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AUTO NOTES

SALES OF DEALERSHIPS: 2012

By Stephen A. Moore

Good News and Bad News

The good news is that there are now buyers for vehicle dealerships. Transactions have, after a prolonged period of limited activity, increased significantly over the last year. Buyers have come back into the market, and there are dealers who want to sell. The bad news is that deals have become more difficult to negotiate. Buyers are being more cautious. Recent past history has tempered dealers' risk tolerance.

What Happened To The Buy-Sell Market In 2008?

As dealers are painfully aware, the retail automotive market declined precipitously during 2008 and 2009, and the malaise continued through 2010. The combination of an economic downturn, bankruptcies by Chrysler and General Motors, and the lack of retail automotive financing were all factors. Employee lay-offs were common, and some dealerships were forced to close. To survive, dealers focused on cutting expenses and trying to keep or find floor plan lenders. Dealerships for sale were generally in financial distress. This resulted in fewer sales of dealerships. Sales that did occur were difficult and complicated transactions. Many sales were completed with the approval of the Bankruptcy Court. Not unexpectedly, sale prices were depressed.

Improved Economic Outlook

What a difference a year can make! Today, dealers who are in the business are looking to grow and expand, whether they are single-point dealers or large dealer groups. The pressure is on to assemble a diverse portfolio of brands, as well as to achieve greater economies of scale. As the financial outlook has improved, both retail customer financing and transaction financing have become more readily available. Most importantly, dealers have a renewed sense of optimism.

Not surprisingly, the sale prices of dealerships have increased over the last two years. Traditional domestics (GM and Chrysler) once again command a goodwill factor. Honda, Nissan and Toyota are back on track from last year's earthquake in Japan. The recent events in Japan have further reinforced the view that a diverse collection of brands is important, so that no particular event can cut off a dealer's supply of new vehicles and parts. Further, just as many people put off purchasing new vehicles during the recession, many dealers held off selling. Pricing was down, buyers were few, and financing was difficult. As a result, dealerships were selling for far less. As noted, there are now a significant number of dealers looking to exit the business. This provides a pool of available dealerships for sale.

Current Challenges

Notwithstanding the much improved climate for buy-sells, the events of the last several years have caused new obstacles to dealership sales. Two obstacles in particular, real estate values and blue sky pricing, have had a large impact on negotiations.

In most instances, real estate is worth significantly less today than it was at the beginning of 2008. Much dealership real estate was either acquired or substantially renovated in the five-year period prior to 2008. In many cases, real estate was highly leveraged (80% to 90% loan-to-value ratios were not uncommon to fund purchases and/or upgrades). Due to the recent decline in real estate values, dealership real estate often is worth less than what is owed to a lender. To further compound matters, loan-to-value ratios have generally been reduced to the 65% to 70% range, further complicating a buyer's ability to finance a transaction, and increasing the cash required to close a deal. Finally, in many instances, image programs and renovations have been deferred. Manufacturers are now insisting that incoming dealers agree to facility upgrades as part of the approval process.

These factors have made selling dealership real estate much more difficult. There has been an increase in the number of transactions where the dealer is retaining the real estate and leasing it to the buyer. In fact, some buyers have indicated that they prefer to lease real estate rather than to buy it, even at fair market value. The events of the last several years have weakened the belief that real estate will always appreciate. These events have also impressed on dealers and lenders that new car dealerships occupy special-use real estate whose value is largely dependent on having a franchise in operation.

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The other challenge to negotiating a transaction is agreeing on the pricing of blue sky/goodwill. Some sellers are still looking for pre-2008 values. They see the market improving and want a piece of what they view as future appreciation. Buyers are more risk-adverse. They are looking for pricing based on current performance and not paying a premium for potential future performance. They have seen the events of the last three years (bankruptcies, tsunami, earthquake, etc.). The "irrational exuberance" that characterized some dealership pricing up to 2008 has largely disappeared.

These two issues have increased the time required to negotiate a buy-sell. Sellers, in some instances, are negotiating with three or four buyers before they can secure a deal. Additionally, buyers are much more adverse to taking risks on other aspects of the buy-sell, including the environmental condition of real estate, successor liability, and other matters. As a result, buyers are often seeking post-closing escrows.

The lesson here is that, yes, there are more buy-sells taking place than three years ago, but it has become more difficult to negotiate and close the transaction for both sides.

Conclusion

Will the number of dealerships sales continue to increase? Yes. Will the increase in dealership values continue? Probably. Are transactions more difficult to negotiate and close? Definitely.

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FEDERAL ESTATE AND GIFT TAX UPDATE *By Elizabeth P. Mullaugh*

As of January 1, 2011, the federal estate tax came back into full effect with a $5 million exclusion. At the same time, the exclusion from federal gift tax was raised to $5 million so that the exclusions are once again unified. The result of this is that each person may transfer during his life or at his death a total of $5 million before tax is imposed. Federal Estate Tax will be imposed on transfers in excess of $5 million, at a flat 35% tax rate. As in the past, there are deductions for certain transfers to spouses and charitable organizations.

The above changes represent a temporary legislative compromise that will expire as of December 31, 2012, after which, if nothing is done, the federal estate tax will revert to pre-2001 levels, i.e., a $1 million exclusion from both estate and gift tax and a 55% top rate of tax.

In its recently released budget proposal, the Obama administration proposed setting estate and gift taxes at their 2009 levels, i.e., a $1 million exclusion from gift tax and a $3.5 million exclusion from estate tax, with a 45% top rate. Given this proposal and the 'default' scenario above, we recommend that clients review their estate plans now to ensure that their current plans do not result in unintended consequences under current law and also to take advantage of opportunities available to utilize the temporarily expanded exclusions from tax.

If you are interested in reviewing your estate plan, please contact any member of the Auto Dealer practice group.

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