An Introduction to Automobile Dealerships

by Bradley R. Carter, MAI

ABSTRACT

An automobile dealership is a special-use property that presents unique challenges in its valuation. To develop a credible value, the appraiser must not only understand the intricacies of this specialized propertytype but also have some familiarity with the automotive industry and trends that affect the properties where vehicles are sold. This article is intended to assist appraisers who are experienced in general commercial real estate valuation and wish to explore issues unique to automobile dealerships.

Automobile dealerships are the real estate that the automotive industry uses to sell its products. Information published by the National Automobile Dealers Association (NADA) indicates that the number of franchised new car dealerships peaked in 1949 at 49,200 and has declined almost every year since. According to Urban Science, the number of dealerships was down to 17,838 at the end of 2013.[1] The decline in inventory was particularly sharp from 2008 to 2010. No material changes in the supply of dealerships have occurred since then.

From a physical aspect, the improvements for an auto dealership may be in one or multiple buildings and typically include a showroom area, offices for both sales and administrative functions, service areas, and waiting areas or lounges. Service areas may include a collision shop or an automated car wash. Sites are typically large relative to the improvements they support, since space is needed for vehicle display and the storage of automobiles in inventory. While the physical features of dealerships are important, perhaps even more fundamental to valuing this property type is an understanding of how the automotive industry markets vehicles and how real property fits into that model.

This article will cover the following topics:

- Definitions of terms relevant to automobile dealerships
- How dealership franchises work
- The profile of a typical automobile dealer
- The components of an automobile dealership
- Dealerships that sell single brands versus those that sell multiple brands
- The European dealership model and how it applies to the United States

Definitions of Terms

The terms *dealer, dealership operating company, dealership,* and *dealership property* are often used interchangeably within the automotive industry and sometimes even by real estate professionals. However, each of these terms has a distinct meaning that is important for appraisers to understand.

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1. Urban Science is a business solutions company focused on supporting the sales and marketing functions of the automotive industry. More information can be found at www.urbanscience.com.

- *Dealer* refers to the individual, individuals, or legal entities who operate automobile dealerships.
- *Dealership operating company* refers to the entity that operates a dealership. A dealership operating company is also known as a *dealership group*.
- *Dealership* refers to the entire enterprise related to a dealership property, which encompasses real property (which may be owned or leased) as well as the business operation. As a practical matter, many automotive and real estate professionals are not careful to distinguish a dealership from a dealership property. For the purpose of our discussions, *dealership* will refer to the entire enterprise (encompassing the business operation).
- *Dealership property* refers to the real property component of an enterprise that is a dealership.

To help clarify the distinct meanings of these terms, suppose someone from an auto manufacturer said, "Joe at Joe-Sells-Cars, LLC, needs to restripe that parking lot over at Missoula Motors. We can't have an eyesore like that right on Main Street!" In this example,

- The dealer is Joe, who operates the dealership known as Missoula Motors. However, if someone said that the dealer is Joe-Sells-Cars, LLC, that would also be correct.
- The dealership operating company is Joe-Sells-Cars, LLC (the entity that operates the dealership known as Missoula Motors).
- The dealership is Missoula Motors (which is an enterprise that encompasses the business operation).
- The dealership property is the rights associated with the land and building(s), or the real property component, that house the dealership on Main Street that operates under the name Missoula Motors.

How Dealership Franchises Work

Since the automotive industry's inception, manufacturers (commonly known as OEMs, which is an acronym for *original equipment manufacturer*) have focused on vehicle design, manufacturing, and brand promotion. Consistent with that business plan and recognizing that the sale of vehicles generates demand for corollary services such as leasing, financing, and repairs, retail distribution is done through a network of independent dealers (or, more specifically, dealership operating companies). Dealers receive exclusive franchises for specific trade areas and act as representatives of the manufacturer to the car-buying public.[2] The trade area that the franchisee has exclusive rights to varies by state, but it is typically a radius of about 10 miles.

Manufacturers grant franchises to dealers, at no charge, and the manufacturers and dealers are in effect partners in the process of marketing automobiles. When a dealer change occurs, the parties involved negotiate a buy-sell agreement for the dealership operating company. However, the franchises are not transferable, so the buyer must simultaneously apply for approval to become a franchisee of the manufacturer.[3] As a matter of practice, informal approval of the buyer becoming a franchisee is usually an early step in the process. Many dealerships market more than one brand. There were a total of 31,440 franchises, or brands awarded to dealers, that could be marketed from the nation's 17,838 dealerships at the close of 2013. When multiple brands are marketed, the prospective purchaser of the dealership operating company submits applications for franchises to each manufacturer, and approval is typically subject to the buyer demonstrating sufficient experience in the industry and having strong financial backing. If the real estate is owned by the dealer, then a sale of the property often accompanies the dealer change. Another fairly common scenario is for the new franchisee to lease the property back from the former operator; this arrangement can be particularly beneficial to a new operator that has limited capital.[4]

A Typical Dealer Profile

Who Buys Auto Dealership Properties?

Highest and best use opinions require thinking about the profile of who is most likely to buy the property being valued. Let's talk a little about auto dealers, the people who operate these properties.

Historically, buyers of auto dealership properties were individuals or family-operated groups. When publicly traded companies entered the market, the trend shifted towards larger groups. There are six publicly traded companies that operate auto dealerships. These companies operated a combined 895 dealerships as of the end of 2013. The operator with the largest number of dealerships was Penske Automotive Group

2. Charles E. Tholen, "Appraising Auto Dealership Facilities," in *Valuation 2000: Papers and Proceedings* (Chicago: Valuation 2000 Alliance, 2000), 81.
3. Bradley R. Carter, "The Rise of the Market for Auto Dealerships: Bad News for Landlords?" *Real Estate Issues* 39, no. 3 (2014): 33–38.
4. Tholen, "Appraising Auto Dealership Facilities," 84.

with 243 ealerships, while the operator with the largest group revenue including all departments was AutoNation with $17,517,600,000. Private dealers range greatly in size, from the vast number of single-store operators to large operators with multiple locations like Hendrick Automotive Group, which sells vehicles at 87 stores.[5] While there has been some consolidation, with larger groups operating a higher ratio of properties than in the past, small operators are still present and even prevalent in many smaller and rural markets.

As of this writing, a new trend has begun to emerge. The industry's recent prosperity has drawn buyers with little or no automotive background. The most notable entry into this market by a group with no previous experience came in October 2014, when Warren Buffett's Berkshire Hathaway Inc. agreed to buy Van Tuyl Group, a large privately owned auto dealership group (or dealership operating company).

Why Do They Buy Them?

A conversation about who buys auto dealership properties cannot go too far without exploring the reasons for these purchases. Many purchases are made for obvious reasons or reasons that are common to any type of real estate asset. However, one analyst involved in the buying and selling of dealership businesses contends that when someone buys real estate for use as a dealership, they aren't thinking about buildings or land; what they are really seeking is an *entry point* (also commonly known as an *open point*) into a market from which they can operate and generate revenue and profits.[6]

To better understand what is meant by an entry point into a market, let's consider a real-life example of a new vehicle dealership property that I appraised. The dealership is located in a small desert town in the Southwest. While there are used car dealers in this town, the nearest place to buy a new vehicle (besides the subject property) is the state capital 50 miles west, and there are no other new auto dealers for several hundred miles in all directions. The dealership sells a high volume of new vehicles relative to the size of the local population, which is a consequence of the lack of competition. However, the local population is so small that the total amount of new vehicles sold is still quite modest.

The dealer also operates a used auto store next to the dealership under a name and signage so similar that the public does not perceive it to be a separate entity from the dealership. This used auto store has inherent advantages over the other local used vehicle stores due to its affiliation with the new car dealership. The new car dealership draws a steady stream of shoppers, and the trade-ins that the dealer receives from her new vehicle operation ensure that her used auto store always has new (albeit pre-owned) inventory coming in. In fact, trade-ins coming from buyers of new vehicles help the used car operation gain the reputation of having the largest selection of pre-owned cars in town.

As we've established, new vehicle sales at this dealership are quite modest. However, the margins are helped by the limited competition, so the new car sales do generate a small profit. As we'll discuss shortly, sales of new vehicles mean the opportunity to make money from financing the purchases, insurance, parts, and service. The used vehicle operation, which boasts a large selection, makes money as well. Furthermore, even though sales of new vehicles are modest, the manufacturer likes having this dealership in its network because there is so little cannibalization (meaning that many of the new vehicle sales are to purchasers who would not have bought this brand had this dealership not existed). In fact, this arrangement is so appealing that a second OEM, who builds cars that do not directly compete with the first, asked the dealer to become one of their franchisees as well. With the second brand added to the mix, the new vehicle sales would increase significantly, which means more money would come in from financing new vehicle purchases and selling insurance, parts, and service. The used vehicle operation now also has more traffic and an even bigger source of trade-ins to replenish its inventory. Again, this dealer is not the only dealer in this town. As we've demonstrated though, the fundamental difference is that the relationship with a major auto manufacturer establishes an entry point into this market to generate revenue and profits that are not available to the owners of the other used vehicle dealerships.[7]

5. "Top 125 Dealership Groups," *Automotive News* (March 17, 2014).
6. Because franchise agreements cannot technically be transferred, the buyer of a dealership property cannot establish an entry point through a real estate purchase alone. Realistically, buying a dealership property is often part of a larger business strategy.
7. In explaining why dealers have an incentive to act ethically, one blogger wrote that owning a new car franchise is like having "a license to print money." While I'm not familiar with the credentials of this blogger, this view relates to the concept that a franchise is an entry point into a market. While owning a new car franchise is by no means an actual license to print money, an affiliation with a major auto manufacturer is valued by dealers as an opportunity to conduct business operations that may generate profit over and above what is directly attributable to new vehicle sales.

The Components of an Auto Dealership: Functions and Profit Centers

The following are the functions and profit centers that typically comprise an automobile dealership:

- New vehicle sales
- Used vehicle sales (retail and wholesale)
- Fixed operations
- Parts
- Finance and insurance

A dealership property houses an enterprise with multiple intertwined profit centers, as shown in Table 1.

New Vehicle Sales

New vehicle sales are typically the primary, as well as the most obvious, function of auto dealerships. However, new car sales are far from the only source of revenue or profit for a dealership. At many dealerships, new vehicle sales are viewed as the instrument that generates and sustains demand for the other components.[8] New car sales bring people in the door, but they are not the only source of revenue that keeps the lights on.

Having an established relationship with the manufacturer (or an entry point into the market) is critical for auto dealerships. While there are multiple revenue streams that do not directly involve selling new vehicles, many would not be possible without a license to sell new vehicles.

Used Vehicle Sales

Many properties known for the marketing and sale of new vehicles sell a significant number of used

Table 1 Average Auto Dealership Profile

	2009	2010	2011	2012	2013	% change 2012–2013
Total dealership sales	$26,645,303	$30,941,801	$35,128,692	$37,993,989	$41,333,975	8.8%
Total dealership gross	$4,060,649	$4,498,949	$5,047,340	$5,216,294	$5,539,675	6.2%
As % of total sales	15.2%	14.5%	14.4%	13.7%	13.4%	
Total dealership expense	$3,658,560	$3,863,023	$4,252,805	$4,380,646	$4,616,427	5.4%
As % of total sales	13.7%	12.5%	12.1%	11.5%	11.2%	
Net profit before taxes	$402,090	$635,926	$794,536	$835,649	$923,248	10.5%
As % of total sales	1.5%	2.1%	2.3%	2.2%	2.2%	
(Net pretax profit in constant 1982 dollars)	$187,454	$291,575	$353,284	$363,959	$396,414	8.9%
New-vehicle department sales	$13,937,579	$16,352,208	$19,114,448	$21,361,580	$23,599,234	10.5%
As % of total sales	52.3%	52.8%	54.4%	56.2%	57.1%	
Used-vehicle department sales	$8,537,426	$10,244,937	$11,369,595	$12,063,177	$12,945,520	7.3%
As % of total sales	32.0%	33.1%	32.4%	31.8%	31.3%	
Service and parts sales	$4,170,298	$4,344,656	$4,644,649	$4,569,233	$4,789,222	4.8%
As % of total sales	15.7%	14.0%	13.2%	12.0%	11.6%	
New-vehicle average selling price	$28,966	$29,793	$30,659	$30,910	$31,762	2.8%
Used-vehicle average selling price	$14,976	$16,474	$17,267	$17,547	$18,111	3.2%
Average net worth (as of 12/31)	$2,235,369	$2,563,220	$2,838,652	$3,005,725	$3,181,198	5.8%
Net profit as % of net worth	18.0%	24.8%	28.0%	27.8%	29.0%	

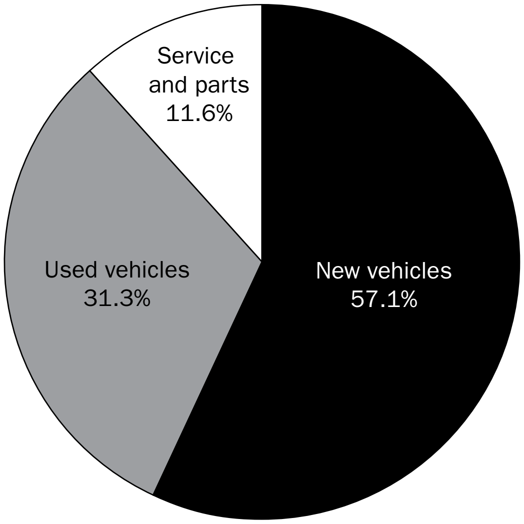
Source: National Automobile Dealers Association, *NADA Data 2014: Annual Financial Profile of America's Franchised New-Car Dealerships* (McLean, VA: NADA, 2014), 3, www.nada.org.

8. New car sales account for less than 20% of dealer margin in the US and often even have negative returns. (Source: McKinsey & Company, *Innovating Automotive Retail: Journey Towards a Customer-Centric, Multiformat Sales and Service Network* (McKinsey & Company, 2014).)

vehicles as well.[9] In fact, it is not that unusual for the sales of used vehicles to exceed the sales of new ones. Used vehicles have obvious appeal in economic downturns because of their lower prices, which has a stabilizing influence on the income stream for the dealership as a whole (see Figures 1 and 2). Even in strong economies, some dealers have found that they can effectively market used autos to consumers who would like to drive something nicer than what they would be able to afford new.

The marketing of new and used vehicles complement each other, as buyers seeking one are often a good candidate for the other. Furthermore, accepting trade-ins promotes dealers' goals by creating inducement for new car shoppers to become buyers while replenishing their used vehicle inventory. In addition to selling used vehicles on a retail basis (i.e., to the public), many dealers use their dealerships to operate substantial wholesale used auto businesses as well.

Figure 1 Share of Total Dealership Sales Dollars as of 2013



Note: The new and used vehicle percentages include finance and insurance revenues associated with those sales.

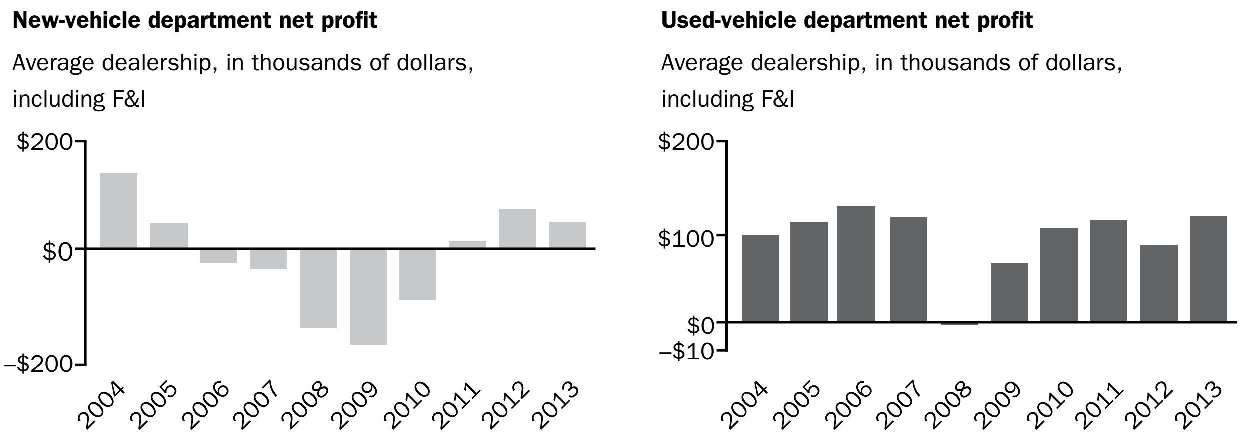
Source: National Automobile Dealers Association, *NADA Data 2014,* 6.

Fixed Operations

Service operations are known as *fixed operations*, or simply *fixed ops.* Fixed operations generate revenue from warranty work, which is paid by the factory, as well as repair and maintenance paid by the customer. Some industry experts note that vehicle quality is constantly improving, depriving dealers of the opportunity to make repairs. A large number of recalls kept many service departments busy in 2014, although it would be hard to attribute that to constant quality improvements.

Fixed operations typically account for a relatively small share of the total revenue generated at a dealership. However, in some instances it accounts for the largest share of the profits. According to Urban Science, revenue from parts and service departments are sometimes sufficient to cover all or

Figure 2 New Versus Used Vehicle Department Net Profit

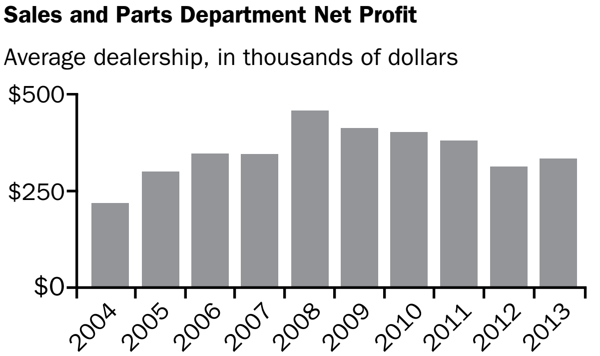


Source: National Automobile Dealers Association, *NADA Data 2014,* 7.

9. Three out of four automotive transactions in the US involve previously owned vehicles. (Source: J. D. Booth, "Fun Used Car Facts," CNN (September 19, 2008), www.cnn.com.

most of the fixed expenses of the entire dealership operation. (Figure 3).

Figure 3 Service and Parts Department Net Profit



Source: National Automobile Dealers Association, *NADA Data 2014,* 7.

Parts

Parts departments have shown consistent growth and profitability over the last several years. Have you noticed that recently constructed dealership properties often have prominent and attractive parts counters that look more like a retail store than a place for mechanics to hang out, whereas their older counterparts have parts departments with bare-bones finishes that are tucked away in back? Selling new vehicles is still what draws consumers, but this design change is a response to the reality that selling parts can be lucrative, too.

Finance and Insurance (F&I)

What happens after you strike a deal to purchase a new car and the salesperson is done shaking your hand? You go to that small office to talk about your financing options. During periods of easy credit, lenders are so tightly interwoven into the car-buying process that dealers make money just by getting loans approved. Buyers paying all cash used to get better deals because they had more leverage. The last time I bought a car, I was told I could only get the best price if I agreed to finance.

Making money through finance and insurance products is more important to dealers now than ever before. The amount of information shoppers have today about automobile prices is so great that it can squeeze dealers who had historically exploited the fact that they knew more than the buyers. Dealers can still prosper, though, because they can sell you that new car at a break-even price and then do so well selling you financing and insurance that on the whole they are very glad to call you their customer. The Internet has made it easy to learn more about OEM pricings and dealer markups, so it's fairly simple to figure out the minimum price a dealer is likely to accept for a car. However, financing (particularly leasing) is as complicated as ever, so the resulting advantage to the dealer remains.

How much money is attributable to the finance and insurance component of a dealership operation? Table 2 shows the revenue from this source for public dealerships at both low and high points in the industry's business cycle.

If you're a real property appraiser, though, does this really relate to what you do? Let's step back for a moment and clarify the link and the distinction between valuing real property and analyzing business considerations. An office where financing and insurance decisions are worked out is usually a small, nondescript office from which a lot of money can be made. But what distinguishes it from any other small, nondescript office? The answer is its location near the auto dealership showroom, because this strategic location can be used to sell lucrative products to people who have just bought a vehicle. The money made selling vehicle financing is a business value consideration; the fact that these sales are usually made from within a structure that attracts customers seeking this product is a real property consideration.

Table 2 Average Finance and Insurance Revenue per Vehicle

Groups	2009	2013
Asbury	$896	$1,308
Group 1	$996	$1,345
AutoNation	$1,104	$1,361
Sonic	$929	$1,138
Lithia	$960	$1,122
Penske	$913	$1,040
Average	$966	$1,219

Source: *Automotive News* company reports, see www.autonews.com.

Single Brand vs. Multiple Brands

As dealership groups tend to become larger, they are better able to hedge the risk associated with changes in the economy and market by selling multiple brands. Just as stock investors seek to diversify their portfolios, auto dealers that offer a variety of products at different price points can help stabilize their cash flows when there are inevitable changes in the business environment. BMWs sell well some years while Kias sell better other years; however, operators who sell both can profit year after year. Dealers often seek this diversity within a single property by selling multiple brands under the same roof. However, as dealership groups tend to become larger, they can often achieve this diversity through opening multiple locations within the same market as well. Furthermore, some manufacturers are opposed to cobranding, preferring their product to be the only one available at a given store.

Applicability of the European Model in the United States

Everything we've discussed so far pertains to selling automobiles in America. Quite frankly, much of this information will do you no good if you are valuing a dealership property in France. The United States is distinctive because strong franchise laws shape the way vehicles are sold, and that in turn shapes the real estate needs of those who sell them. Let's take a brief look at the European model, though, as it is conceivable that current practices abroad could hold some information about the future in the United States.

The fundamental difference in the way that vehicles are marketed in Europe versus the United States is that overseas OEMs sell to consumers directly without a middleman (i.e., a dealer). Some automakers in the US are seeking opportunities to have first-hand interactions with prospective customers and expose them to their products without forcing them to visit a dealership, and these automakers have begun experimenting with European retail strategies domestically. However, US dealer franchise laws prevent manufacturers from getting directly involved in the marketing process too deeply. Tesla Motors is currently challenging that premise and attempting to sell a limited number of vehicles to consumers directly in certain states. This effort is facing significant legal opposition from groups representing dealership networks, but warrants monitoring. If OEMs are ever allowed to sell significant amounts of their product without dealers, it could have a profound impact on the demand for and design of dealerships.

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Web Connections

Internet resources suggested by the Y. T. and Louise Lee Lum Library

American International Automobile Dealers Association
http://www.aiada.org

Automotive News—Directory of Local Dealer Associations
http://www.autonews.com/section/dealer-associations

National Automobile Dealers Association (NADA)
—Research
http://www.nada.org/industryanalysis/

—American Truck Dealers
https://www.nada.org/ATD/

National Independent Automobile Dealers Association (NIADA)—Used Car Dealership Information
http://www.niada.com/