.

Since auto finance companies can't collect race and ethnicity data from borrowers, the CFPB relies on a proxy method to determine finance companies' compliance with fair lending laws. Recently, the American Financial Services Association (AFSA) conducted a study of this proxy method and concluded that it contains significant bias and high error rates.

Based on its study results, AFSA has called on the CFPB to create a new tool for examining disparities in dealership interest rate markups. "The use of race and ethnicity proxies creates significant measurement errors, overestimates the population counts and results in overstated disparities," AFSA stated. ■

Dealership M&A activity remains strong

Warren Buffett made a big splash among auto dealerships recently when his Berkshire Hathaway Investment company announced plans to buy the Van Tuyl Group, the nation's fifth-largest dealership group, for an estimated $4 billion. Buffet said he anticipates that Van Tuyl will receive offers from the owners of "hundreds of dealerships" this year who are interested in selling.

This would continue the recent trend of strong dealership M&A activity. According to data compiled by The Presidio Group, an advisor to buyers and sellers of auto dealerships, 74 public and 243 private dealership franchises were bought or sold in 2014, up about 60% from 2013. ■