

# Dealer News

A newsletter for your dealership

## Introduction

Welcome to the Spring edition of Dealer News.

*This newsletter addresses issues relevant to the statutory compliance, leadership & management and the business operations of dealerships.*

*The BDO Dealer Services Team concentrates on servicing the needs of dealers in the following sectors: Agricultural, Caravan, Marine, Motorcycle, Motor Vehicle and Truck. With extensive dealership experience, we are well placed to advise on the issues facing your business.*

## Inside this issue

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- **Return on equity:  
How do you rate?**
- **Exit strategies for smooth  
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## Fraud in dealerships

### *Would losing \$200K in a year affect your cashflow?*

While for many this would have a severe impact, in some instances it may go unnoticed for many years. So how can you minimise the risk of fraud?

Fraud covers a range of offences from the misappropriation of assets including cash, trade secrets or intellectual property to bribery and the alteration of computer records. In most cases good systems and controls are the front line deterrent to fraud.

A simple example experienced by many dealerships is the situation where one person both receipts and banks cash received. It is much easier for one person to hide 'missing' cash than if the roles were split between two people.

Often, business owners cannot believe an employee has taken money. In many situations the employee is long-standing, trusted and treated as part of the family—small business often have a 'family atmosphere'. It is this 'atmosphere' that can allow a defrauding employee to go unnoticed.

Business control systems need to be effective, efficient and reflective of operation size. If there are too few employees for duty segregation, other controls need to be implemented: dual signatories, monthly reconciliation reviews, limiting authorisation of payments and computer password security.

Premises security is also important with individual PIN codes for security systems allowing owners to track office entry on weekends and after hours.

Read your insurance policy: Does it cover employee fraud and the ensuing cost of any investigation? Does it limit payout on the claim made? Be aware of fraud reporting time frames to avoid any insurance non-compliance issues.

Fraud control does not need to be costly but done correctly it could save you both time and money in years to come. **If you would like further information on reducing your risk of fraud, please contact your local BDO Dealer Services Partner.**

# Return on equity: How do you rate?

## What is an acceptable rate of return for an equity investment in a dealership business?

This question is often asked but the answer is based on a mixture of folklore, market evidence, and trial and error. In this article we present a theoretical framework for developing a model for calculating a fair rate of return on an equity investment in a dealership.

### Capital asset pricing model

The Capital Asset Pricing Model (CAPM) is a useful model that describes investor behaviour and the tradeoffs investors make between risk and return. The model presupposes that rational investors require a higher rate of return for acceptance of a higher risk. Investors can reduce diversifiable risk by spreading their investments, but in the end investors have to accept the risk inherent with investing in the market.

The CAPM model suggests that there is a linear relationship between risk and return. Using a formula, the relationship of the CAPM is usually expressed as follows:

$$E_R = R_f + (\beta)(R_m - R_f) + \epsilon$$

$E_R$  = Expected return on owners' equity

$R_f$  = Risk free rate of return

$\beta$  = Co-variance risk (riskiness of particular investment to the market)

$R_m$  = Long term historical return on shares in publicly listed securities

$\epsilon$  = Adjustment for lack of market liquidity

The above formula is difficult to accurately calculate without the appropriate information and the relevant skills needed to then interpret this information. However, this formula can be defined on a practical level as a summation of the following:

- Risk free rate (eg. Government bond returns)
- Additional return for risk premium for investing in a dealership; and
- Additional return for investing in a private company instead of a public company

### What is a fair return?

Applying the formula determined in the CAPM above it could be argued that the expected after tax return from an equity investment in a dealership business should be in the order of 21.5%. The following outlines how, by adopting certain variables and applying these to the CAPM formula, you can determine a fair return:

$R_f$ : An amount of 6% based on the currently prevailing long-term bond rate of 5.82%.

$R_m - R_f$ : 7% based on the commonly accepted risk premium for public securities in Australia.

$\beta$ : 1.5

There are three public companies operating in the retail motor industry in Australia. Each of these companies has published beta ( $\beta$ ) rates calculated on the share price movements compared to the general market.

Company	Operations	Beta ( $\beta$ )
AP Eagers Limited	Diversified retail motor car group, parts distribution business and property holdings	1.4
Auto Group Limited	Motor vehicle auction business	2.0
Adtrans Group Ltd	Diversified retail motorcar and truck group and parts distribution business	1.35

As the above indicates, there is limited comparable industry data on the Australian Stock Exchange. In time, the introduction of Automotive Holdings Group Ltd to the share market will allow further comparison. However, even where comparable information is available it must be used with caution because of the unique characteristics of each dealership.

For the purposes of our analysis, and using the above information as a guide we have adopted a  $\beta$  of 1.5 as being representative of the industry.

$\epsilon$ : 5% being our estimate for this example of the additional return required by owners for the lack of liquidity associated with shares in privately owned companies because there is no ready market for such securities. This equates to approximately 20% to 25% of the total return.

Accordingly, 
$$E_R = 6\% + (1.5 \times 7\%) + 5\% = 21.5\%$$

It is important to note the expected rate of return is derived from market data, and all market data is based on after tax rates of return on publicly listed securities. Accordingly, the amount of 21.5% is an after tax rate of return. You should also be aware that most dealerships are funded through a mixture of debt and equity. When undertaking an assessment of your own dealership you need to consider this issue and adjust your analysis accordingly.

Finally, when undertaking an analysis of return on equity you must ensure all available information is considered. The information in this article may not apply to all circumstances and may not consider all information relevant to your dealership.

# Exit strategies for smooth succession

*Many dealership owners cherish the vision of building a business that they can pass down to the next generation of their family.*

While many owners do just that, some find themselves facing an uncertain future. Many have concentrated their wealth and working life in the dealership, finding themselves relatively alone in deciding what comes next.

Succession strategies provide certainty for owners and their business as well as manage significant risk. The more time spent planning, the smoother and more effective it will be: *succession is a process, not an event.*

Whilst there are a number of exit strategies available to owners, transition to the 'next generation' can be a very rewarding experience. This article outlines a process designed to help dealership owners increase their prospects for a successful transition and/or exit to family or non-family by working through a few critical steps.

## **1. Clarify your goals: personal, ownership, business, and financial**

Until you have clarified your own goals, it is not possible to effectively prepare your dealership for transition. Many dealers assume their family and highly valued managers understand what is planned/expected of them. The result of this assumption is frustration—why won't these individuals 'step up' and lead? Ultimately, a lack of clarification around owner's goals can lead to feelings of betrayal—potential owners leave the dealership because things didn't work out or they weren't interested.

## **2. Communicate openly with all your key stakeholders about your goals and expectations, and clarify their goals and expectations of you—in writing**

What do you expect or require of family members or key managers before you will relinquish authority? Is ownership transition on the table? What must happen before you will transfer ownership?

Many owners unwittingly oversell to non-family and family alike the possibility that 'one day this could all be yours'. Many employees feel both flattered and pressured to respond in a way that the owner interprets as, 'Yes! I accept!'. In many cases, this is where the conversation about goals and expectations ends.

Dealership owners would benefit enormously from first assessing the abilities and willingness of others to accept responsibility before discussing the many opportunities and costs associated with ownership.

## **3. Focus first on the dealership**

Detail matters a great deal in succession. The best way to begin the succession process is with a thorough assessment of what the dealership needs in the future (strategic plan).

While many owners find it difficult not to take the lead in this process, it is far more constructive for all if the potential successor(s) lead the process. The insights gleaned from the planning process will also go along way toward increasing the confidence of the owner as he or she struggles to let go. The effort and ability required to lead the dealership planning process highlights any gaps in ability, interest or cohesiveness of a future business owner.

## **4. Create a leadership development plan**

Considering the future needs of the dealership will help everyone identify the specific needs and gaps in the area of leadership. The owner and successor(s) should consider these needs in several areas:

- Managing the work—all operational aspects.
- Managing the people—structure, leadership style, and transitional issues.
- Managing the money—access to information, financial management knowledge, and critical dealership-specific performance measures.
- Learning how to be an owner—ownership issues, profit allocation, implications of buy-out provisions.

While many owners find it difficult, their commitment is critical to the success of most family business transitions. Most owners underestimate the degree to which their organisation is dependent on things known only to them.

Owners who make a commitment to document and transfer this information will go a long way toward increasing their chances of effective succession.

## **5. Define the transition process**

Business transitions have many important dimensions: due diligence, cash flow considerations, taxation implications and stakeholder consequences, just to name a few.

Many owners have come to regret their failure to adequately define the many details of these transitions in writing. These details should include specific milestones and a succession timeline.

Whilst the details may evolve over time, the initial discipline of documenting the process will go a long way toward improving the prospects for a smooth and successful transition.

***If you would like further information on exit strategies, please contact your local BDO Dealer Services Partner.***

# Hot Topics

## Holdback and dealer swaps

Since the recent changes to the GST treatment of holdback there has been confusion within the motor industry as to the GST treatment of holdback when vehicles are swapped between dealers. Following discussions with senior tax office staff we can confirm that dealer-to-dealer holdback payments are subject to GST.

## MTAQ stands tall

The Motor Trades Association of Queensland has had for some time serious concerns as to the direction and governance of its national body the Motor Trades Association of Australia and has recently terminated its membership of that body. Whilst this was an extremely reluctant position to adopt, unless and until significant changes are made to its processes, the MTA-Q will function as a stand alone organisation.

BDO Kendalls supports the MTA-Q and its members and will be facilitating relevant advice concerning compliance, accounting and taxation matters.

## Romalpa clauses

With the recent demise of a large used vehicle auction house, it is a timely reminder to ensure your documentation for the wholesaling of used vehicle and equipment provides you with adequate protection in the event of default in payment. A properly drafted Romalpa clause allows you to retain title in the goods until such time as you have been paid in full for the goods.

To enforce a Romalpa clause, you must have a trade agreement with each business you are selling goods to on credit terms. We recommend dealers consult their legal advisers to ensure they are adequately protected.

## Salary survey closing soon!

Do you know how much you should be paying your staff? Given this valuable information is often difficult to find in the market place, BDO developed a comprehensive survey specifically for motor dealers, taking into account geographical location and dealership size. The survey looks at cash salaries and benefits for all employees ranging from detailers to dealer principals.

BDO's annual motor dealer salary survey for 2005 is closing soon. Participation entitles you to a complimentary copy of the survey results. Alternatively, the final report can be purchased for \$440. If you'd like to participate, please contact Angela Yates on 07 3237 5956 or ayates@bdokendalls.com.au to obtain further details, including your confidential security code.

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