Blue sky: much more than a numbers game

Posted By: Joseph Aboyounon: March 14, 2018In: Contributors
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A Subaru dealership purchased five years ago for three times earnings was obviously a phenomenal investment for the Buyer and a poor decision on the part of the Seller. Conversely, the purchase of a Hyundai store at that time for the same multiple was likely an ill-advised acquisition and a blessing for the Seller. How does one ensure that it is on the right (successful) side of such scenarios?

The clear and important lesson learned from such scenarios is that blue sky is not simply a multiple of earnings. Rather, it entails a complex consideration of a myriad of factors and a reasoned allocation of weight to each to make a true (and safe) assessment.

The widely-publicized reports on blue sky multiples for automotive franchises, both regular and high-line, are a good starting point in your evaluation. However, the pure reliance on multiples can be extremely risky and, in certain instances, completely inaccurate. For example, what if a high-line dealership reflects no or negative profits? Would a BMW franchise in such condition have no value? Conversely, what if the dealership is a major over-performer? Is a Chevrolet store truly worth a multiple of three if it is averaging $5,000,000 profit per year?

Simply stated, earnings are just one consideration in the evaluation process, albeit an important one. Beyond earnings, there are many additional (sometimes intangible) factors to consider. The following are some of the most salient from my perspective:

- <u>Facility</u>: Even the value of a well-performing dealership must be discounted if its facilities are deficient, whether in terms of franchise requirements or operational constraints. This problem translates into additional costs for the deal and should be employed as a discount against a proffered price. It is also likely to result in an additional rent factor not reflected in historical earnings.
- <u>Performance</u>: Ironically, many sophisticated Buyers will shy away from an over-performing store and are attracted to the poorly-run operation. The obvious "problem" with the former is that it leaves very little room for upside growth.
- <u>Historical Strength of Franchise</u>: Certain franchises have held strong in terms of sales and quality over many years. Others had their ups and downs. Still others have been consistently problematic. Of course, the ascribed multiple for a franchise takes this into account. However, the more difficult job is to assess the direction of the franchise. The Subaru and Hyundai examples above are prime examples.
- <u>Competition</u>: A market devoid of strong competition, both involving the same franchise and other lines that are likely to be competitive, is obviously an important positive factor. The converse is also true. A market saturated with strong performers of either the same line or competitive lines presents a strong concern for the Buyer and, hence, forms the basis for discount.
- <u>Franchise Issues</u>: A dealership rife with franchise issues is a double-edged sword for a Buyer. Such issues typically include deficient sales performance and poor C.S.I. On the one hand, it is an opportunity for a Buyer since it usually provides a major upside potential. On the other, it could take a Buyer year to rectify the problem(s), which will likely impair profitability. This factor must be carefully evaluated. In all likelihood, it becomes a discount factor for most Buyers.
- <u>"Negative Blue Sky"</u>: Of similar ilk is a Seller that has so poorly operated (even with a strong franchise, such as Toyota) that it could take a Buyer years to overcome the negative impact on operations, customers and employees. In a recent negotiation, I heard a Buyer refer to this as a "negative blue sky", which is a perfect perception of this scenario. Obviously, this factor can severally impact the otherwise strong value of a particular franchise.

- Deal Structure: Some Sellers will insist on an equity sale structure of the buy-sell transaction in order to avoid certain adverse tax consequences. This may take the form of a stock sale or membership sale, as opposed to the traditional asset format. This structure normally results in diminished tax benefits to the Buyer, not to mention the risks inherent in an equity purchase. As such, a buy-sell structured as an equity purchase should result in a diminished value for the blue sky.
- Other Factors: Here are other factors to consider in weighing blue sky value:
- Whether the Seller's employee staff is qualified and strong at every level.
- Whether the deal involves some additional costs, such as significant obligations to be assumed (e.g., computer/software contracts, equipment leases, maintenance agreements, and the like).
- Whether there are outstanding collective bargaining agreements, whether effecting service employees, sales employees, or both

Evaluating blue sky from either the Seller of Buyer side of the table is no easy task. Earnings and prevailing multiples certainly weigh heavy in this regard. However, the full understanding of the true value of a franchise or dealership must entail a comprehensive analysis of all relevant factors to achieve the optimal result.

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