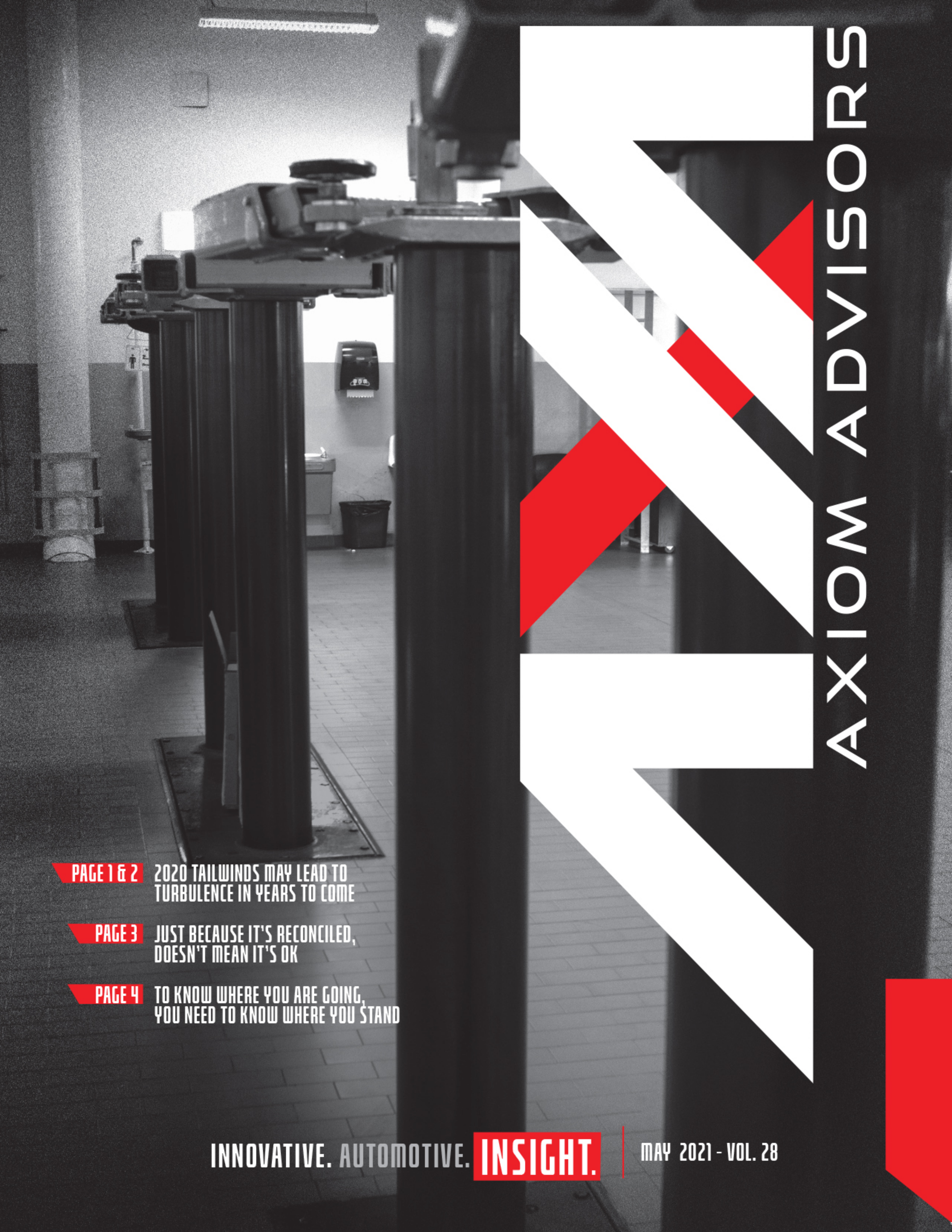

AXIOM ADVISORS

INNOVATIVE. AUTOMOTIVE. INSIGHT.

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2020 TAILWINDS

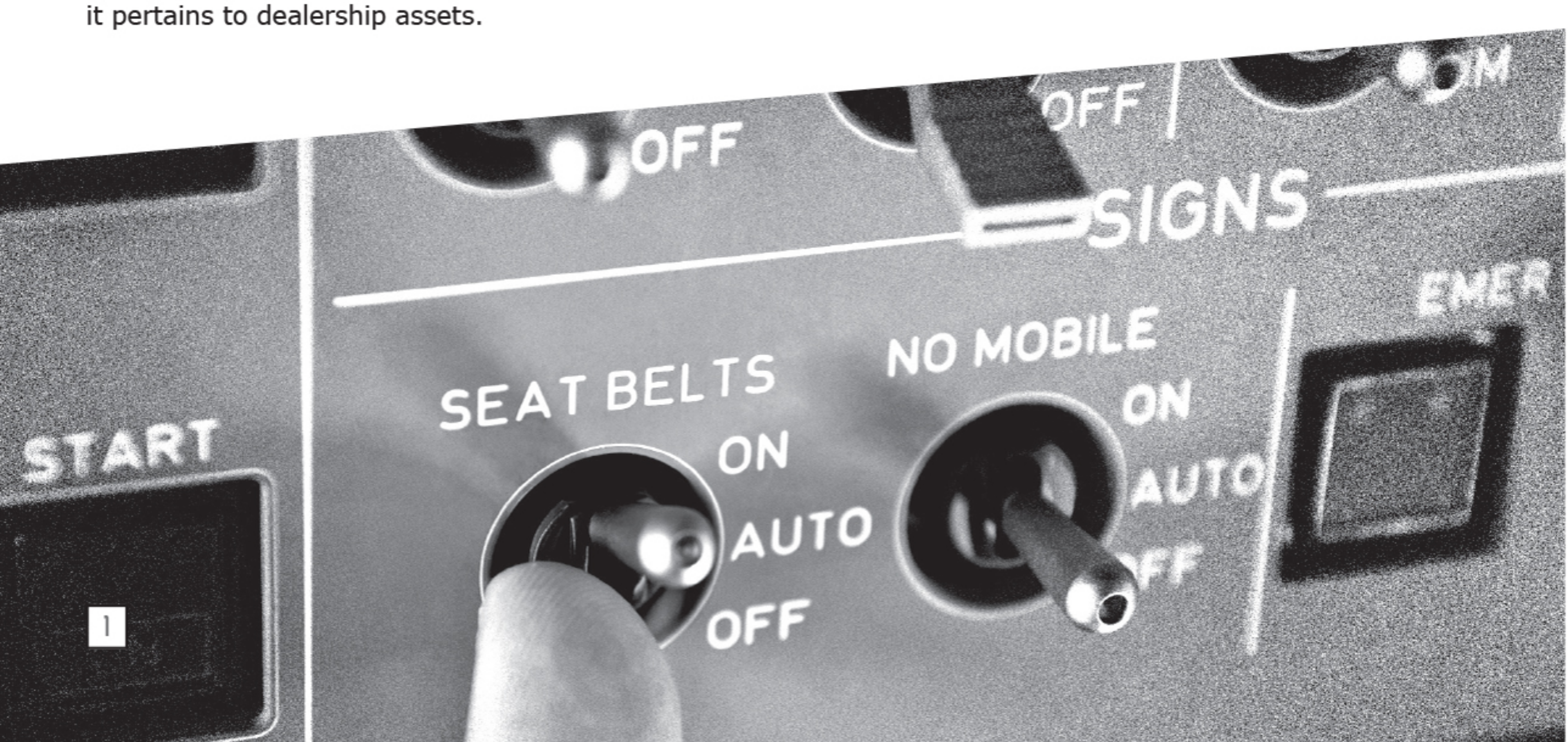
MAY LEAD TO TURBULENCE IN YEARS TO COME

- BY PHIL VILLEGAS

The apparent exuberance by which some buyers are approaching dealership acquisitions in the current market leaves me scratching my head as to what I may be missing.

Yes, I fully understand the last 5-6 months have been some of the best profitability months dealers have seen. There has been a convergence of factors that have fueled dealer profitability the last few months and while it's currently a great time to be a car dealer, there are some serious considerations that need to be given to anyone currently contemplating a dealership acquisition from now through 2021.

It does not escape me that we live in a free market where the value of an asset is determined by what a buyer is willing to pay for such an asset. Though I can give allowances for some irrational pricing of assets that may be considered limited, exclusive or even abstract, items the likes of art, wine, classic cars and watches for example that can drive passionate collectors to drive up prices, but I cannot subscribe to this model of thinking when it pertains to dealership assets.



Even though dealerships are currently a hot commodity, this is by no means indefinite. Please keep in mind this is the same industry that no less than a year ago was being written off by many experts due to the emerging mobility movement, manufacturer margin compression, facility demands, impact of vehicle electrification on profitability, antiquated retail sales model and threats by direct to consumer sales. While I have never bought into the apocalyptic view some experts had for dealers, like many others I was cognizant of some of the headwinds to come over the next decade. While I am still very bullish on the retail automotive industry and the role dealers will play for decades to come, I am struggling with the valuations of dealerships over the past few months.

Despite the excess liquidity that appears to be available, I would be hard pressed to use 2020 net profits to serve as the exclusive basis by which any multiple is applied to in calculating the goodwill value. There are several elements currently bolstering net profitability in 2020 that are certain to not be present in 2021 or years to follow. Factors that I would be advising our clients to consider and likely discount in the valuation of any transaction in the coming months would be as follows:

Sustainability of Current New and Pre-Owned Gross Profit Levels:

Current low supply of new and pre-owned inventory levels that have boosted grosses are likely to correct themselves in the coming months.

Sustainability of Current Low Flooring Expense:

Low inventory levels combined with faster inventory turns has most dealers netting income in flooring. As inventory days' supply levels increase to normal the net expense will inevitably increase.

Special Lender and Vendor Discounts:

In the midst of the pandemic lockdown, most major banks, DMS providers and other vendors provided expense reductions/deferrals over a period of a few months which helped improve dealer profitability.

Personnel and Compensation Levels:

Many dealers used the pandemic lockdown to cut pay-plans and personnel. Many of these dealers have not returned to full staffing or pay levels and likely will.

Low Interest Expense:

While we expect rates to remain low for a few years, it is not realistic to plan on having these rates through the entire acquisition loan period.

A focal point in any acquisition valuation is to forecast how that individual store will likely perform under new ownership. Often new owners can bring a combination of energy, selling approaches, economic synergies that will allow them to boost the profitability of an acquisition. While this still remains the case, a diligent buyer will also recognize the strong tailwinds that have impacted dealers in 2020 and the inevitable turbulence that is likely to come in 2021 and later as things return to normal or even worse, slide into a recession.

JUST BECAUSE IT'S RECONCILED, DOESN'T MEAN IT'S OK

- BY MARILOU C. VROMAN, CPA, CFE

Most dealers and their personnel in financial management roles are quite familiar with the fundamental requirement to reconcile cash balances with the bank. Many of our clients perform daily reconciliations in addition to a full monthly reconciliation to ensure all transactions have been captured, and the GL is an accurate representation of the dealer's cash position from one day to the next. Because of the inherent risk in cash, is common for an outside auditor to request copies of bank statements and the related reconciliations to ensure proper cash controls are in place. However, is viewing a reconciliation which balances to zero and ties out to the bank and GL balances sufficient to know your cash is properly controlled?

We often examine bank reconciliations and supporting statements, but from a different perspective. We know bank reconciliations are usually expected by the controller or CFO and are likely reviewed. However, our goal is to identify anomalies which may otherwise be missed. Both auditors and managers will perform procedures such as testing for proper cutoff and ensuring deposits in transit have cleared the bank in a subsequent period for example. However, one of the blind spots we have found is in the list of outstanding checks.

Outstanding checks are virtually guaranteed to appear in a typical bank reconciliation. Most outstanding checks will typically be less than a month old. I don't know about you, but I have not yet met a person who collects checks instead of depositing or cashing them. However, it's not uncommon to see outstanding checks age several years without clearing the bank. Even though some dealers have check stock which expressly states "void" after a certain period, such as 90 days, we have seen banks clear stale-dated checks, nonetheless. At a certain point however, the oldest checks are unlikely to ever clear because they were either lost or replaced and should have been voided.

As such, the detail of outstanding checks is often overlooked when a bank reconciliation is reviewed for completion, since the oldest items seem to stay from one month to the next. So what type of risk could reside in your outstanding checks?

A simple scheme to divert a dealer's funds without detection is to use aged outstanding checks to offset or clear inappropriate disbursements. For example: Check #51052 was issued for $1,000 to reimburse a customer's deposit but has been on outstanding for over two years. An individual with access to cash and the bank reconciliation could easily issue a new check payable to cash for $1,000, void the GL posting in the DMS, and cash the check. When the check later clears the bank, it can be reconciled with the old outstanding check #51052. The old check will drop off the reconciliation and no one will question it. With some dealers having outstanding checks totaling millions of dollars, this exposure can be significant.

In a perfect world the bank reconciliation is performed by an individual with no access to cash (segregation of duties). In reality, smaller accounting departments may not be able to fully segregate all cash functions from the reconciliation process. In this case, when verifying the monthly bank reconciliation is complete, we recommend looking at changes in reconciling items from one month to the next. This includes changes in outstanding check numbers, dollar amounts and/or dates. An outstanding check will normally drop off the reconciliation by either being voided or by clearing the bank. If neither of these things happened, there may be larger be problem. If an aged item suddenly disappears from the reconciliation or is changed, question it to find out why. Stay one step ahead and inspect what others don't expect.

TO KNOW WHERE YOU ARE GOING, YOU NEED TO KNOW WHERE YOU STAND

- BY LUIS DEVILLE

Numbers are the language of business. Numbers are mainly used to count, measure and label. Dealers and store managers use numbers produced by their operations every day to measure their performance, set goals, and keep track of business transactions. Therefore, it is vital that accounting records are up-to-date and accurate as a basis for business decisions and forward-looking initiatives. Accounting is the foundation of business decisions. If your dealership's financial records are not up-to-date, accurate and complete, then neither will your sales projections and related expense calculations, for example, be correct. In order to make good strategic decisions, you need to use financial data from General Ledgers that are reliable.

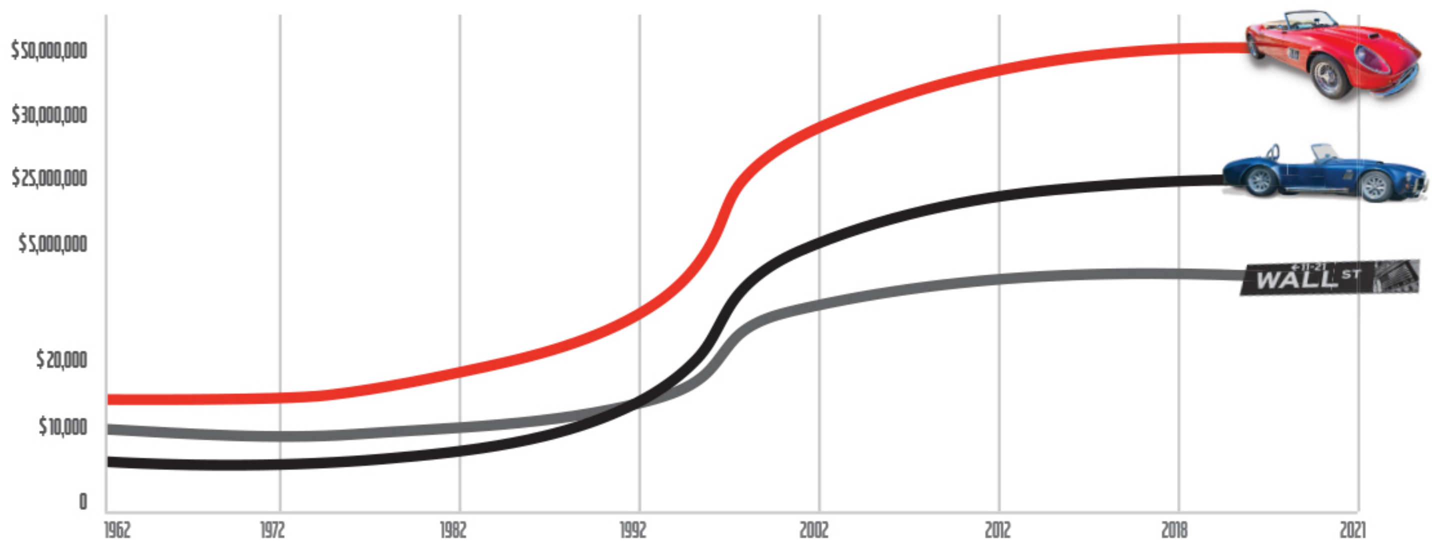
One way to ensure your numbers are reliable is to start with the right staff in your accounting department. The right staff means they have knowledge about proper accounting and there are enough staff members to complete monthly duties. With sufficient staff and proper leadership, this helps ensure that transactions are being recorded in the ledgers correctly and on-time. All too often we find dealers limiting administrative headcount to reduce their expenses only to discover their understaffing was significantly more costly due to unnecessary write offs and decisions made upon inaccurate financial data. Having the right staff will increase the accuracy and completeness of the numbers you use to make strategic decisions. Year-end financial statement audits and reviews are often viewed as a "catch all" to detect and correct reporting errors made throughout the year. However, these audits and reviews have materiality constraints, and by the time the audit is complete, it is often too late to change the decisions which were made based on inaccurate data during the prior year.

We recommend internal audits and review procedures throughout the year, including regular and detailed analysis of your dealership's trial balance, schedules and supporting ledgers. These processes can help you gauge how reliable the data you are using is and whether you have the right staff in the right position, or if you need more employees before it is too late.

We realize that accounting primarily deals with recording what has already happened. However, in order to move forward you must look at the past to get an understanding of what has led you to where you currently are, so you can achieve greater clarity to get your operation to where you want to be.

THE RISE IN VALUE OF THE S&P 500, FERRARI & THE AMERICAN CAR

(IN LOGARITHMIC SCALE)



- In 1962, The 1962 Ferrari 250 GTO had an original cost price of $18,500 - it was sold at auction in 2018 for $48,405,000. A Rise in Value of 2,616% from 1962 to 2018.
- In 1962, Investing $12,000 in the S&P 500 would have the value of $3,610,465 in 2018. A Rise of Value of 300% from 1962 to 2018.
- In 1962, The 1962 Shelby 260 Cobra CSX 200 had an original cost price of $6,610 - it was sold privately in 2018 for $13,750,000. A Rise of Value of 2,080% from 1962 to 2018.

The most expensive car sold at auction is the 1962 Ferrari 250 GTO, which sold for 48.4 million in 2018.

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PHIL VILLEGAS
pv@axiom-auto.com

MARILOU C. VROMAN, CPA, CFE
mv@axiom-auto.com

AXIOM ADVISORS
4500 Biscayne Blvd., Suite 345,
Miami, FL 33137
Phone: 786.350.2675
www.axiom-auto.com