## Building a New Dealership Facility:  Does it Pencil?

Jeffrey B. Forsberg, CPA PS


In the competitive environment of auto retailing, improving the customer experience with a new flagship facility or remodel can be the dealer's most daunting and expensive option.  You should be taking measure of the following factors:

### Intangibles

A newer facility has undeniable appeal to both customers and employees.  In an industry that is often defined as a people business, customer satisfaction receives a lot of press and attention (the plethora of CRM products at NADA this past January suggested it's the only important thing).  Less attention is paid to employee satisfaction (ESI), which certainly impacts your CSI. The lesson is that any building proposal will benefit by listening to both your customers and employees.

Unfortunately, customers rarely articulate how their buying decisions are influenced by the subliminal qualities of your facility, so some of this is leap-of-faith.  However, there is a trend of making dealerships a "destination point" by dedicating space for café offerings, laptop stations, and other amenities.  This has the potential of converting intangibles into more customers and higher profit.  In my conversations with dealership architects at NADA, current trends in design include the removal of sales towers, more glass, fewer walls, and an emphasis on open layouts that create a "customer-centric" environment.  At approximately $100 to $160 per square foot, smart decisions on design and layout can maximize the upside potential of your facility investment.  Toyota's vision of a "state of the art" facility was on display at NADA this year that reflect these trends:

### Factory Pressure

Manufacturers are not always subtle communicating their desire for dealers to break ground on a flagship facility. Arm-twisting by the factory may run afoul of franchise laws, so factory money is more prevalent.  However, there are usually strings attached, including factory input and approval on the building that can raise the cost (just ask your local Honda dealer). Specific branding and signage are favored options of the franchisor, or a separate showroom if you have multi-lines. However, you could be seriously out-of-pocket, even with factory help, if you weren't otherwise planning on either.  Manufacturer participation usually represents taxable income, but don't let this dissuade you from making your own inquiry as to its availability.

### Lower your building costs

Higher depreciation deductions effectively lower the actual cost of a project from a reduction in income taxes. In the world of tax accountants, it's called cost-segregation. Briefly, this improves your cash flow by identifying parts of your building that can be written-off over 5, 7 and 15 years instead of waiting 39 years to claim 100% of deductible building costs. Dealers will pay less income tax during the early years of the new building. This tax deferral effectively amounts to an interest-free loan. The value of this interest-free loan on a present value basis will approximate $150,000, or more, on a $3,000,000 facility.

A non-tax method for lowering building costs is what's known as a "construction cost audit." This service scrutinizes contractor bills for evidence of overcharges by the builder. On average, savings from identifying overcharges can save 1% to 2%, or $30,000 to $60,000, on a $3,000,000 project. Both cost segregation and construction cost audits may help make a financially marginal project viable. Unfortunately, these benefits alone will never justify new construction.

### Economic: "Build It and They Will Come" (or would they come anyway?)

Economic factors should be where the proverbial rubber hits the road. Currently, dealers face the reality of flat demand and lack of growth in new unit sales. Overcapacity, driven by manufacturers' chase for survival through market share, is another challenge. When your sales growth depends on winning new customers at the expense of other dealers, the end game turns into offering something the other dealer isn't. A new or upgraded facility is your most costly option to achieve this objective. Let's look at the dollars and cents (or sense) of things:

Bottom line thinking requires that a new investment in real estate earn a reasonable rate of return. In our example, a dealer is thinking of putting up a new building for $3,000,000 (we'll put aside the cost of business interruption for clarity, but don't ignore it in your own calculus). An average rate of return for real estate is generally 10%. In other words, one should expect a $300,000 annual return on an investment of $3,000,000. Raising the rent $300,000 each year will require more gross profit from all departments to justify green-lighting the project.

A general rule of thumb is that rent expense should not exceed $350 per new and used vehicle units retailed (luxury brands will justify higher rent guides). Using our example above, selling an additional 71 new and used retail units per month will satisfy this desired rent factor (71 monthly units times 12 months times $350 per unit approximates $300,000 annual rent). Optimal rent factors per vehicle retailed will vary, depending on a host of variables, including franchise, location, etc. Assumptions that underlie profit projections from new construction should be evaluated carefully because errors in judgment can prove costly for these single-purpose facilities.

If the dealership is relocated from a marginal site to a freeway location, less optimism is needed to add more vehicle sales per month. On the other hand, it's a stretch to expect that new bricks and mortar alone will deliver significantly more unit sales from the same location. And unless the dealership was critically short on service capacity, only the most optimistic operator could expect significant growth in repair orders. The same can be argued for a spike in parts sales.

Dealers considering a new facility need to know if expectations for business expansion are realistic. Of course, you will want to do more than break even. If only minimums are met (i.e. dealership profit stays the same) you may have to console yourself with CSI and ESI improvements. On the other hand, it's possible that if no upgrades are made, dealership profits will slide, making an investment necessary in order to maintain current profitability. Every situation is unique just as each parcel of real estate is unique. Be sure your due diligence emphasizes a realistic assessment of the economic factors that can prove pivotal to the future success of your dealership.