Lending to Automobile Dealerships Credit Risk Management Issues

by Erik Day

In the November 1998 issue of *The Journal of Lending & Credit Risk Management*, the author provided a picture of auto dealerships today and then discussed "lending to" issues. This month's article zeroes in on specific challenges facing auto dealers and the credit risk management issues they represent for lenders. The author then lists questions lenders must be able to answer to help ensure successful loans to large and small dealerships.

More than 50 million new and used vehicles are sold each year in the U.S. In light of global issues and the financial exposure faced by the U.S. banking industry, what are the potential risks to the U.S. economy, and more specifically, automobile retailers and those institutions that provide financing? This is a difficult question to answer due to the dynamics of the U.S. economy and its global integration and rapid technological gains. Evolution of business has forced many forecasting models to be reevaluated in terms of how tried and true economic indicators will or will not impact the economy.

It's Not Black and White

World economy. The Asian crisis is projected to bring growth in the gross domestic product (GDP) down to 2.5%, compared with 3.2% in 1997. A slower growth rate, however, is more likely to persuade the Fed to forgo raising interest rates, and that, in turn, will help the long-term growth of the automobile industry.

Home sales correlation. Buying a vehicle is still considered a big decision and, for many consumers, remains second only to purchasing a house. As such, these two industries closely mirrored each other until recently. Data available from the National Automobile Dealer's Association's (N.A.D.A.) *Industry Analysis &*

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Outlook report reveal that from 1982 to around 1991, new vehicle sales expanded or shrank in correlation to housing starts and existing home sales. With a predicted growth rate of 1-1.5% per year, the number of households could grow 14%—by 12 million—in the next 10 years. This correlation would seem to indicate that although the number of vehicles per household has begun to taper off from its post-World War II highs, the number of vehicles per household still could grow 9% in the next 10 years. However, from 1992 to today, N.A.D.A. data show that housing starts and existing home sales growth surpassed gains made by the auto industry. This can mean either that cyclical sales swings of the past have finally flattened to predictable levels or that consumer preference has changed and people no longer feel the need to buy a new vehicle every few years.

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Auto leasing. Automobile leasing now accounts for more than 60% of the average dealership's new vehicle sales. Because the customer is forced to re-lease or purchase a vehicle at the end of the lease, dealers now are better able to predict sales volumes. In 1988, the average auto loan was 56 months; this has since fallen to 53 months—a direct result of more people leasing their vehicles. This enormous lease market is creating other issues, such as what to do with all the vehicles coming off-lease and what their effect is on the used car market. In 1991, off-lease vehicles amounted to just 3.5% of the used vehicle market. By 1997, off-lease vehicles expanded to 7.2%. Further expansion is expected by the end of 1998. The market for used vehicles in the U.S. still overshadows the new vehicle market. There are roughly 39 million used vehicles sold in the U.S. each year. However, so many nearly new vehicles coming back to the market will likely drag down prices of new cars. That could have an adverse impact on dealer profits, but should prove favorable for the consumer.

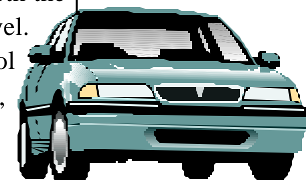
Percent of disposable income. Americans are spending less of their disposable income on new vehicles. In 1997, the percentage of GDP allocated towards the purchase of a new vehicle fell to 3.8%, down from the traditional average of around 4.2%. One reason for the decline is the high debt rate facing many American consumers. Unlike the beginning of the current economic cycle, they can no longer take on more debt. So consumption can only increase as long as their income grows. On the other hand, corporate America is beginning to feel wage pressures due to a decline in the skilled labor pool, so many professionals are starting to see real wage increases from higher demand. This fact, in conjunction with unprecedented manufacturer incentives, may help to explain why new vehicle sales are still projected to see their fifth straight year of more than 15 million units sold in the U.S.

Inventory levels. Another issue facing auto makers is high inventory levels, but this should start to ease over the next few years. Two of the Big Three have closed plants or announced that they will close them. A year ago, there were more than a million vehicles of over capacity in North America; in the next two years, it should drop to 250,000 units. Most over capacity, however, is in trucks, which is a growing segment as evidenced by the popularity of sport utilities.

Despite unknown volatility in the marketplace, Americans still love their cars. With that said, macro economic considerations can and should be taken into account when lending to automobile dealerships, but it is as important to understand how the automobile market has changed to evolve with this dynamic economy.

Evolution and Trends

The automobile industry—manufacturers and dealerships alike—is rapidly adjusting to meet consumer demands and sustain profitability in this somewhat cloudy economy. A dip in a particular product line or market share is sure to bring on customer rebates to prop sales back up to predictable levels. Additionally, manufacturer-to-dealer incentives have evolved as a subsidy to sustain franchise profitability. This is a direct result of shrinking margins at both the manufacturer and dealership level. Manufacturers have had to retool engineering processes, cut costs, and make less money per car to continue the earnings growth



expected by Wall Street. In turn, dealers are seeing their profits erode from 12% mark-up to closer to 5% per new vehicle. They, too, must retool processes and cut costs to make this strategy work.

Dealerships now are faced with economic Darwinism in this highly competitive market. This is evidenced by the shrinkage of new car franchises over the past two decades. Data from N.A.D.A.'s industry outlook report indicate that the number of new vehicle franchises has dropped from 30,100 in 1972 to just over 19,500 in 1998. This consolidation trend indicates that fewer dealerships are actually selling more vehicles.

Unprofitable or ill-equipped dealerships are giving way to those better suited to operate in today's environment. Stand-alone or small franchise dealerships are facing enormous pressures from larger mega-dealers able to undercut prices due to economies of scale. Depending on the market, it may just be a matter of time before outside forces push a dealer into dissolving the franchise or becoming acquired by a large dealer group. For example, how can a small dealer with one or two franchises that generate annual revenues of $25 million to $50 million compete with the likes of Republic Industries, Inc. whose 211 dealerships and 296 franchises posted revenues exceeding $5.49 billion in 1997?

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According to a survey taken by *Ward's Dealer Business* magazine in its September 1998 issue, dealers are frightened of the cloudy future that lies ahead. Larger dealer groups, such as Republic Industries, Inc., are quickly penetrating major metropolitan market segments and mid-size cities with clusters of same-brand dealers. This trend, still in its infancy, is beginning to take its effect on the profit and loss statement for many smaller dealers. According to the survey, many dealers felt that the one obvious solution for dealer survival in this era of consolidation, aside from selling out, is to pool together to remain competitive. What that means, however, no one is sure.

Lending Issues

Understanding the changes in the automotive sector and how it is and will continue to affect dealerships will better prepare a lender for the various risks associated with a particular relationship. It is apparent that vehicle sales will continue to be a prominent force in the U.S. economy, but who they are and how they are to be sold is the underlying question that will become clearer as the consolidation trend matures.

Lenders should realize that this is a dynamic market facing many risks. As a result, past loans made on borderline deals or lack of prudent credit standards will soon come to surface if your borrowers are faced with many of the issues discussed above. Despite a healthy economy and a high profile industry, the car business is going through some changes.

Their industry focus has historically helped dedicated auto-finance companies to be better equipped to understand these issues. However, the banking industry still represents a significant portion of lenders in the automotive segment and, as a result, must be able to comprehend this information in order to make sound credit decisions going forward.

Lenders who have not been through a downturn in the economy may not have exercised prudent lending techniques when structuring loans. In this highly competitive environment, it is important to understand how a dealership or dealer group fits into the overall equation of the industry. This will assist a lender in structuring the financing request according to the risks associated with a particular transaction.

Commercial lending today has become more of an art than a science because of the enormous amount of variables that go into putting a deal together. Loan structure, profitability, balance sheet ratios, geographic location, product lines, ownership and management experience, as well as the guarantor's secondary financial support, are just a few of the items that go into determining the viability of lending to automobile dealers.

Credit Risks Associated with Dealerships

Mega and public dealers. Diversification and economies of scale are positive attributes for larger dealer groups, however, credit risk is greater due to high dollar exposure, concentration issues, and the sheer complexity of dealing with multiple entities. Credit facilities can also take on many forms. Many large dealer groups are opting to forgo traditional floor plan lending for larger credit lines utilized for numerous business needs such

as inventory financing, working capital, and acquisition capital. These types of credit facilities require careful structuring in terms of financial covenants at the group and individual dealership level, limitation on usage of funds, loan-to-value guidelines, and specific criteria regarding the acquisition of dealers.

To better understand these larger dealers and their associated capital requirements, a lender should meet the key players to get a sense of overall business strategy and raise some high-level questions, such as:

- How many and what type of franchises? This is important in determining the dealer group's particular dependency upon domestics or imports and, more specifically, upon franchises that may be experiencing some problems in the marketplace.

- What is the current and/or planned geographic structure? This will assist a lender in understanding the dealer group's economic exposure in specific regions, its underlying customer base, and competitive pressures.

- What type of management and financial controls are in place? The key here is to determine whether the group is managed from a centralized, regional, or individual dealership level. As groups become larger, it becomes crucial for the lender to implement controls that can quickly identify internal weaknesses, determine capital requirements, and manage cash flow. Cash flow is especially important due to the high sales volume and low margin strategy utilized to remain competitive and retain customers. Reporting controls are key in maintaining financial consistency and accuracy of bookkeeping. And management controls should be in place to maintain focus and accountability at each dealership, as well as competency of management at the executive level.

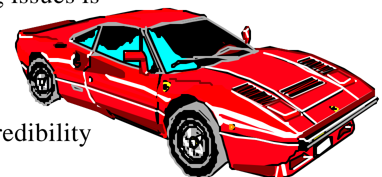
- How does the business operate? The point of this question is to understand the organizational structure. For example, is each dealership a separate entity under a holding company? Does each dealership stand on its own in terms of cash or is there a sweep account utilized? How are earnings treated—left in the store or paid out in management fees? Again, these questions will help the lender understand how cash is flowing through the system and provide a comfort level on how business is being conducted.

- How does this dealer group differentiate itself from others? Many large mega dealers essentially focus on similar strategies that involve certain regional focus, but the varying factors usually include how management and personnel issues are handled or how acquisitions are structured. If it's a public dealer group, determine whether there are stock options given to the previous owner and any time restrictions. Is the same crew continuing to operate the dealership or will new personnel be hired? This is important because many dealer principals have simply cashed out but remain in the store. As such, motivation to operate successfully can deteriorate if the right incentives are not implemented. Also, what is the group's purchase policy/formula for acquiring additional dealers? Many groups, quick to keep pace with other industry giants, can and have paid too much. This can cause some capitalization issues and degrade the balance sheet if overlooked.

> **LOAN STRUCTURE, PROFITABILITY, BALANCE SHEET RATIOS, GEOGRAPHIC LOCATION, PRODUCT LINES, OWNERSHIP AND MANAGEMENT EXPERIENCE, AS WELL AS THE GUARANTOR'S SECONDARY FINANCIAL SUPPORT, ARE JUST A FEW OF THE ITEMS THAT GO INTO DETERMINING THE VIABILITY OF LENDING TO AUTOMOBILE DEALERS.**

Keep in mind that these simply are high-level questions that should be addressed prior to going into all the due diligence that's necessary in making a sound credit decision.

Small dealers. Small mom & pop dealerships, depending on their operating performance, product lines, and competitive market pressures, can offer a better return while minimizing dollar exposure. However, understanding the following issues is paramount in making a sound lending decision.



- Smaller dealers have credibility

simply because they've been in business for a long time, are socially committed to the local community, and have a demonstrated track record of profitability. This, however, does not ensure continual success. Similar questions to those for mega dealers should be raised, but smaller dealerships need further consideration. Added emphasis must be placed on small dealers' operating efficiencies and fixed operations in light of their uncertain futures from consolidation price pressures, eroding margins on new vehicles, and the negative effect of off-lease vehicles on margins in what was once considered one of the dealer's more profitable departments.

- As margins decline to sustain sales volume, smaller dealers with above-average fixed costs will begin to see their break-even point pushed up further. Having strong absorption from fixed operations, which is very important in offsetting exposure to sales fluctuations, is one of the more important ingredients in sustaining successful operations for a small dealer. Many customers still prefer the personal attention from a smaller dealer when it comes to servicing their vehicle. However, much of this back-end business is correlated to customer retention and sales growth on the front end of the business. If competitive pressures begin to depress front-end sales growth, service and parts business will usually decline over time.

- As noted above, operating efficiencies are crucial for smaller dealers. Because the span of control requires less personnel, smaller dealerships should have an active dealer principal who plays many roles. This will alleviate the need for unwarranted management levels and the extra overhead. While smaller dealers must consider many other items, keeping costs down in this low-margin era will become even more important in sustaining profitability.

- Additionally, succession plan issues also need to be considered because many long-time small dealership owners are at retirement age. Hopefully, family members who have been working in various capacities at the dealership are prepared to take over, but this may not always be the case. This is also another reason for a large number of dealers selling out to larger groups.

SMALL MOM & POP DEALERSHIPS, DEPENDING ON THEIR OPERATING PERFORMANCE, PRODUCT LINES, AND COMPETITIVE MARKET PRESSURES, CAN OFFER A BETTER RETURN WHILE MINIMIZING DOLLAR EXPOSURE.

Conclusion

Considering the magnitude of this industry and the rapid changes its undergoing, good lenders must continually educate themselves in many capacities. Understanding car dealers is just one component. The lender must be aware of what's going on with the manufactures, auto auctions, as well as consumer debt related to the auto business. This is a large cycle that is all interconnected.

Comprehending the macro economics of the industry is just half the battle. Above all, the lender needs to have a solid understanding of the type of dealership and how it conducts business. Lending to automobile dealerships can be both risky and rewarding, so the lender is advised to maintain prudent credit standards and price accordingly. This will prove beneficial in the long run.

References

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Ward's Dealer Business, September 1998.