AUTO DEALERS’ 2018 ECONOMIC OUTLOOK

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2017 was a good year for the auto industry, but signs point to the possibility of a new era of declining sales. Automakers are cutting the production of cars to focus more on higher margin SUVs and crossovers because of the continued growth in demand for these vehicles. All major automakers are investing heavily on autonomous and electric vehicles. The implications of the proliferation of autonomous and electric vehicles for dealerships is widely speculated by industry leaders, but most agree that dealerships will have to invest in new technology to sell and service these vehicles. The changing automotive landscape is creating uncertainty among dealerships, causing many dealers to decide that it is a good time to sell. Gross profit margin at dealer-
ships stabilized in 2017 after several years of decline, likely a result of increased emphasis on F&I revenue. With unemployment down to levels not seen since 2000, and wages beginning to rise, the economy is showing signs of strength; however, the Federal Reserve will likely take measures to slow economic growth in order to combat the threat of inflation.

The seven-year streak of positive sales growth ended in 2017 as total new light vehicle sales dipped in the U.S. for the first time since 2009. Light vehicle sales in the U.S. dropped 1.8 percent to 17.2 million, off the record high of 17.46 million set in 2016. Despite the drop, 2017 recorded the fourth highest year in unit sales.

New car sales continued to fall in 2017, declining 11.5 percent following a drop of 8.7 percent in 2016. Sales of trucks, CUVs, and SUVs increased at a slower pace, increasing 4.4 percent in 2017 after increasing by 7.4 percent and 11.7 percent in 2016 and 2015, respectively. Figure 1 shows annual sales of U.S. light vehicles.

The National Auto Dealers Association (NADA) predicts U.S. sales will decline 2.3 percent in 2018 to 16.7 million. NADA senior economist Patrick Manzi expects light trucks and SUVs/CUVs to account for over 65 percent of total light vehicle sales in 2018. Cox Automotive, Kelley Blue Book’s parent company, also forecasts new car sales at 16.7 million units for 2018. In its 2017 annual report, AutoNation predicted total unit sales to be 16.8 million in 2018. B. Scott Smith, CEO of Sonic Automotive, expects new vehicle volume to be between 16.75 million and 17 million units, as stated in the company’s 2017 fourth quarter report.

**SEASONALLY ADJUSTED ANNUAL RATE (SAAR)**

Surprising most experts, SAAR reached 18.5 million in September 2017, the industry’s best month since 2005. The Bloomberg consensus SAAR forecast had been 17.4 million for that period. SAAR was negative year-over-year in each month of the years until the spike in September. Many analysts believe the September spike was due to summer hurricane activity necessitating the replacement of storm-damaged vehicles and catch up sales from a decline in August. Other factors cited were a five-weekend sales month and increased incentives to move 2017 inventory.

According to an article by Automotive News, traditionally it takes dealers 30 days to restock inventory and for victims to receive insurance proceeds to replace totaled vehicles after a major hurricane. However, Houston is a prime market for highly profitable pickups. As a result, automakers, lenders, and dealers rushed vehicle resupply, cut red tape, and offered special incentives to flood victims after Harvey pounded Houston in late August. This may also explain why trucks/SUVs/CUVs captured 64.7 percent of total volume in September, the highest percentage ever.

Figure 2 shows the decline in SAAR for the first half of 2017, then the spike in September. Since 1990, SAAR has demonstrated a pattern of two growth and plateau cycles.

Unit sales for big three domestic manufacturers were down in 2017 year-over-year. Unit sales of Ford and GM slipped 1.2 percent and 1.4 percent, respectively. Unit sales by FCA were hit hard, declining 8.4 percent. FCA sold approximately 186,000 fewer vehicles in 2017 than it did in 2016, with some of the decline attributable to the company’s strategy
to reduce sales to daily rental car companies. The Jeep brand, traditionally the FCA’s strongest, fell off 11 percent in 2017, pulled down largely by a 67 percent drop in Patriot sales. On the positive side, RAM sold over half a million trucks for the first time in 2017, and the Grand Cherokee had a positive sales growth, up 13 percent. Other notable sales declines in 2017 include Hyundai and Kia, falling 11.5 percent and 8.9 percent, respectively. Hyundai announced plans to launch a pickup truck and a small SUV, the Kona, in the U.S. as part of a broader plan to meet consumer demand for trucks and SUVs. Figure 3 shows a year-over-year comparison of the major brands.

In 2017, compact cars outsold midsize cars for the first time by more than 200,000 units, and minivan sales fell below 500,000 for the first time in six years. Figure 4 further dissects the trend in unit sales, showing light vehicle sales by vehicle type. Domestic car sales fell by 10.3 percent, while domestic light trucks/SUV/CUVs increased 2.5 percent from 2016 to 2017. The largest swing in sales was made in the import market as sales of import cars fell 15.3 percent while import trucks/SUVs/CUVs grew 11.7 percent. According to Edmunds, SUVs are growing as a percent of the luxury market, with much of the growth being realized in the import category shown above. Edmunds expects small SUVs to account for 29 percent of the luxury market in 2018—up from 16.5 percent in 2013 and 8.5 percent in 2008. Figure 5 shows the total units retailed for each public dealership group. Penske has shown steady growth in each year as a result of acquisitions in the U.S. and abroad. Asbury, Group 1, and Sonic unit sales were flat to minimal in 2017 versus 2016. AutoNation remains the largest, but year-over-year growth was flat in 2017.

COMMENTS FROM THE CEOs

Mike Jackson, CEO of AutoNation, in an article published by Automotive News, assured the industry that dealerships would not vanish. However, he believes firmly that disruption and revolution are coming to the industry that will affect manufacturers, suppliers, and dealers. He believes the big disruption coming in five to ten years is the use of autonomous vehicles by taxis, Uber, Lyft, and rental cars. Vehicles for personal use will still be most of the market.

Jackson went on to say that brick and mortar dealerships will always have relevance because people want to come to a place to confirm they are making a good decision on an expensive purchase. He believes that everything tedious and boring will be digitized, and dealerships with scale and brand will have significant advantage. Service departments will not disappear, but there will be a migration to those with technical expertise because of the complexity of the
Figure 4

U.S. LIGHT VEHICLE SALES BY VEHICLE TYPE

Figure 5

TOTAL UNITS SOLD
(EXCL. WHOLESALE)

SOURCE: PUBLIC FILINGS
vehicles. Dealerships have a partnership with the manufacturers that gives them access to the tools, the training, and the parts. As they make investments in infrastructure, the number of entities that can work on these vehicles will decline over time.  

Former GM Vice Chairman Bob Lutz is predicting a much more dramatic shift for the automotive industry, expecting that within 15 – 20 years, human-driven vehicles will be legislated off the highways. He believes this will lead to the demise of automotive retailing as we know it, with dealers existing only as a fringe business for people who want “vintage” vehicles. Lutz went on to state that dealerships will be okay for about 10 to 15 years, but they are ultimately doomed.

Ford’s new CEO Jim Hackett met with investor groups in October 2017 and announced plans to cut $14 billion in costs, shift $7 billion from cars to light trucks, and speed product development and technology implementation. He summed up his vision for Ford in six words: “smart vehicles for a smart world.” Hackett stated in an article by Automotive News, “If Ford wants to compete and win, it must improve its competitive ‘fitness’ and think more like Apple and Tesla than General Motors and Fiat Chrysler.” Hackett is predicting highly connected cities in which cars talk to streetlights without congestion. Ford is so sure about autonomous and electric vehicles that it has vowed to invest $11 billion in electrification by 2022 so it can introduce 40 new vehicles including 16 that are fully electric.

Asbury Automotive Group CEO Craig Monaghan announced in October 2017 that he was stepping down after nine years of leading the company. COO David Hult is his replacement. In a reversal of strategy, Asbury closed its remaining used-only stores, located in Florida. The Q auto store count peaked at four, but never reached profitability. Monaghan said getting inventory was part of the problem and Q auto also struggled to arrange financing without a captive lender. Group 1 Automotive CEO Earl Hesterberg told analysts that financing was one reason his company is staying out of the used-only business. “We’ve looked at it many times over the years, and our impression has always been that the critical factor to success is to be the bank also,” Hesterberg told analysts on a conference call.

AutoNation, Sonic, and Penske are going in the other direction, investing in used-only ventures. AutoNation opened its first AutoNation USA used car center in Texas in 2017, in addition to expanding into branded car parts, auctions, and collision centers. The company’s used car business has a “no haggling” pricing policy so customers deal with one employee throughout the buying process, and most of the transaction is completed on a tablet. Sonic’s management expects to have 20 EchoPark stores by the end of next year, even though the operation continues to generate a loss. Penske chairman Roger Penske does not believe a captive finance company is necessary to have a successful used-only business, stating “I don’t know that at the moment we have the capital available to start a finance company. It’s something we can look at once we have a history, and maybe we get a partner to do something like that.” Penske Automotive intends to double the number of its used-only locations, operating under the name CarSense, within the next 24 months. Penske acquired CarSense in 2017, a stand-alone used vehicle retailer with five locations in the Pittsburg, PA, Philadelphia, PA, and southern New Jersey markets.

**TAX LAW’S EFFECT ON DEALERSHIPS**

Major tax reform was approved by Congress in the Tax Cuts and Jobs Act passed on December 22, 2017. Most economist agree that the overall reduction in taxes to individuals and businesses will result in short-term boosts to the U.S. economy. The Joint Committee on Taxation is forecasting that the bill will boost growth of gross domestic product (GDP) by 0.8 percent over the first 10 years. The economic team at Goldman Sachs estimated that the U.S. economy will get a 0.3 percent boost in both 2018 and 2019 as a result of the tax law. The Urban-Brookings Tax Policy Center (TPC) estimated that the average American will get a tax cut of $1,600 in 2018, with the biggest benefit going to households making between $308,000 and $733,000. By contrast, the highest income one percent of households, which will make about $733,000 and up, would get an average tax cut of roughly $50,000 or 3.4 percent of their after-tax income. About 80 percent of households would get a tax cut while 5 percent would pay more in 2018 (the rest would pay roughly the same as under current law). Among middle-income households, about 90
percent would pay less and 7 percent would pay more.

The federal corporate tax rate falls from 35 percent to 21 percent. How the corporations spend the savings will be demonstrated in the coming years. Critics of the law believe the savings will be used for stock buybacks and increased dividends to shareholders. Proponents of the law believe companies will invest more in new projects and raise wages to employees. In January 2018, Group 1 Automotive announced it will give $500 bonuses to non-management dealership employees out of savings from the tax law. Group 1 joins Fiat Chrysler, Walmart, AT&T, Fifth Third Bancorp, The Home Depot, and many others in boosting employee pay.

The increased tax savings by individuals and potential for higher pay could translate into increased consumer demand for vehicles. However, it could actually dampen sales for high-tax regions such as the northeast and west coast because of the law’s $10,000 cap on deductions for state and local taxes.

**AVG. TRANSACTION PRICE**

The average transaction price for new vehicles in January 2018 was $34,910, down 1.3 percent from the previous month, but up 3.9 percent year-over-year. The largest increases were by Volkswagen and Honda. Other increases of note include General Motors and FCA. Transaction prices for GMC rose seven percent, with the redesigned Terrain emerging as its best performer. Buick’s Enclave rose nine percent. FCA’s average increased on a strong mix of RAM trucks and Jeep SUVs. Dodge rose eight percent, an average that was helped by the discontinuation of the Dart sedan. Figure 6 shows the increases over the 12 months for each major brand.
Edmunds.com reported the industry sold 9.3 million retail used vehicles in the third quarter of 2017. Used vehicles sold by franchised dealerships accounted for 31 percent of total sales, unchanged from the previous period in 2016. Certified pre-owned (CPO) vehicles are becoming more prevalent, as the total has climbed in each Q3 since 2012. Figure 7 shows the number of CPO units sold relative to total used unit sales by franchised dealers.

According to Edmunds.com, the average transaction price for a retailed used vehicle in the third quarter of 2017 was $19,402, up only 0.9 percent over last year. Edmunds also reported the average number of miles on a used car transaction has dropped 14 percent, likely a result of a record number of lease returns. Lease returns are expected to continue hitting the used market at record rates in 2018.

**VEHICLE FINANCING**

In its Q4 2017 State of the Automotive Finance Market report, Experian reported that credit scores have improved since the same time last year. As Figure 8 demonstrates, the largest shift was positive for prime and super prime borrowers.

Experian also reported that 30-day and 60-day delinquencies are improving, especially in Florida and Texas, as improvement in these larger states make up a big part of the improving average. Unchanged from the previous year, 85 percent of new vehicle purchases were financed, and 53.5 percent of used vehicle purchases were financed. New vehicle leases accounted for 28.9 percent of new vehicle purchases.
purchases, largely unchanged from the previous period.

Average monthly payments for new and used vehicle loans reached all-time highs. The average monthly payment for a new and used vehicle loan reached $515 and $390, respectively. The average new vehicle loan term at the end of 2017 was 69.06 months, longer by about 15 days than at the end of 2016. Average loan term for used vehicle loans was 64.12 months, basically unchanged from the previous year.

Interest rates for automotive loans are rising. The average interest rate for a new vehicle loan was 5.11 percent, a 37-basis point increase over Q4 2016. Interest rates for other loans rose also, but to a lesser degree. **Figure 9** shows the year-over-year interest rate changes for automotive loans. **Figure 10** the sources of financing for new and used vehicles. Captive lenders and credit unions have gained market share, while banks have lost ground.

Credit scores for new vehicle buyers improved in Q4 of 2017 but remain lower than in 2012. Credit scores for used vehicle buyers also improved in Q4 2017 and are at the highest level over the observed period. **Figure 11** shows the trend in credit scores. **Figure 12** shows the trend in rising loan amounts, interest rates, and monthly payments since Q4 2015.

**Profit Margin Compression**

According to NADA, average gross profits at dealerships declined in each year from 2010 to 2016. The declining trend was snapped in 2017 as the average gross profit margin at dealerships held steady at 11.4 percent. Average pre-tax margin for 2017 was 2.3 percent, down from 2.5 percent recorded in 2016.
### Table: New and Used Dealership Averages

<table>
<thead>
<tr>
<th></th>
<th>Q4 2015</th>
<th>Q4 2016</th>
<th>Q4 2017</th>
<th>Q4 2015</th>
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<tr>
<td><strong>Loan Size</strong></td>
<td>$29,551</td>
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<td><strong>Interest Rate</strong></td>
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### Figure 12: Dealership Margins

- **Gross Profit Margin**
- **Pre-Tax Profit Margin**

**Source:** NADA

### Figure 13: Public Dealership Groups - Gross Profit Margin

- **Penske**
- **Asbury**
- **Lithia**
- **AutoNation**
- **Group I**
- **Sonic**

**Source:** Public Filings

### Figure 14: Loan Averages

- **Loan Size**: Q4 2015: $29,551, Q4 2016: $30,621, Q4 2017: $31,099
- **Interest Rate**: Q4 2015: 4.63%, Q4 2016: 4.74%, Q4 2017: 5.11%
- **Loan Payment**: Q4 2015: $493, Q4 2016: $506, Q4 2017: $515
- **Loan Term**: Q4 2015: 67 months, Q4 2016: 68 months, Q4 2017: 69 months
- **Lease Payment**: Q4 2015: $412, Q4 2016: $414, Q4 2017: $430

**Source:** Public Filings
**Figure 13** shows the gross profit margin, the pre-tax profit margin in each year, and the change in gross profit margin in each year.

Public company gross profit margins are better than the numbers reported by NADA. In 2017, most groups’ gross margin improved or held steady relative to 2016. **Figure 14** shows reported gross profit margins for the public dealership groups.

Gross profit margin on new units dropped or held steady in 2017. **Figure 15** shows the gross profit margin for new units by each public dealership group. Penske stands out with a gross margin in excess of seven percent. This is likely because 70 percent of retail dealership revenue is generated from premium brands such as Audi, BMW, Mercedes-Benz, and Porsche. Additionally, 37 percent of revenue is from international markets. Asbury’s gross profit for new vehicles was lower than its competitors in 2017. The company reported in its 2017 annual report that the low gross profit margin is a result of a higher mix of revenue from import brands, which traditionally have a lower margin than luxury or domestic brands.

Gross margins for used vehicles are declining for all of the public dealership groups. Lithia’s gross margin has declined in each year, but still maintains a much higher margin than the group. Lithia’s management stated in the Company’s 2017 annual report that used vehicle sales will remain a focus for the company. According to company filings, Lithia’s volume-based strategy allows the company to buy
more vehicles via trade-in, which creates relatively higher gross margins for used vehicle sales. **Figure 16** shows gross profit margins for public dealer groups’ used vehicles.

F&I revenue has increased each year for all public dealership groups. Interestingly, the dealer groups with the lowest gross margins for new vehicles, AutoNation and Asbury, also have the highest F&I revenue per unit sold, demonstrating their strategy to give up margin on the frontend of the deal to pick profit up on the backend.

NADA data shows that F&I income has become more of a priority in recent years as F&I penetration rates are increasing for new and used vehicles. F&I penetration rates are around 90 percent for new vehicles in recent years, and above 70 percent for used vehicles in 2016 and 2017. **Figure 18** shows F&I penetration rates for new and used vehicles over the years.

**FIXED OPERATIONS**

As gross margins on vehicle sales shrink, fixed operations (service, parts, and body shop) are increasingly important as these operations have contributed relatively more to overall gross profit in each year since 2012. Average parts and services absorption ratios have increased each year since 2015. **Figure 19** shows several years of fixed operations gross as a percent of total dealership gross and the parts and service absorption ratios.

**VEHICLE AGE**

Software analytics company IHS Markit reported that the average vehicle age on the road rose to 11.6 years near the end of 2016, which is a record high. The aging vehicle in operation (VIO) is sure to be a boon for dealerships’ fixed operations business. The average age growth of VIO will bring new opportunity for the automotive aftermarket, IHS Markit says. The 40 percent drop in new light vehicle registrations experienced during the downturn in 2008 through 2010 is something that is likely to be felt by businesses involved in aftermarket auto parts and service for years to come. According to IHS Markit, the shifting dynamic of the age of vehicles in operation indicates the volumes of vehicles in the new to five-year-old category will grow 16 percent by 2021, vehicles in the six- to 11-year-old range will grow just five percent, and vehicles that are 12+ years old will grow 10 percent. The oldest vehicles on the road are growing the fastest as vehicles 16 years and older are expected to grow 30 percent from 62 million units today to 81 million units in 2021.

Americans set a record 3.22 trillion miles driven on the nation’s roads in 2016, up 2.8 percent from 3.1 trillion miles in 2015, according to data released by the Federal Highway Administration.
**F&I Revenue per Unit (Same Store)**

2016 Average $1,371

- SONIC
- GROUP I
- AUTONATION
- LITHIA
- ASBURY
- PENSKE

Revenues range from $- to $1,800.

**F&I Penetration Rates**

2011: 81.5%
2012: 73.2%
2013: 76.8%
2014: 80.0%
2015: 85.5%
2016: 90.3%
2017: 95.0%

Source: NADA Average Dealership Profiles
DEALERSHIP BUY/SELL ACTIVITY

In November 2017, Kerrigan Advisors reported that 149 dealership buy/sell transactions were closed in the first nine months of 2017, down from 172 transactions in the same period 2016. The investment banking firm focused on the dealership industry, predicted that total deal activity would reach 200 by the end of 2017, making it the fourth most-active buy/sell year on record.

Kerrigan Advisors projected for 2018 that the evolution of the dealership business will drive more sellers to market. Additionally, more sellers are including real estate in the sale, and captive finance companies are playing more of a role in acquisition financing.

Kerrigan Advisors noted a large increase in domestic-branded dealerships being transacted in 2017, likely a result of lower blue sky multiples relative to some imports. They expect domestic franchises to dominate 2018’s buy/sell market due to an increased supply coming to market and still-attractive blue sky multiples. Figure 20 shows buy/sell market share as reported in The Blue Sky Report, Third Quarter 2017.

The Haig Report, a quarterly publication by the Haig Partners, reported that they see more “supply” of dealerships available for purchase than any time they could recall. Haig suggests that the reason for the increased supply is due to the aging dealer body, or a realization that dealerships have peaked in terms of value. A trend in declining prices is possible as a result of the bulk of dealers wanting to sell.

According to the Haig Report, public dealership groups increased acquisition spending in 2017, with five of the six groups spending $935 million on U.S. acquisitions through the first three quarters, up 62 percent from the previous period. This makes 2017 the year of the highest level of spending on U.S. auto acquisitions over the past decade (except 2014 with Berkshire Hathaway purchased Van Tuyl).

Figure 21 shows public dealership acquisition spending by year.

The stock value relative to earnings for the public dealership groups have a strong correlation to the prices paid for acquiring private dealerships. When a stock is trading at a low value relative to earnings, a company will typically buy back its own stock or find other ways to reinvest in the business. When a dealership group’s stock price is trading at a high price relative to earnings, it makes sense to acquire other dealerships as long as the price of the acquisition is lower, relative to earnings, than the buyer’s stock price.
The price-to-equity (or “P/E”) ratio is a common metric to track when evaluating a public dealership group’s value relative to earnings. “Price” represents the stock price per share and “earnings” represents the company’s earnings per share. For example, if a company has a P/E of 11.8, such as Sonic Automotive at the end of 2017, then investors are paying $11.80 for $1.00 of Sonic’s earnings.

Figure 22 shows the average historical P/E ratios (weighted equally) for the public dealership groups for the end of the year over the last 10 years. Since 2014, P/E multiples have trended down.

Private dealers should pay attention to public P/E ratios. Public buyers of dealerships must make acquisitions that are accretive to earnings. This simply means a buyer cannot pay more for a dealership, relative to earnings, than the price of its own stock, relative to earnings. As a result, as P/E ratios decline, so does acquisition pricing.

Dealership stocks went on a run for several months in 2016 following the presidential election; however, a falling SAAR pushed all the public groups into negative territory through midyear 2017. Lithia Motors, Inc. finished the year up 17 percent, while all the others were up slightly or negative for the year. Sonic Automotive was down 19.1 percent. Figure 23 shows stock performance for each
dealership group in 2017. Lithia Motors, the fourth largest dealership group in terms of new vehicle sales, could surpass Group 1 in its number three spot in dealership size in 2018. Last year, Lithia added about $1 billion in revenue with the acquisition of the five-rooftop Downtown Los Angeles Auto Group, and another $500 million with the acquisition of Baierl Auto Group. The market apparently approved of these acquisitions, as reflected by its stock’s performance in 2017.

In an article by Automotive News that interviewed some of the top dealership buy/sell experts, Erin Kerrigan stated that many large, family-owned dealership groups are wrestling with the idea of selling. She states, “The dealer is at an age where they have to make a decision to pass the business on [to the next generation] or to decide it’s the responsible thing to sell.” The article cites the uncertain impact on dealerships from the implementation of self-driving cars, vehicle subscription services, and electric vehicles as catalysts for generational dealerships to consider selling. Alan Haig was quoted in the article as saying that the increased requirements by manufacturers such as facility upgrades, along with manufacturers’ incentives, thinner margins, and moving towards a digitized world have caused many dealers to consider selling.

**Economic Outlook**

**U.S. ECONOMIC GROWTH**

According to a February 28 release by the Bureau of Economic Analysis (BEA), real GDP increased 2.3 percent in 2017 (that is, from the 2016 annual level to the 2017 annual level), compared to an increase of 1.5 percent in 2016. In the 88 years for which the BEA has calculated the annual growth in real GDP, the period from 2006 through 2017 is the only 12-year period in which real GDP did not grow by at least three percent in any year.

On December 17, the U.S. Federal Reserve released its most recent economic growth forecast, bumping up projections for near-term U.S. economic growth. The Fed increased its 2018 growth forecast from 2.1 percent to 2.5 percent, edged up its 2019 forecast from 2.0 percent to 2.1 percent, and boosted its 2020 projection from 1.8 percent to 2.0 percent.

The Atlanta Federal Reserve is expecting a GDP gain of 5.4 percent in the first quarter, which would be the best quarterly increase since the recovery began in mid-2009.

**INTEREST RATES**

The Federal Reserve, as expected, raised its benchmark interest rate three times in 2017, totaling five hikes since the U.S. financial crisis. Fed policy makers announced on December 13 an increase in the benchmark federal funds rate to a range of 1.25 percent to 1.5 percent, pushing the Prime rate to 4.5 percent. The Fed traditionally hikes interest rates when the economy appears overheated and inflation is a concern.

**EMPLOYMENT AND WAGES**

December 2017 was the 87th straight month of net job gains, extending an all-time U.S. jobs growth record. At the end of 2017, unemployment was at 4.1 percent, the lowest rate since 2000. The U.S. underemployment (U-6) rate—defined as unemployed individuals plus part-time workers who would prefer to be working full-time—was 8.1 percent in December, according to a U.S. Labor Department report released on January 5, 2018. This figure reached as high as 17 percent in 2010. In February 2018, the number of Americans filing for unemployment benefits (U.S. weekly jobless claims) fell to a 45-year low.

Many economists believe that 2018 will be a period of rising wages. In January 2018, wages in the U.S. were up 2.9 percent relative to last year, the fastest pace of wage growth since June 2009 when the Great Recession technically ended. Reuters reported that 29 states recorded wage growth at three percent or better in 2017. As a sign of a strong economy, job openings have increased since last year, with total openings at 5.8 million as of the end of 2017 versus 5.5 million at the end of 2016, according to the BEA.

**INFLATION**

Inflation has not been a concern for the Federal Reserve for years, as price increases have been below the Fed’s target of two percent. However, the economy is showing signs that it is heating up as unemployment is low and wages are rising. Prices are rising for materials such as steel and aluminum, and the recent indications by the
Trump administration that it is considering tariffs on imports of those materials only poses a greater threat to rising prices for the core components of critical industries such as automobiles and construction.

For the trailing 12 months ended in January 2018, the consumer price index rose 2.1 percent, the same as in the prior month. This was higher than the consensus estimate by economists, which was 1.9 percent.

TRADE-WAR LOOMING?

President Donald Trump’s proposed tariff on imported steel and aluminum, at 25 percent and 10 percent, could be the beginning of a trade war. The stock market reacted by selling off in March 2018 after the resignation of the President’s chief economic advisor, Gary Cohn, who was opposed to the tariffs. The U.S. is the world’s largest steel importer, putting trade with other nations in peril as this could cause retaliation by steel exporters for American-made products.

Automakers account for more than a quarter of steel demand in the U.S. according to the American Iron and Steel Institute (AISI), making the industry the second-largest consumer after construction. The response from automakers has been mixed. GM issued a statement stating, “We purchase over 90 percent of our steel for U.S. production from U.S. suppliers.” Toyota stated, “The majority of our steel and aluminum purchases come from the United States,” implying, along with GM, that the price of imported steel and aluminum may not affect it as much as others. A Hyundai spokesperson came out against the tariffs stating, “Changes to the existing tariff structure could negatively impact our current U.S. production and further expansion.”

SMALL BUSINESS IS OPTIMISTIC

The National Federation of Independent Business (NFIB) Index of Small Business Optimism in 2017 recorded the strongest year ever in the history of the index. The average monthly index for 2017 was 104.8; the previous record was 104.6, set in 2004. “We’ve been doing this research for nearly half a century, longer than anyone else, and I’ve never seen anything like 2017,” said NFIB Chief Economist Bill Dunkelberg. Added NFIB President & CEO Juanita Duggan: “2017 was the most remarkable year in the 45-year history of the NFIB Optimism Index. With a massive tax cut this year, accompanied by significant regulatory relief, we expect very strong growth, millions more jobs, and higher pay for Americans.”

MANUFACTURING

The Institute for Supply Chain Management (ISM) issued a report in March 2018 that stated U.S. manufacturers expanded in February at the fastest rate since May 2004. The ISM also reported that order backlogs at factories hit a 13-year high, and delivery times are slowing (a positive indicator), continuing a 17-month trend.

GAS PRICES

AAA predicts national gas prices will rise to $2.70 per gallon this spring and early summer, a level not seen since 2015 when the average price reached $2.81 per gallon. The price increase will likely occur in April, according to AAA, the time when refineries switch over to their summer blend which is more expensive. If the average price reaches the level predicted by AAA, then it will be about 40 cents per gallon more than the average in spring 2017.

While AAA is predicting an increase in gas price, other factors are at play that may keep prices low. The Energy Information Administration (EIA) reported that U.S. oil production broke a 47-year output record in November 2017. Only Russia has more oil production output than the U.S., but that may change as early as this year, according to the EIA. The increase in U.S. production has offset the production cuts made by Russia and OPEC (Organization of Petroleum Exporting Countries), keeping prices relatively low.

HOUSING

In February 2018 the National Association of Realtors reported that prices for homes are at all-time highs in 64 percent of major U.S. cities. Home building increased 2.4 percent to 1.202 million units in 2017, the highest level in 10 years. However, in the last month of 2017, single family building permits were down 11.8 percent, possibly signaling a stall in 2018 as housing prices and interest rates continue to see upward pressure, possibly pricing many out of the housing market.
Manufacturer Tidbits

TOYOTA

Toyota Motor Sales U.S.A. was hit by the volume of off-lease vehicles in 2017 and customer’s preference to trucks and SUVs. The company’s fourth quarter profit fell 73 percent from previous period in 2016 due, in part, to heavy discounting to boost sluggish sales.

Toyota announced it will join with Mazda to build a $1.6 billion plant in Huntsville, Alabama that will employ approximately 4,000. This number will add to the 1,350 employees at Toyota’s engine plant in Huntsville.

Thoughts on the 2018 Camry redesign? See Wall Street Journal article, 2018 Toyota Camry: Drives Like a Dream, Looks Like a Nightmare.

NISSAN

Nissan’s stated goal is to reach 10 percent U.S. market share by 2019. It is among the fastest-growing auto makers in the U.S.; however, its momentum comes at a price as its operating margins fell sharply in recent quarters. Nissan is making a bet on sales to lower-margin fleet customers at a time when many automakers are reducing exposure to this rental car market. Nissan had sold 281,167 vehicles to rental buyers through November, the most of any automaker and 10% more than GM.

In an apparent contradiction, Nissan’s CEO Hiroto Saikawa has given orders to the new North American leadership for less pressure on Nissan dealerships to take inventory, fewer market incentives, and more focus on profitability and brand value. He also stated that he wants less reliance on fleet sales.

HONDA

American Honda’s U.S. annual sales reached a record for the third consecutive year in 2017. The CR-V was Honda’s top-selling vehicle in the U.S. for the first time, surpassing the Civic. The 2018 Accord won North American Car of the Year in January, however; U.S. sales slid in February 2018 as the Accord, Civic and CR-V had a decline in demand relative to February 2016.

FIAT CHRYSLER

FCA’s CEO Sergio Marchionne was quoted in March 2018 as saying that the company would entertain offers to buy the company after completing its growth plan in 2018. Earlier last year, FCA was reported to have had buyout talks with Zhejiang Geely Holding Group, a Chinese manufacturer controlled by Chinese billionaire Li Shufu. It was reported that Shufu opted not to make a formal offer for FCA because the parties were too far apart on valuation. Shufu announced in early 2018 that his company invested a $9 billion stake in Daimler, making his company Daimler’s largest shareholder.

FORD

It has been somewhat of a revolving door for Ford’s executives. Last year, Mark Fields was fired as CEO of Ford and replaced by Jim Hackett. After running the office furniture maker Steelcase and serving as interim athletic director at the University of Michigan, Hackett took the role as Ford CEO after working as chairman of Ford’s Smart Mobility subsidiary. Ford’s North American president, Raj Nair, was ousted in February 2018 for unspecified “inappropriate behavior.” He was replaced by Kumar Galhotra, who was formerly over Lincoln and the company’s chief marketing officer. The former CEO of Ford Credit, Joy Falotico will take over at Lincoln and as chief marketing officer.

In early 2018 Ford announced plans to roll out 16 fully electrified vehicles within five years, the first arriving in 2020. Ford said it would invest $11 billion on EV technology by 2022.

GENERAL MOTORS

In early 2018, GM announced it was cutting the maximum amount a salesperson can earn in bonus payments from its Standards for Excellence Program to $150 per car from $225. This is an interesting decision in light of the bonuses some companies are giving as a result of the cut in federal corporate tax rates.

GM announced plans to launch driverless ride-hailing fleets that come without steering wheels or pedals in 2019.

GM is putting more focus on SUVs and trucks, and is considering scaling back production of Buicks, Chevys, and Cadillacs. GM unveiled its fourth generation Silverado in February 2018. The company spent over $3 billion to retool plants to focus on pickups.

HYUNDAI-KIA

Hyundai and Kia are trying to pick up lost market share by introducing two large crossovers. It has been speculated that the Kia Telluride,
introduced as a concept car in 2016, will be one of the crossovers. The Hyundai crossover is expected to be built on the same platform as the Telluride. It will be the biggest Hyundai crossover since the Veracruz was dropped in 2013.

Hyundai’s new Kona crossover made its retail debut in February 2018. “Through the first two months of 2018 our SUVs continue to deliver and our car-to-SUV mix creeps closer to the industry with 39 percent of our sales coming from SUVs,” John Angevine, director, national sales, Hyundai Motor America, said in a statement. “Despite an overall decline to start the year, we remain highly optimistic that we can take greater advantage of the SUV craze as Kona enters dealerships in larger numbers.”

SUBARU

In January 2018 Subaru announced the Ascent, an eight-seater SUV that comes with 19 cup holders. The Ascent goes on sale this summer, starting in the low $30,000s. The Ascent is designed to compete with the Honda Pilot and Toyota Highlander.

In March 2018, Tom Doll was named as CEO of Subaru of America, the first American to hold that spot since 1990. Doll had been with Subaru since 1982.

VOLKSWAGEN

In 2017, Volkswagen’s stock value surpassed the stock’s value prior to the emissions scandal, recovering $40 billion in value. Hinrich Woebcken, CEO of Volkswagen America, stated that the recovery was possible because the North American region is able to exercise autonomy from corporate headquarters in Germany, allowing it to design and build vehicles based on what American’s desire – crossovers. In 2017 VW introduced the Atlas and the Tiguan, both three-row crossovers.

DAIMLER

Zhejiang Geely Holding Group has built up an almost 10 percent stake in Mercedes-Benz maker Daimler AG.

Daimler warned investors that profit growth in 2018 will be reduced as a result of increased spending on new technologies such as electric and autonomous vehicles. 2017 was a good year for Daimler, as it set a record for the number of cars sold, thanks in part to demand for its E class and SUVs.

BMW

BMW is also focusing on the crossover market to make up for lagging sales. BMW is rolling out several new or redesigned BMW X crossovers to go on sale in the U.S. in 2018. The X2 arrived in U.S. dealerships in March of this year. The redesigned X4 compact and the X5 midsize will be available later in 2018.

TESLA

AutoNation CEO Mike Jackson said that Tesla is either the greatest Ponzi scheme of all time or will eventually work out for investors in an interview after Tesla surpassed General Motors and Ford Motors in market share value in 2017.

Tesla sold 103,082 units in 2017. Its Model 3, priced at $35,000, was delivered to buyers for the first time in July 2017. The company struggled to meet productions targets, as it has been forced to revise production estimates. As reported in a February 2018 filing, it expects to produce 5,000 Model 3s per week by mid-2018. Many speculate that it is critical that Tesla hit is production targets before competitors roll out similar EVs to the market at the same price point.

MOVING FORWARD

2018 will likely be a year of declining monthly SAAR and of dealerships right-sizing inventory. We are likely at or near the peak average transaction price. The automotive credit market is very healthy, but as interest rates rise, monthly payments rise, putting pricing pressure on vehicle sales that are already sold at tight margins. Dealerships will likely focus on back-end revenue sources, such as F&I to make up for the small margins. The increased supply of dealers coming to the table to sell will likely keep blue sky multiples steady, with premiums still being paid for major brands in major markets. Dealers should be assessing what their world will look like in the next 10 to 15 years, and making plans to evolve along with the industry or risk the possibility of becoming obsolete.
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