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How to position your dealership for the future

History is replete with examples of prominent businesses that went bust when their industries underwent rapid change and they didn't adapt quickly enough. For example, Kodak didn't take digital photography seriously, and Blockbuster didn't see the rise of streaming services until it was too late.

With the rapid shift to online car buying caused by the COVID-19 pandemic, as well as the rise of online retailers like Carvana and TrueCar, the automobile industry may be on the cusp of a similar change. In fact, one auto industry executive has said that the pandemic accelerated the shift to online car buying by at least three years.

What do car buyers expect?

Positioning your dealership for the future starts with understanding customer expectations when it comes to car buying. According to a report released last year by The Harris Poll and global retail consulting firm Urban Science, 61% of consumers believe that the entire vehicle purchase process (especially the online process) will change permanently as a result of the pandemic.

Here are a few more survey findings that help shed light on what today's consumers think about the car buying experience:

- About 36% believe there's no reason to visit a car dealership again,
- More than 78% see some benefit to shopping for a new vehicle entirely online vs. in-person,
- About 70% are comfortable doing contracting or financing paperwork and discussions online,
- Around 82% believe specific elements of the vehicle purchase process can't be replicated online (especially the test drive), and should be done in person, and
- Nearly 93% have some concern about an entirely online new vehicle purchase process.

The report concludes that dealerships should prepare to give car buyers the ability to purchase a vehicle in the manner they desire, which may be online, in person or a combination of the two. Buyers should be allowed to choose the combination that works best for them.

What is a good online shopping experience?

Given the importance of virtual car shopping today, dealerships

Misconceptions about Millennials and car buying

Planning for the future should involve strategizing how to sell vehicles to Millennials, or those ages 25 to 39. Some believe that Millennials have little interest in owning cars, pointing to factors like delays in getting driver's licenses, concerns about the impact of carbon emissions on the environment, and the ready availability of ride-sharing services like Uber and Lyft.

But this assumption might be false. Millennials bought more new cars in 2020 than any other age group, according to research conducted by J.D. Power. This demographic accounted for 32% of total new car sales, topping Baby Boomers for the first time ever. And Millennials were twice as likely as Baby Boomers to shop for, and buy, a new or used car completely online.

In addition, the *2020 EY Mobility Consumer Index* published in late 2020 found that almost one-third of non-car owners intended to buy a vehicle in the next six months — and nearly half of them (45%) were millennials. "Millennials leading the increase in global car ownership would have been unthinkable a year ago," stated the report. "The industry should recognize that there is a new market out there that didn't exist until very recently."

need to focus on creating an exceptional online experience for customers. This includes making a good first impression by presenting online shoppers with an aesthetically pleasing, user-friendly website that's easy to navigate.

For example, make it simple for customers to find the make and model of vehicles they're searching for. Replace cumbersome online forms with live chat whenever possible. And allow online shoppers to add accessories, like spoilers and custom rims, and to view cars digitally and from multiple angles. This could help boost high-margin accessory sales and store profits.

It's also important to seamlessly merge the online and brick-and-mortar shopping experiences. Most buyers today start by performing online research on vehicles. When they decide to visit a dealership in person, the process should feel like one continuous interaction.

Moreover, any information shoppers have obtained online should be consistent with what they find when they set foot in the dealership. This includes vehicle descriptions, special promotions and offers, and monthly payment estimates. Customers shouldn't feel like they have to start from scratch when visiting the store. Ultimately, the goal should be to make things as fast and convenient for customers as possible, regardless of which shopping method they choose.

Given the importance of virtual car shopping today, dealerships need to focus on creating an exceptional online experience for customers.

Start planning now

Now's the time to ensure that your dealership is well positioned for the future. Think about some ways you can adapt to the changing world of car buying — and avoid becoming one of the Kodaks or Blockbusters of the automobile retailing world.

Buying or selling a dealership?

An earnout provision may help close the deal

In a volatile economy, deals can be elusive — whether you're selling cars or a business. What happens when a purchase, or sale, of a dealership is held up because the parties can't agree on the financial terms? An earnout provision can help bridge the gap.

Get to know an earnout

An earnout provision is contractual language that commits the buyer to make additional payments to the seller if the business achieves agreed-upon financial targets after the sale. Sometimes earnouts are called "payouts" or "contingent payments."

Earnout arrangements can be the answer when the seller and the buyer disagree on the purchase price, and the seller believes that the business will do well. An earnout also can be useful when the buyer can't come up with the full purchase price, and the deal will collapse without seller participation.

Come to agreeable terms

In an earnout agreement, the seller typically accepts a payment lower than the asking price and maintains an interest in the business. As mentioned, if the agreed-upon financial targets are met during a specified period, the seller will receive additional remuneration. Some earnout provisions give the seller the right to claim company assets if the buyer fails to meet the payment schedule.

For example, say an auto dealer is firm with a $2.5 million asking price for his business based on projected earnings. But the buyer is only able to pay or finance $2 million. The two parties could agree on an earnout provision whereby the seller will be paid $1.75 million at closing and receive payments totaling $750,000 over the next three years. These payments would hinge on the dealership achieving, for instance, $20 million in gross annual sales for each of those years.

Set up financial targets

A crucial part of an earnout provision is developing the financial targets or milestones. As noted, these will entitle the seller to be paid the balance of the purchase price. Set targets carefully, making sure that the new owner will likely achieve them.

The targets might involve gross sales, as in the example above, or some other metric, such as the number of new and used retail units sold or gross profit percentages by department. Or consider a different metric: A buyer might agree to pay the seller, for instance, 20% of annual earnings that exceed the previous year's earnings by a certain amount. Your CPA can help develop or assess ideal targets for an earnout arrangement.

Realize the risk factors

During the life of the agreement, various factors might affect the buyer's ability to meet financial targets. Thus, the length of time over which post-closing payments will be made can be a risk factor. Three years is generally the longest term covered by an earnout provision.

Another example of risk is that the new owner might decide to take on the costs of an expensive renovation project or relocate the dealership. If the buyer decides to write off a portion of the renovation project's expenses or the move, the resulting change could lower earnings, causing the seller to lose out on one or more earnout payments.

To guard against this scenario, both parties need to identify any contingencies — the "what ifs" — that could affect the buyer's ability to meet the financial targets. Moreover, they must build in some protective measures so that the seller is adequately paid. Such measures could include restrictions on owner salary and compensation or on rent increases, or ceilings on the amount of capital expenditures allowed per year. A keen understanding of every risk facing the dealership is essential to crafting the right targets and identifying the contingencies to attach to each.

Get good advice

Each situation is unique, and the parties come to the table with different strengths and weaknesses. So, make sure that you obtain good financial and legal advice applicable to your specific situation. You might find that an earnout provision is the right solution for your deal.

Why LIFO accounting might be attractive right now

Both new and used car prices have risen sharply this year, due mainly to a combination of high demand and tight inventories. For example, Ford reported an average vehicle transaction price of $43,600 in April, while General Motors reported that transaction prices rose by an average of $3,500 per vehicle in the first quarter of 2021 compared with the same period last year.

This rising-price environment makes now a good time to consider the benefits of switching to last-in, first-out (LIFO) inventory accounting. This accounting method can lower income taxes and create other financial benefits for dealerships.

The nuts and bolts

LIFO counts the last vehicles to arrive at a dealership as the first ones sold when calculating the cost of goods sold. Conversely, with first-in, first-out (FIFO) accounting, the first vehicles to arrive at a dealership are counted as the first ones sold. When vehicle prices are rising, like they are now, using LIFO raises the cost of goods sold, which lowers net income and taxes.

For example, assume that a dealership paid $35,000 for a 2021 model vehicle in the spring and then bought the same model in the fall for $38,000. In November, the dealer sold one of

these vehicles for $43,000. How much profit would the dealership report for this sale?

If the dealership uses FIFO, it would deduct the amount paid in the spring ($35,000), resulting in a taxable profit of $8,000. But if the dealership uses LIFO, it would deduct the amount paid in the fall ($38,000), resulting in a taxable profit of just $5,000.

LIFO tax benefits can accumulate from one year to the next, creating a LIFO reserve (or the difference between LIFO and FIFO inventory calculations). This reserve can grow quite large over time.

In addition to reducing income taxes, using LIFO might help you reap other financial benefits. For example, LIFO usually makes it easier to match inventory costs to revenue.

Potential drawbacks

There's an old saying that the tax tail shouldn't wag the dog, and this may come into play with LIFO. Why? While lowering income reduces current taxes, it also lowers reported net income on your financial statements. This is due to the fact that if LIFO is used for tax reporting purposes, it also has to be used for financial statement reporting.

Most dealerships — especially those that are publicly held — want to increase, rather than decrease, net income on their financial statements. The same goes for privately held dealerships that might be sold in the near future. These owners usually want to maximize net income on their financial statements to increase the business's earnings stream and, therefore, its selling price.

There's no one-size-fits-all solution that's right for every dealership when it comes to which inventory accounting method to use.

Also, when selling a dealership, owners may have to repay the LIFO reserve. This lowers their after-tax proceeds from the sale.

Make the right choice

There's no one-size-fits-all solution that's right for every dealership when it comes to which inventory accounting method to use. Talk to your accounting professional about which method is best for your situation.

Using VINs and AI to improve online marketing

In the same way that DNA reveals details about each person's individual traits, a vehicle identification number (VIN) gives you access to almost everything you'd want to know about a vehicle. This includes its trim level, model year, engine type, platform and where it was built. The VIN acts as a unique identifier for the vehicle — no two vehicles in operation have the same combination of 17 characters (digits and capital letters).

Mining the data

Some tech-savvy dealerships are now using VINs to more precisely target online marketing of their vehicles. High-tech digital tools like artificial intelligence (AI) help dealerships mine the data contained in VINs to describe their vehicles more completely and accurately. This makes it easier for customers to find the exact make, model and trim package they're looking for.

VINs are used in conjunction with AI to better allocate marketing dollars and determine the best places to market specific vehicles online — whether using Google, Facebook or a third-party website, such as Autotrader or CarGurus. AI also uses VINs to discover which vehicles are in the greatest demand in particular regions of the country and determine whether price adjustments should (or shouldn't) be applied.

Digging deeper

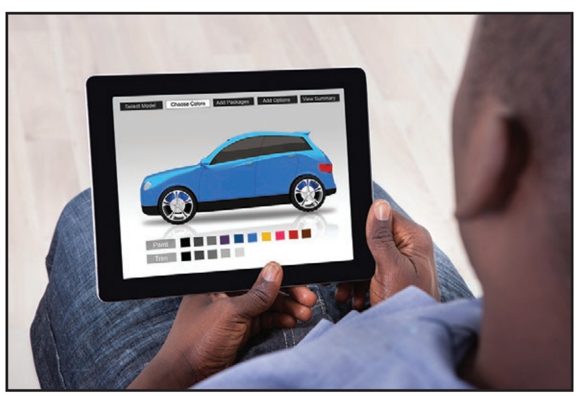
AI crunches massive amounts of data (or "big data") to determine what the market is saying about a vehicle and its features. For example, a vehicle might be getting lots of views from online shoppers, but little interest as measured by click-throughs. In this case, a price discount might be in order.

On the other hand, a vehicle might be getting lots of click-through traffic and generating significant interest among online shoppers. In this case, it will probably sell sooner rather than later, and the price should probably be left alone. It's even possible that the right online shoppers aren't seeing the vehicle. This could indicate that the vehicle is being marketed on the wrong online channels.

Using high-tech marketing

While VINs and AI put a high-tech twist on marketing new and used vehicles, the concepts behind dealership marketing strategies haven't changed. For decades, experienced salespeople have used *human* intelligence to determine how interested shoppers are in certain vehicles on the lot and to help them find exactly what they're looking for.

These tools do the same thing, but on a much bigger scale — and outside the confines of a dealership showroom. The goal remains the same: to get cars in front of as many buyers as possible. Talk to your CPA advisor about how your sales team can use VINs and AI to improve the online marketing of your vehicles.



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Proven expertise in helping dealerships build success

In automotive accounting, as in other specialized practice areas, experience matters. That's why dealerships throughout Massachusetts turn to Paul A. Cerrone, CPA for their tax, accounting and auditing needs.

Our more than 30 years of experience in the automotive industry enable us to excel in helping our clients advance their success. Our team is ready to assist you with these and other highly professional services tailored to your specific needs:

- Accounting, reporting and auditing
- Corporate and personal tax planning and filing
- Inventory and operations management
- Cost segregation and profit analysis
- Payroll and bookkeeping
- Cash management and LIFO accounting
- Internal controls and accounting systems
- Budgets, forecasts and projections
- Business valuations and consulting
- Succession planning and ownership transition
- Gift and estate planning
- Representation before tax authorities

Paul A. Cerrone, CPA, MST, CVA, managing partner, is an ADP Certified CPA with more than 30 years of experience in serving automotive dealers. He specializes in helping clients minimize taxes, maximize profits and achieve their business and personal financial goals. Paul can be reached at 508-845-7600 or pcerrone@cgscpas.com.

We would welcome the opportunity to put our expertise to work for you, your family and your company.

Please call us at 508-845-7600 and let us know how we can help drive your success to the next level.