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Simple payroll testing tips**

Excerpt from **"Avoiding Closing Table Surprises"** by Marilou Vroman

Buying and selling dealership's is no small task. The key components of the transaction are typically Goodwill, Real Estate, Fixed Assets and Inventories. Certain other matters may fall within a grey area depending on how the APA has been written. Here are some items buyers and sellers should keep in mind:

- Employee compensation plans
- Payroll considerations
- Employee Vacations
- "Sacred Cows"
- Non-disclosed employee privileges
- Loyalty to the seller

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Let Tesla Try Selling Its Own Cars ▲ By Phil Villegas

Dealer associations are misguided in their attempt to fight Tesla's factory-run retailing system.

As featured in **WARD'S Dealer Business**

In 1879, George B. Selden applied for a U.S. patent on the Automobile, a horseless carriage with 4 wheels powered by a gasoline engine; on November 5, 1895, the patent was granted.

In 1884, Nikola Tesla began working for Thomas Edison, working as an electrical engineer and helped advance many of Edison's Direct Current (D/C) concepts. Tesla left Edison in 1886 and in 1888 was granted a patent on an Alternating Current (A/C) motor; the basic principals used in today's Tesla cars.

In 1899, Selden sold his patent to the Electric Vehicle Company, a company that made and sold approximately 2,000 electric cars that were intended for taxi cab fleets in major cities. As the company struggled to compete with gas-powered cars, the company diverted its efforts in collecting royalties from all gas-powered vehicle manufacturers.

In 1902, the Manufacturers Mutual Association, later known as the Association of Licensed Automobile Manufacturers (ALAM), was formed by a group of automobile manufacturers to collectively negotiate the royalty fees paid to the Electric Vehicle Company.

In 1903, the ALAM filed suit against Ford Motor Company for patent infringement in a move that could be easily viewed as protectionist given Ford's manufacturing and assembly innovations that would adversely impact other ALAM members. While Ford initially lost the lawsuit in 1909, Ford ultimately won on appeal in 1911 and the rest is history.

In 2003, Tesla Motor Company was founded to commercialize electric vehicles and bring innovations for performance based electric cars to the mainstream.



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In 2012, Tesla Motor Company faced lawsuits from State Dealer Associations on its ability to bypass the dealer franchise system and operate its own stores.

The irony that over 100 years ago, an Electric Car Company controlled the patent rights to the automobile and had control over the licensing rights of all gas-powered car manufacturers and that the very association created to protect the manufacturers against these royalties also used that power to try to eliminate any emerging competition like Ford.

While I may take some criticism for these opinions, I believe that much like in the case of ALAM against Ford, some dealership attorneys going after Tesla for owning and operating its own stores may be a misguided use of their efforts to protect dealers.

While protectionist efforts have their place and time, I believe dealers currently face greater threats to the franchise system from existing manufacturer imaging requirements and incentive based programs that are compressing margins and eroding dealer profits. Through these image and incentive based programs certain manufacturers are homogenizing their franchisees to the point that it is barely discernible that these stores are not owned by the factory.

I completely understand the argument on protecting the franchise system and any perceived threat to it. I work for dealers, I do not do any work for any manufacturers, and it is in my own best interest that the dealer franchise system thrives.

While the efforts to limit Tesla's ability to retail its own vehicles are viewed with greater implications in mind, such as one of the major auto manufacturers deciding to launch a new brand for which they own all the retail locations; a move that would in turn squeeze dealers out of the business. My opinion, if the manufacturers honestly thought it would work, they would have succeeded at it decades ago. The last manufacturer who tried the factory owned concept was Daewoo, and we saw how long that lasted.

People get up in arms about Tesla opening and operating their own stores, a venture where they are taking on all the economic risks. If Tesla was going the way of the state franchise system, a good portion of the financial risk would be passed along to the dealer. Dealers would have to spend well over a million dollars in exclusive facilities, branding, tooling and capitalization to equal the same market presence that Tesla has established. A prospective investment by dealers that would optimistically only bring a

few hundred unit sales and minimal service business. If Tesla had gone the franchise route, many if not all of these dealers would currently be losing money, and worse yet, these dealers would never truly know when Tesla would "pull the plug" on the whole venture; Tesla's losses have been escalating and the manufacturer has yet to turn a profit.

How many times have dealers been burnt by speculative distributors or manufacturers bringing a product to market, look at one of the more recent cases when Global Vehicles attempted the launch of the Mahindra pickup truck; a venture by which a few hundred dealers lost close to \$200,000 each with a franchise sign-up fee that total approximately \$40 million dollars to Global Vehicles without one vehicle being retailed.



I would rather see some of the attorney's efforts protecting dealers from speculative emerging manufacturers. Some of these manufacturers take advantage of the dealer franchise system by disproportionately displacing a significant part of their brand launching investment on the dealer, with little to no safety net for the dealer if the manufacturer falter's. Many dealers willingly take on these risks in the hope that they will have the next Toyota or BMW franchise in the making. As I've mentioned in the past, it typically takes a newly launched great franchise about 20 years in the U.S. before it really starts yielding dividends to dealers.

My view is to let Tesla have a run at it; let them try their Apple store boutique concept. This is a luxury that will be short lived if they expect to hit their own volume projections for this year of 20,000 spread across less than 30 locations that are set up at shopping malls. If they are successful, then there are lessons to be learned by all and we will all be stronger dealers for it.

While studies show that up and coming generations of new drivers do not view cars as the same expression of freedom as my and preceding generations saw them. In fact, new drivers are waiting longer these days to obtain drivers licenses; this has been attributed to younger generation getting a sense a freedom and individuality via their iphone or smartphone, and not a car. This younger generation view vehicles as utilitarian appliances for transportation, this is a big risk Tesla is taking on in a population segment that cannot afford the product that is being marketed to them. The mall/Apple store concept is not unique to Tesla, there are dealers who for years have operated remote showroom locations at malls with varying degrees of success; but none of them with enough success to even consider abandoning the traditional dealership location.

Not too long ago there were similar fears amongst dealership attorneys when the publicly held dealership groups started buying up points and how that would impact the franchise and retail system. A little over 10 years after the bulk of the consolidation took place, most non-public dealers do not have a sense of feeling threatened by publicly owned dealership groups. While certain economies of scale can often be achieved by public dealer groups, this doesn't guarantee corporate run enterprises will be successful in the retail business. Family or independently owned stores are run with true entrepreneurialism, an element that is difficult for large and publicly owned dealer groups and Tesla to replicate or compete with.

Facts are there is no better system to retail vehicles competitively than the franchise system.

So what do I expect from Tesla in the future?

In 2015, Tesla abandons factory owned store model and assigns franchise points to dealers due to competitor market share gains and investor pressure for higher sales and returns. ▲

Avoiding Closing Table Surprises

Things you should know before you sign the APA

▲ By Marilou C. Vroman, CPA

Buying and selling dealership's is no small task, nor is it something to be taken lightly. With transactions that can take months to complete and involve tens to hundreds of millions of dollars, both the financial risk and reward can be overwhelming. Buy-sells can affect dealership owners and its employees both financially and emotionally.

That being said, most dealers will engage the help of their attorneys, consultants and CPA's to partner with them in the long journey from considering a Letter of Intent ("LOI"), to the closing table and beyond. With a strong team of experts, the buyer and the seller can reach the closing table in a smooth and efficient manner.

Both the buyer and the seller want to come away from the closing table knowing that they have received everything they have been promised, and nothing less.

While each party to the transaction has his or her primary roles and objectives to accomplish in the transaction, there is a risk that certain matters of the dealership may not be specifically addressed in the Asset Purchase Agreement ("APA") and may get overlooked.

The key components of the transaction are typically Goodwill, Real Estate, Fixed Assets and Inventories. These components which make up the majority of the purchase price are typically well defined within the APA. Certain other matters may fall within a grey area depending on how the APA has been written. Here are some items buyers and sellers should keep in mind as negotiations heat up.

Employee Matters

• **Employee compensation plans:** Have there been any significant increases in management compensation since the signing of the APA? The seller may have good intentions to take good care of certain employees by increasing their compensation before the dealership changes hands. However, the buyer should reasonably expect to compensate dealership employees at market rate, not above. If the employee faces a potential reduction in pay as a result of the buy-sell, both the employee's morale and performance may be adversely affected. The buyer should gain a solid understanding of employee pay plans during the due diligence process, in order to confirm if any significant changes have been made and to ensure that any unreasonable pay plans are addressed prior to closing.

• **Payroll considerations:** Most closings will not occur conveniently at the end of a pay period. Accordingly, the seller and buyer should only pay for employee time incurred while generating their respective share of the dealership's revenue. The easiest solution is for the accounting office to prepare a final payroll up to the day of closing such that all regular earnings, commissions and bonuses earned as of that date have been paid. However, some earnings are based on monthly or annual performance. Month end and/or year-end bonuses that remain unpaid at closing should be estimated and credited to the buyer, if any component of those bonuses were earned prior to the dealership sale.

• **Employee Vacations:** How are employee vacations and time off accrued and paid? Some employees choose to work for years without a vacation, perhaps in hopes of cashing out one day on a two month trip to Europe on the company's dime. Is vacation earned over the course of a calendar year? Or is it based on an employee's anniversary date? Does it expire or can it be rolled over from year to the next? Depending on the language in the employee's pay plan or the dealership's employee manual, the selling dealer may have accrued a significant liability to pay for the employee's vacation time. The buyer should gain a detailed understanding of paid time off for employees and how it is earned. Some dealers adopt a "use it or lose it" policy, which simplifies matters somewhat. As with payroll; however, there is likely vacation time that has been earned by employees as of the date of closing that should be paid for by the seller. The buyer should request from the seller a schedule of accrued, but unused vacation liabilities due to employees as of the closing date and credit this amount to the buyer.

• **"Sacred Cows":** The Dealer's daughter or son, the Service Manager's nephew, etc. – It is important to gain an understanding of employee relationships and their roles in the dealership. Not every relationship in the dealership is a bad one. While employee relationships typically increase the risk of a conflict of interest, such as management acceptance of less than standard performance, sometimes there is "talent in the gene pool". The buyer should take time to understand the performance expectations of these employees and the degree of control these related employees have over each other, if any. The buyer should exercise extra caution if related employees have access to assets or to cash and have the ability to collude in inappropriate activities. The buyer has the right to either not hire, or to terminate any employee based on their performance. Ultimately, performance should be the deciding factor.

• **Non-disclosed, undocumented employee privileges:** Certain employees may enjoy peripheral benefits that are not part of their pay plans. Such as access to a company car, company paid travel for a spouse, fuel privileges, housing allowances, and so on. Employees may become accustomed to receiving these items and will expect these perks to continue after the dealership sale has been completed. It is important for a buyer to understand the nature and extent of these expenses prior to closing so there are no "surprises." As part of the due diligence, the buyers should request details of historical expenses and get a solid understanding of items that appear to be unc customary, non-operating, or fall outside of industry guidelines.

• **Loyalty to the seller:** Certain employees will understandably maintain a degree of loyalty to the seller. The seller may have some difficulty in the sudden transition from the dealership's owner to the dealership's customer on the date of closing. For example, the long-time Service Manager may continue to

service the seller's vehicles and may find it awkward to charge retail for the repairs. The seller may be interested in acquiring vehicles at a discount and has a long standing friendship with the General Manager. If past relations between the Seller and the Management team have been good, these employees will typically be inclined to continue to take good care of the seller. The buyer should ensure there is a clear understanding of the privileges and/or discounts a seller will be entitled to following the date of sale.



Customer & Vendor Matters

• **Legal matters and customer relations:** There is a risk that certain transactions may have "gone sideways" prior to the closing date and the customer was dissatisfied, but the customer's complaint, or the attorney's letter will not surface until after the dealership is sold. The dealership Controller or General Manager may have discretion in determining which party is responsible to pay for legal or customer relations matters which originated prior to the date of sale. Ultimately, Management should enforce the language in the APA if it addresses this type of situation. The parties involved should be notified accordingly to ensure there is agreement in the way the obligation is treated. The buyer should be sure to inspect the cash disbursements activity closely in the months following closing to ensure that these types of transactions have been treated in a fair and equitable manner.

• **Verbal promises to customers:** The APA will typically be address the treatment of customer obligations such as deposits and "we-owes". Typically these items have been recorded on the seller's books as liabilities to the customers and are credited to the buyer at closing. At times however, certain promises are made to customers that have not been documented. For example, a customer may have made a deposit on a vehicle and the vehicle was promised to be sold at significantly below invoice.

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In order to protect the buyer, signed buyer's orders should be on file with every customer deposit disclosing the proposed selling price of vehicles for which a deposit was received. In addition, a promise could have been made to install certain accessories for a customer but the accessories were not included on a "we-owe" or in the buyers order e.g. "The salesperson promised it to me." It is the buyer's discretion whether to honor the transaction as agreed. But just as employees expect continuation of their payroll and benefits, a customer will not care if the dealership has changed ownership. To a customer, the deal is the same and their only concern is whether the transaction will be honored as originally agreed. These items should be clearly defined in the APA to prevent misunderstandings after closing.

- **Pricing arrangements with vendors:** Certain vendor relationships may exist with Management where pricing may not be competitive as a result. Buyers should be aware of long-term contracts and agreements with certain vendors such as advertising agencies prior to closing to ensure that advertising and marketing initiatives continue seamlessly following closing, but not at an extraordinary expense. Certain vendor relationships may exist where the vendor is conducting transactions that are not at arms-length from dealership Management, and there may be a conflict of interest. For instance, the vendor may provide gifts or inducements to the General Manager or Controller. The buyer should evaluate the most highly compensated vendors and obtain new proposals to keep the existing vendors honest.

Purchase Price Matters & Adjustments

The APA will be straight forward on the purchase price of the assets of the dealership. Following the closing; however, certain omissions may be discovered and there should be a provision in the agreement as to how these items will be addressed. The honor system would be great but is difficult to enforce. Some of the items that could surface after the closing are discussed below.

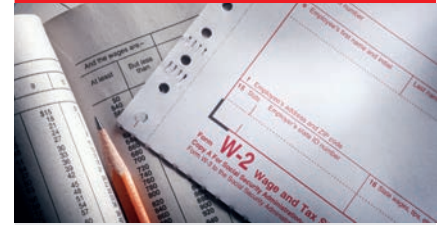
- **Fixed assets:** A detail fixed asset schedule will typically accompany an APA with a list of all the equipment, furniture and fixtures etc. that will be transferred. In the case of an accounting department that has not maintained good records, it is important that a physical inventory be conducted to identify the assets being transferred. In addition, an asset may have been purchased by the seller and be on the books, but may not be present at the dealership, or may not be a necessary part of ongoing operations. The buyer should understand the purpose of the boat, the RV, and the race car that are on the books before agreeing to purchase them. Conversely, some fixed assets may not have a value on the books since they have been fully depreciated, but should be included such as special tools and certain diagnostic computers. These items may not have a book value, but would be costly to the buyer if they had to be replaced.

- **Miscellaneous inventories and supplies:** The dealership will be likely stocked with reams of paper, toner cartridges, brake clean, postage, and various types of office equipment and supplies. Many of these items would not be on the dealership's books since they were expensed when acquired. However, these items do have a value and it is not uncommon to get to the closing table and find disagreement between the buyer and the seller about whether these items are "included" in the purchase price. While a full inventory of these items is not necessary, the value should be estimated and discussed prior to closing. While the dollar amount of these items may not be significant relative to the aggregate transaction, undue tension or stress at the closing table could become expensive.

- **Proration of revenues and expenses:** Certain bills may come in following closing such as rent, utilities, advertising, data processing, and so forth. The method of proration should be predetermined and agreed to by the buyer and seller. The proration of expenses



Insighter Information



HAVE YOU TESTED YOUR PAYROLL LATELY?

Here are some quick payroll and personnel tests to stay better informed of potential risk areas:

FEDERAL WITHHOLDING

Is the company withholding properly in accordance with IRS guidelines? Is any of the withholding being charged to the company? Divide withholding amount into gross earnings by employee. Are any percentages too high or too low? Is there a W-4 on file to support number of withholding allowances claimed?

BENEFITS

Is the company incurring more benefits expense than it should? Test employee benefits deductions by comparing employee deduction amounts to the statements for Medical, Dental and 401(k) contributions.

DIRECT DEPOSITS

Is there an active employee for every account in your direct deposit file? Do multiple employees share the same account number? Download several weeks of direct deposit files to verify employee names and account numbers are valid.

RELATED PARTIES

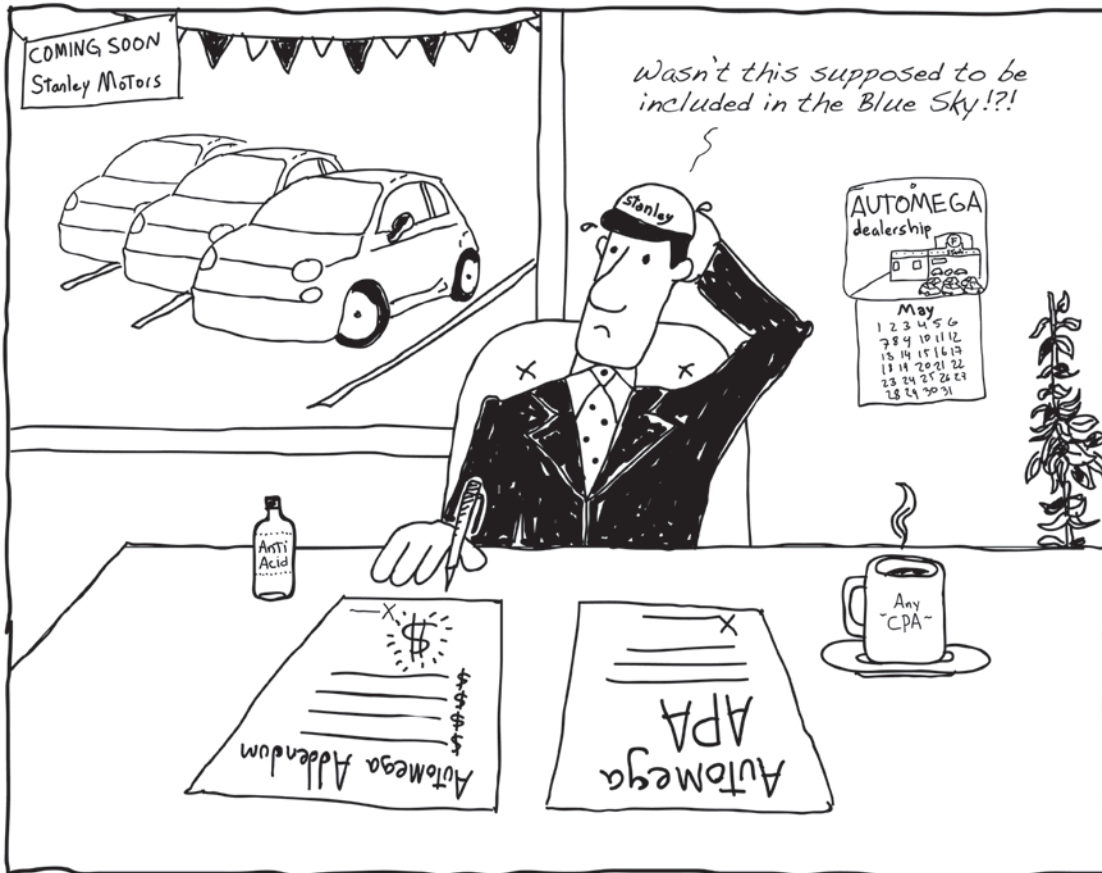
Do any of your employee's share the same address as one of your vendors? Identify the existence of related parties by checking employee addresses against vendor addresses. Ask employees if they are aware of any related parties.

is typically based on the percent of benefit received for incurring the expense or the number of days of the billing period each party owned the dealership. Care should be taken to ensure certain overhead expenses are fairly allocated between both parties. With regard to revenues, such as manufacturer incentives, the nature of the incentives should be evaluated and the method to earn the incentive should be clearly understood. While the seller may receive the entire payment, there is a likelihood that a portion belongs to the buyer. For example, certain factory incentives may be based upon acquiring a certain percentage of off-lease

vehicles. The buyer of the dealership may be entitled to a portion of the incentive as a result of acquiring these units through the buy-sell. The risk of owning the off-lease units has transferred to the buyer and therefore the reward should follow. Similarly, the seller should be compensated fairly for incentives earned prior to closing, even if received by the buyer.

In considering the acquisition of a dealership, there are many items that can end up falling between the lines of the APA. The scenarios listed above are just a sample of the potential items that could surface during the course of the dealership acquisition process and after the transaction is finalized.

The buyer should maintain frequent and open lines of communication before and after the closing with his advisors, the seller, and designated Management throughout the process of acquiring the dealership. Understanding the many grey areas in the APA is instrumental to minimizing undue stress, enabling seamless continuation of dealership operations, and ensuring the entire acquisition process flows smoothly from the letter of intent to the closing table and beyond, with no surprises. ▲



Axiom Advisors was formed in the spirit of providing a fresh, new alternative to meet the specialized needs of retail automotive dealers.

What makes Axiom Advisors different? Our team of professionals has the unique combination of over 60 years of hands-on retail automotive industry experience working directly in dealerships, paired with the assurance of professional accounting experience. Our advisors

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