Auto Dealers' Economic Outlook

Insights for Automotive Dealers
Spring 2024

HHM DEALERSHIP SERVICES
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Welcome to the HHM Auto Dealers' Economic Outlook

The biggest questions going into 2024 is not if dealership profits will decline from recent levels, but how far and how fast will profits decline and what is to be expected as “normal” profit margins in the near term. Over the last four years, the dealership industry has lived through a crash in demand triggered by the Pandemic lockdowns, followed by supply chain breakdowns causing inventories to plummet, resulting in profits soaring to new heights. Now that dealerships have autos back on their lots, dealers walk a tightrope between having inventory to sell yet avoiding a regression back to pre-pandemic margins.

The decline in profit across the dealership industry has begun. Average earnings for the public dealership group declined about 12 percent in 2023 year-over-year. Average gross profit on new and used vehicles fell by 21 percent and 7.4 percent, respectively, for the group of six public dealerships.

For public dealers, the decline in earnings in 2023 was a direct result of declining average gross profit on new units. The decline in average used gross margins, began in 2022 for public dealers, and had a marginal effect on overall profit in 2023.

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Introduction

By Travis Flenniken, CFA, CVA
Director

U.S. new unit sales growth in 2023 was 12.7 percent. Forecasters are expecting a slowdown in demand for new unit volume, with an average prediction of 2.4 percent growth in 2024. Predictions from last year were predicated on the supply side of the equation, but for 2024 forecasts, it’s back to estimating consumer demand. The average inventory days’ supply is 80 days at the end of February 2024. Plentiful inventory levels are especially true for certain domestic auto dealers and electric vehicles (EVs).

While the total number of new units sold in 2023 is below pre-pandemic levels, the number of light trucks, SUVs, and CUVs sold in 2023 exceeded the level set in 2019. Sales of light trucks, SUVs, and CUVs topped 12.4 million units sold in 2023 versus 12.2 million in 2019. Used vehicle sales growth was flat in 2023 compared to 2022.

Market share is shifting as Stellantis lost ground in 2023 and Hyundai gained. Honda is coming back now that it has inventory to sell. Tesla’s torrid pace of market share gain in 2022 slowed in 2023.

The average decline in the price of new vehicles in 2023 was 2.6 percent, with EVs contributing significantly to that figure. Used vehicle pricing continued its softening in 2023, with wholesale pricing declining by 13.1 percent. A used vehicle in 2023 between $15,000 - $20,000 will average 70,000 miles, almost twice the number of miles for a vehicle in the same price range in 2019.

EVs hit an all-time high of 1.2 million units sold in 2023, amounting to 7.6 percent U.S. market share, but breaking this record involved deep discounts from Tesla and others. Even with new legislation that provides buyers of EVs a rebate from the dealership at the time of purchase, EV inventories are piling up. In early 2024, Ford announced it was halting deliveries of its F-150 Lightning to perform quality checks, and a few weeks later announced it was cutting production targets to roughly half of original plans. Analysts estimate that Ford lost $36,000 per EV sold in Q3 of 2023. In the same quarter, GM announced that it cut its original EV production targets for 2023 and 2024 and refrained from providing new targets. EV start-up and publicly traded Fisker, issued a warning in March 2024 that there was “substantial doubt” about its ability to stay in business. After billions of dollars spent over 10 years, Apple announced in early 2024 that it is giving up on the design of an Apple EV.

The expected downturn of the U.S. economy in 2023 never materialized. At the beginning of 2023, a survey of 71 economists conducted by the Wall Street Journal put the probability of a recession within the year at 61 percent. In early 2024, that same group cut their expectations for a recession to 39 percent but are expecting only 1 percent economic growth in 2024. However, Goldman Sachs is putting only a 15 percent probability on a recession in the U.S. and expects growth of 2.4 percent.

Barring another shock to the system, 2024 should be a good year for dealerships.

Much of the economic outlook is predicated on what happens with inflation, which drives the Federal Reserve's decision on cutting interest rates. There are signs in early 2024 that inflation may be more stubborn than hoped, but the Fed is holding to the position that it expects to cut interest rates more than once in 2024, with the most-likely first cut coming in June. The unemployment rate is holding steady, but there are signs of it softening, as the increase in wages is slowing down, along with the number of job hoppers.

In an election year, things have the tendency to get crazy...this election, especially. But while political and economic factors may create volatility in markets and in our lives, Americans will still rely on their vehicles. HHM expects dealerships to have a year where the number of units sold will fall in line with 2023 levels. Gross profit on new unit sales will be above 2019 levels because prices will stay well-above 2019 prices, but profit margin percentage may revert to 2019 levels. Used prices will continue to soften but stay above pre-pandemic levels. Gross profit from the sale of used vehicles will stay above 2019 average gross per unit, but gross profit margin will likely settle to 2019 levels. HHM also expects growth in demand for EVs will continue to slow but demand for hybrid vehicles will accelerate.

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- HHM is a full-service accounting and consulting firm providing traditional assurance and tax services, in addition to offering specialized services such as mergers and acquisitions, business valuations, succession planning, and tax planning for high net worth clients.
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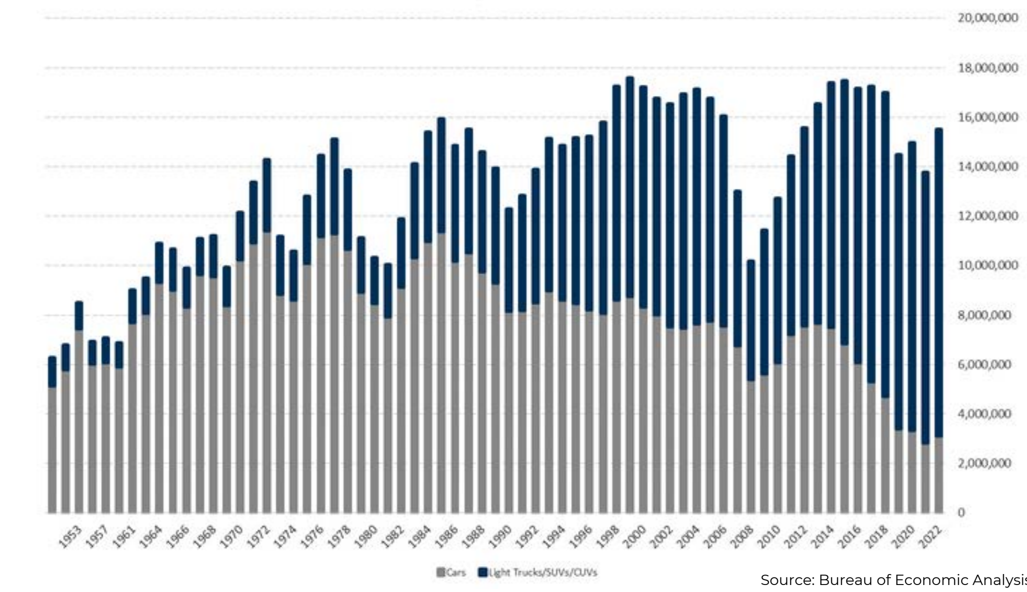
New Units Sold in 2024

The number of light vehicle units sold in the U.S. at the end of 2023 totaled 15.5 million, a 12.7 percent increase over the 13.8 million units sold in 2022. The total remains below the pre-pandemic level of 17 million in 2019. Figure 1 shows annual U.S. unit sales.

Figure 1: Total U.S. Light Vehicle Unit Sales

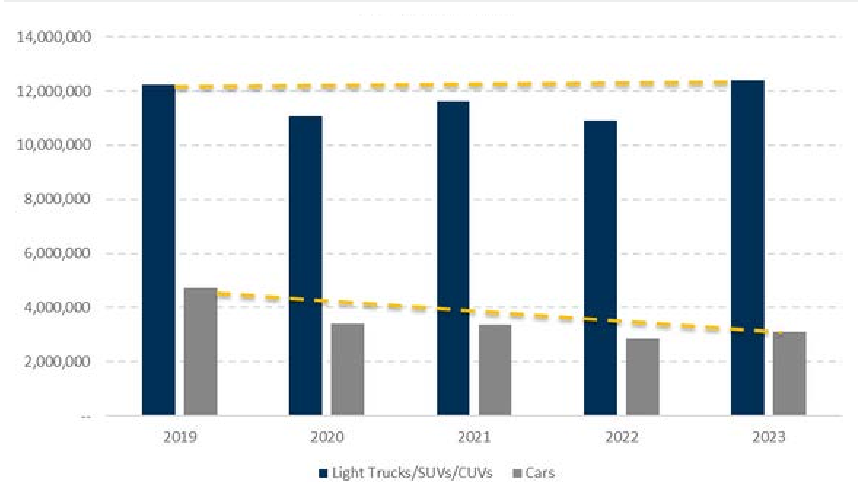


Source: Bureau of Economic Analysis

Sales of light trucks, SUVs, and CUVs topped pre-pandemic levels with 12.4 million units sold in 2023 versus 12.2 million in 2019

There were 3.1 million total cars sold in 2023, up from 2.9 million in 2022, but this level is 34 percent lower than in 2019. Crossovers were the most popular segment, with 47.9 percent of the total, up 2.6 percent of 2022. EVs topped 1.2 million units sold, making up 7.2 percent of all new light vehicles sold. Hybrids made up 7.6 percent of units sold in 2023. Figure 2 shows unit sales broken down in the two classifications each year since 2019. [1]

Figure 2: U.S. Units Sold

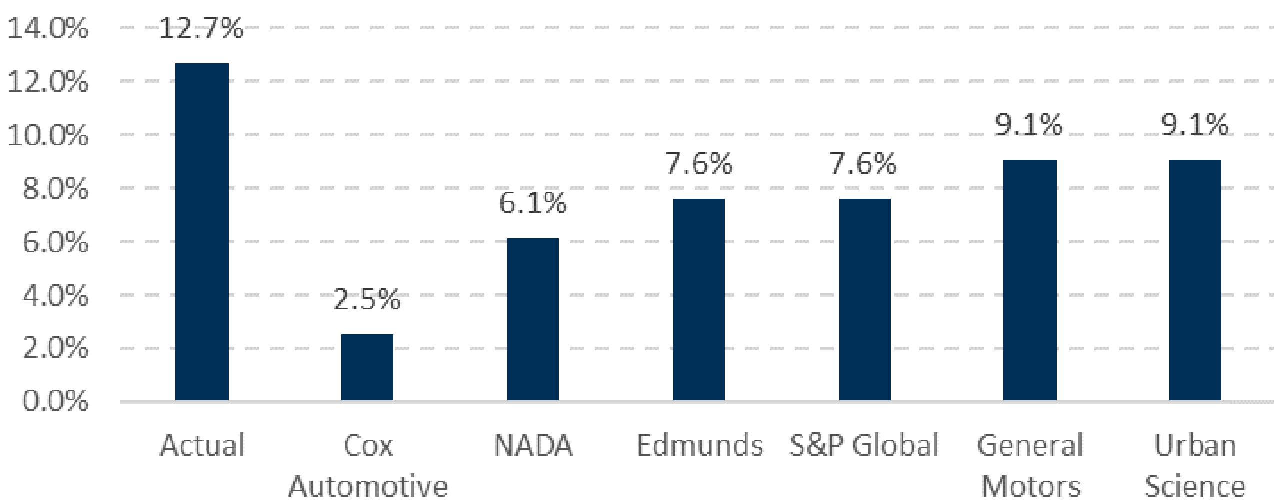


Source: Bureau of Economic Analysis

The Smart Guys Aimed Too Low

U.S. new unit sales growth in 2023 was 12.7 percent, well-above the predictions of many leaders and analysts in the industry. Inventory availability was the unknown factor going into 2023, along with the anticipated effect that higher interest rates would have on demand. Inventory availability is no longer a major factor, yet it appears the experts are aiming low again for 2024, possibly in anticipation an economic slowdown. Figures 3 shows the growth forecasts by various industry experts in 2023 compared to actual growth.

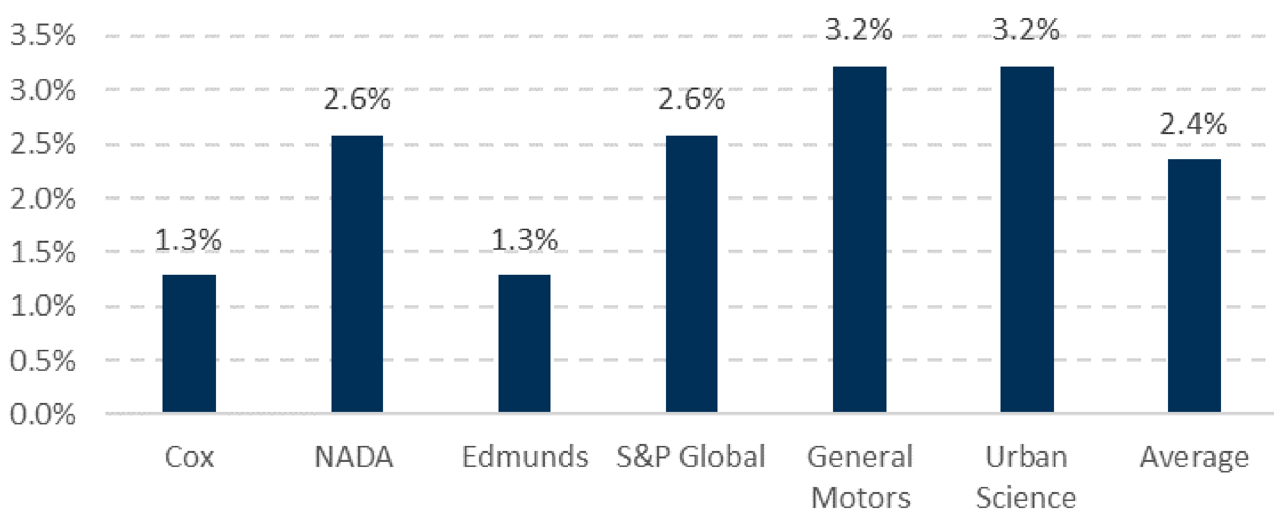
Figure 3: 2023 New Unit Sales Growth % Actual vs. Forecasts



Source: HHM Research

Figure 4 shows what the same group expects in 2024.

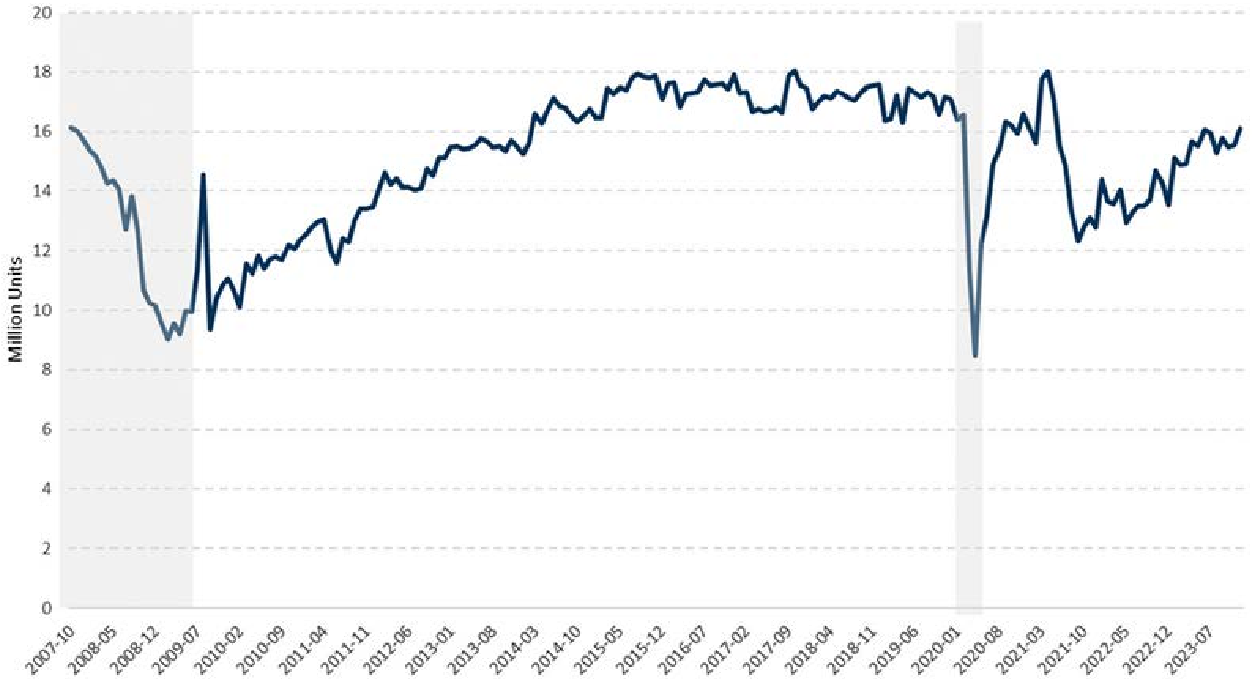
Figure 4: 2024 New Unit Sales Growth % Actual vs. Forecasts



Source: HHM Research

The Federal Reserve publishes the seasonally adjusted annual rate, referred to as SAAR, each month. SAAR provides the annual number of new units sold but accounts for the seasonality of the industry. In January 2024, SAAR fell to 15 million, a 10-month low, but in February, it bounced back to 15.8 million units. Figure 5 shows SAAR since 2008, the beginning of the Great Recession, until December 2023. The gray bars indicate recessions.

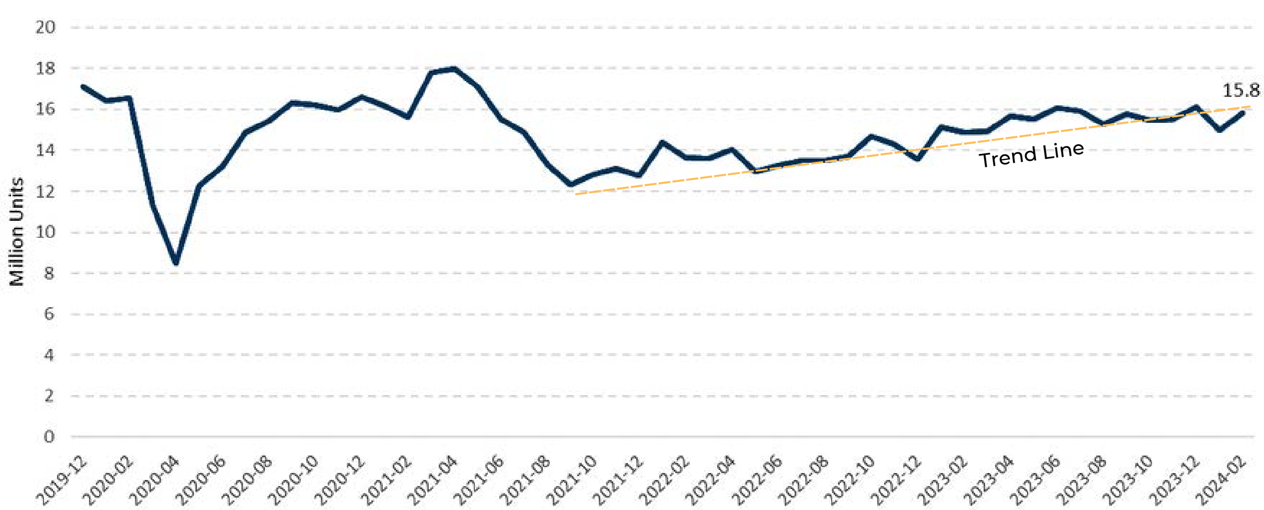
Figure 5: 2024 U.S. Light Vehicle SAAR (2007-2023)



Source: Federal Reserve Bank of St. Louis

Through several dips and peaks, overall SAAR has climbed since September 2021. Figure 6 shows SAAR since the end of December 2019 through February 2024.

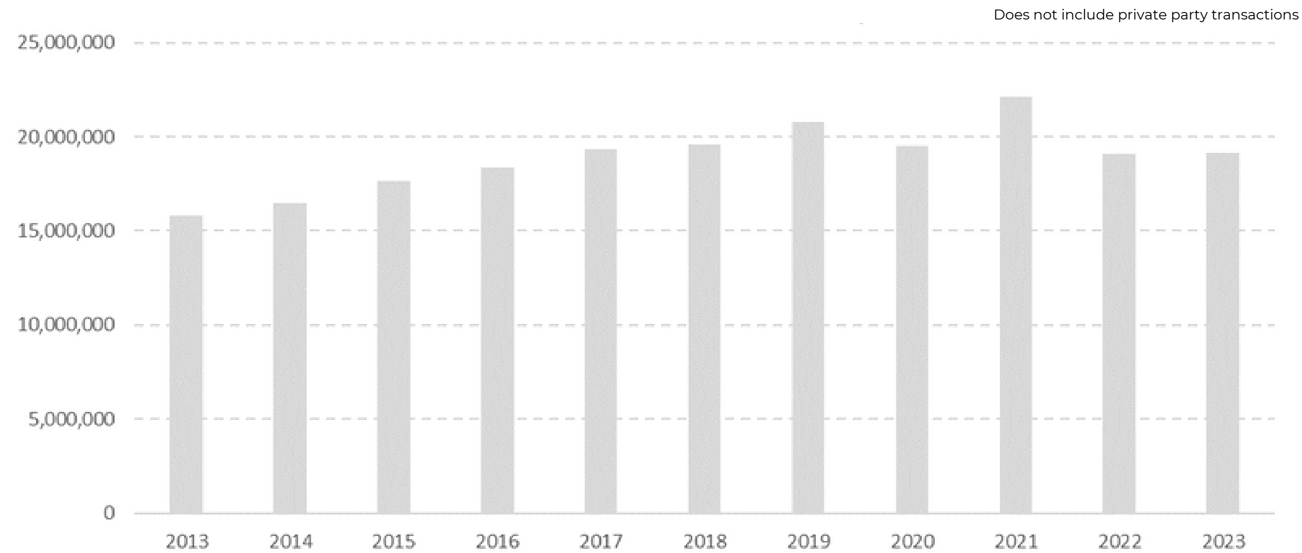
Figure 6: 2024 U.S. Light Vehicle SAAR (2009-Feb. 2024)



Source: Federal Reserve Bank of St. Louis

Used vehicles sales growth was flat in 2023 compared to 2022. There were approximately 19.1 million used vehicles sold at dealerships in 2023. The record was set in 2021 at 21.2 million, a post-pandemic period when Americans had cash from Covid relief programs . Figure 7 shows annual sales of used vehicles at dealerships since 2013. [2]

Figure 7: Used Unit Retail Volume at Dealerships



Source: Cox Automotive/vAuto

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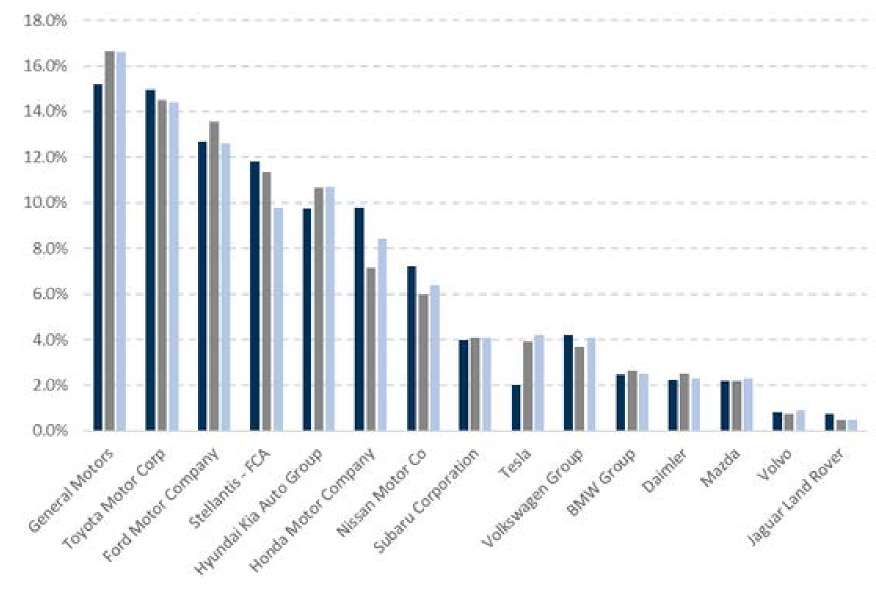
Travis Horton has spent most of his career focused on growing the firm's dealership niche, which he leads. His clients range from single-point, family-owned dealerships to mega dealer groups across the U.S. He is a sought-after speaker/presenter at state and national industry meetings and enjoys helping clients succeed. He is known throughout the industry for orchestrating buy/sell deals, and providing proactive tax planning to his clients, both large and small.

Market Share

Stellantis falling hard, Hyundai gains, and Tesla's growth slows.

General Motors retains the top spot in U.S. market share with 16.6 percent of the market, the same as in 2022, and Toyota holds a firm second place with 14.4 percent market share, followed by Ford with 12.6 percent. Stellantis slipped from 11.3 percent of market share in 2022 to 9.8 percent. Hyundai rose to 10.7 percent, edging Honda's 8.4 percent. Tesla almost doubled market share from 2021 to 2022 but increased only to 4.2 percent in 2023 from 3.9 percent the previous year. Figure 8 shows the U.S. market share of each automaker over the last three years.

Figure 8: U.S. Market Share



Source: coxautoinc.com

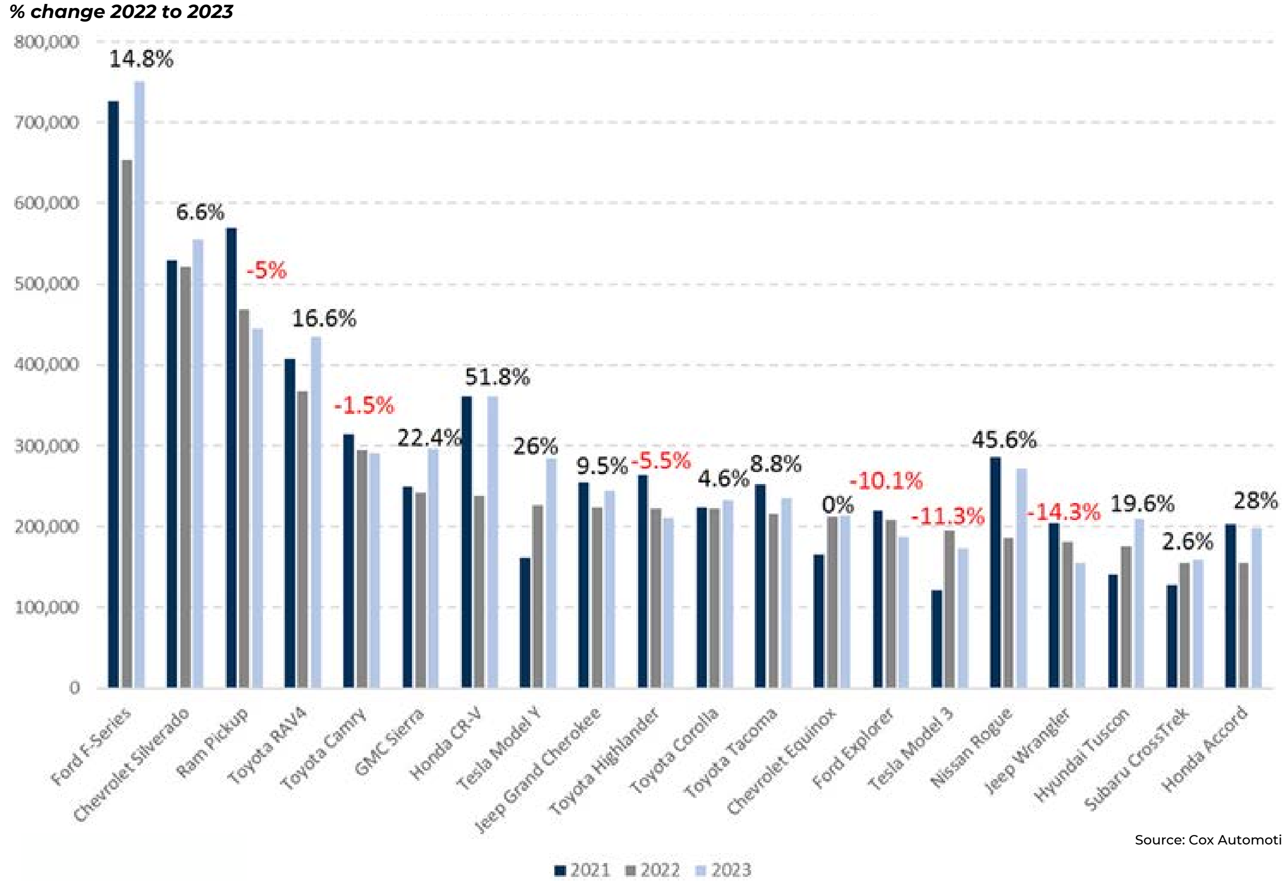
Stellantis was the only major automaker to report lower year-over-year sales in 2023. The company announced in February 2024 that it will be lowering prices and adding features and models to its lineup, currently at 14 vehicle brands. It also announced the Wagoneer nameplate, will be folded into the Jeep lineup. [3] According to the Haig Report Q3 2023, "Stellantis produced a lot of high trim package vehicles at the same time that affordability became a big issue in the industry." It went on by citing the listing price of some Jeep Wranglers above $60,000. In March 2024, Stellantis announced another round of layoffs after announcing a cut in January 2024. [4]

Hyundai Motor Company stepped up as the fourth-largest vehicle seller in the U.S., jumping ahead of Stellantis in 2023. Hyundai's brands include Kia, Genesis, and Hyundai. Tesla's growth slowed in 2023, with its management stating that the company is in between two growth waves: the first one related to the release of Models 3 and Y and the second wave that will start with the next-generation vehicle platform. [5]

Market Share by Model

Of the total top 20 models, there were six that declined in sales and two were Stellantis brands. Sales of Tesla's Model 3 declined by 11 percent and the Ford Explorer declined by 10 percent year-over-year. The largest annual gain of the group was Honda's CR-V, increasing 52 percent and Nissan's Rogue up 46 percent, a result of having available inventory relative to the previous year. Figure 9 shows U.S. market share in 2021 - 2023 by model.

Figure 9: Top 20 Selling Models in 2021 - 2023



Source: Cox Automotive

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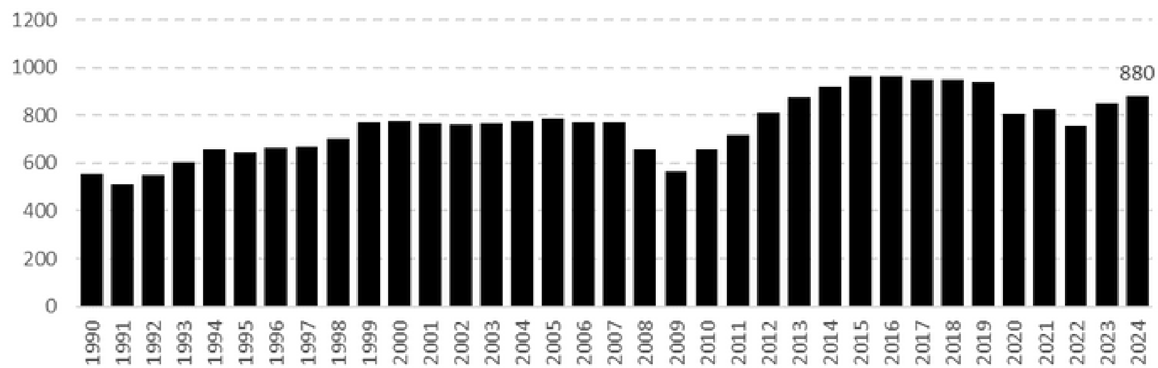
Rob Malone serves the audit and tax needs of auto dealers across the country. He works with some of the firm's largest clients, and also provides support to dealerships through internal control analysis and strengthening process improvements. His planning and problem solving skills make him the perfect business partner for automotive leaders.

Dealership Throughput

Dealership throughput (the number of new and used vehicles sold each year) per dealership is still below pre-pandemic levels.

Dealership throughput (the number of new and used vehicles sold each year) per dealership is still below pre-pandemic levels. According to Urban Science, there were 18,347 dealerships with a total of 30,504 franchises at the end of 2023. The average number of vehicles sold in 2023 (new and used) reached 880, up 3.4 percent over 851 sold in 2022. The highest point was reached in 2015 and 2016 when throughput reached 966 and 965, respectively. Figure 10 shows annual throughput at U.S. dealerships since 1990. [6]

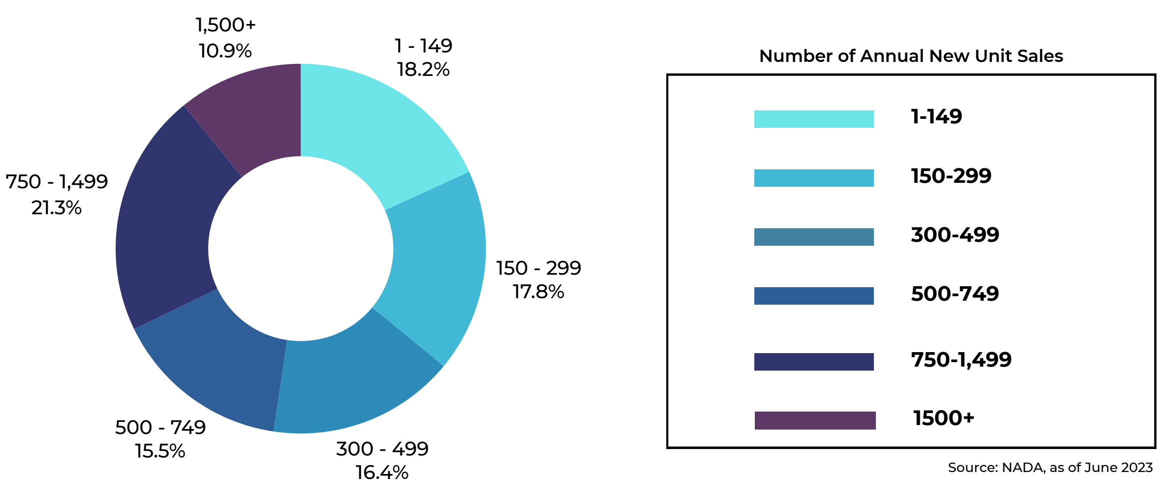
Figure 10: Avg. Number of Vehicles Sold per U.S. Dealership



Source: Urban Science

The NADA provides a breakdown of dealerships by the number of new vehicles sold. The segmentation is fairly well distributed, with the largest group of dealers selling between 750 – 1,499 new units . Figure 11 shows the distribution of dealerships by new vehicles sold. [7]

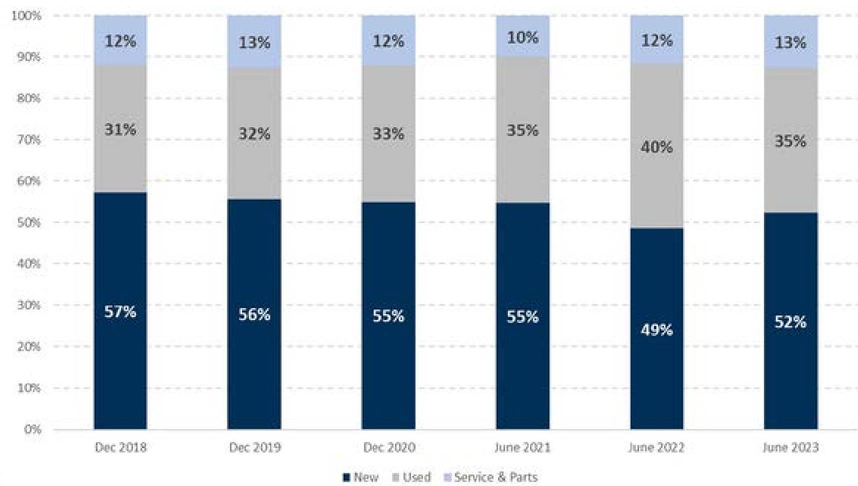
Figure 11: Dealership Distribution of New Units Sold



Source: NADA, as of June 2023

Average revenue segmentation shifted in 2023 as more new inventory became available. The percentage of revenue from service and parts has increased since 2021, likely a result of consumers choosing to repair their vehicles rather than purchase a vehicle due to rising prices. New vehicle sales as a percentage of total sales is below pre-pandemic levels. Figure 12 shows revenue segmentation by department since 2018.

Figure 12: Revenue Segmentation by Department

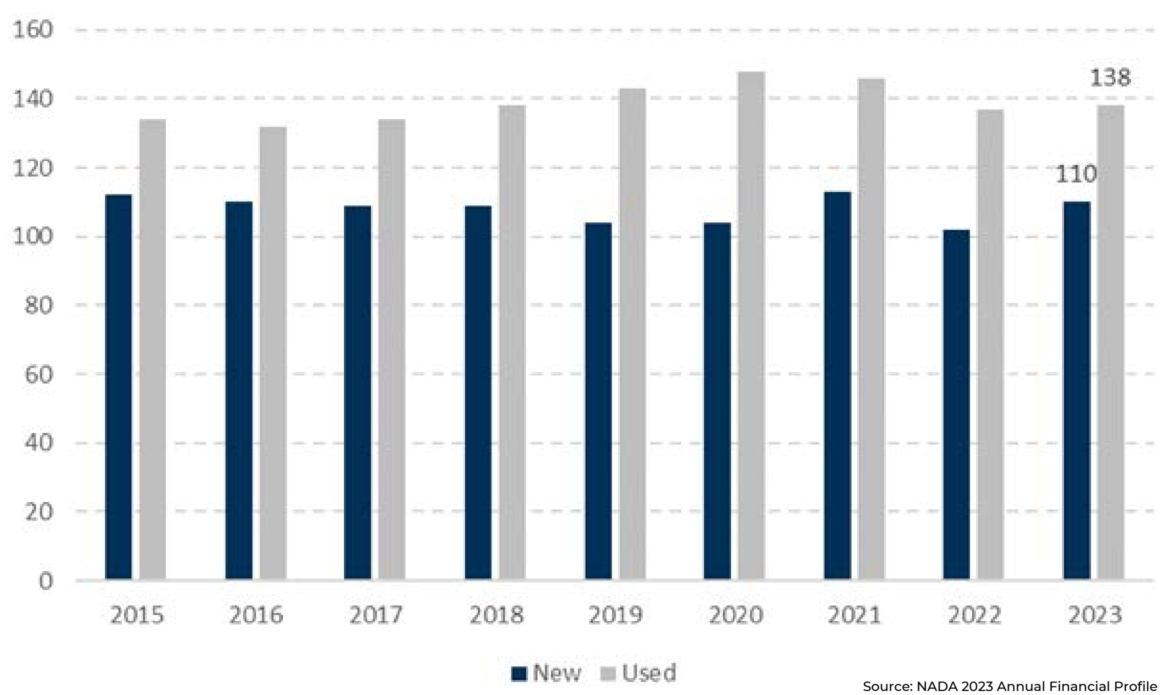


Source: NADA

Average new unit and used unit sold per salesperson rose to 9.2 and 11.5 per month, respectively.

The average unit sales per salesperson in 2023 was 110 new vehicles per year and 138 used vehicles per year. Figure 13 shows average unit sales per salesperson for new and used.

Figure 13: Average Unit Sales per Salesperson



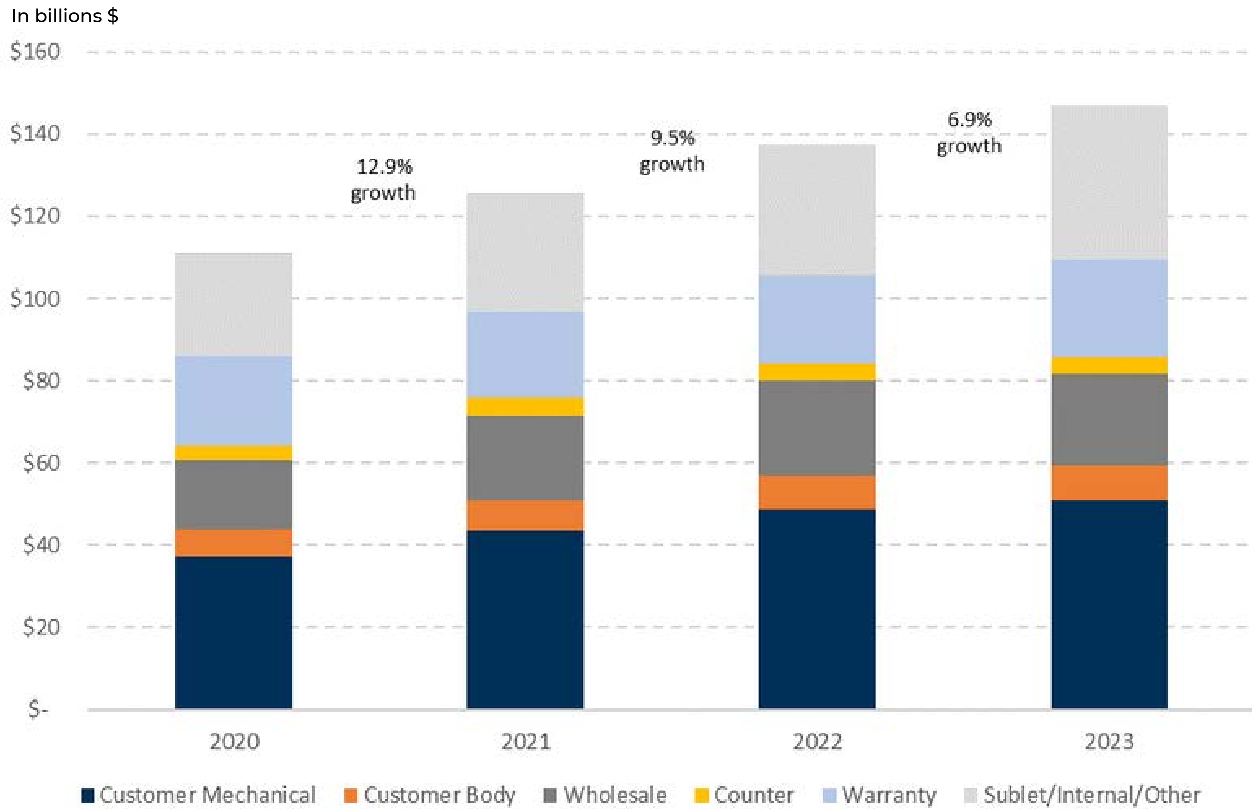
Source: NADA 2023 Annual Financial Profile of America's Franchised New-Car Dealership

Inventory Units

Revenue from service and parts continues to grow

Revenue from service and parts reached $146 billion in 2023. Figure 14 shows annual revenue from the service and parts department of U.S. dealerships since 2020.

Figure 14: Dealership Service and Parts Revenue



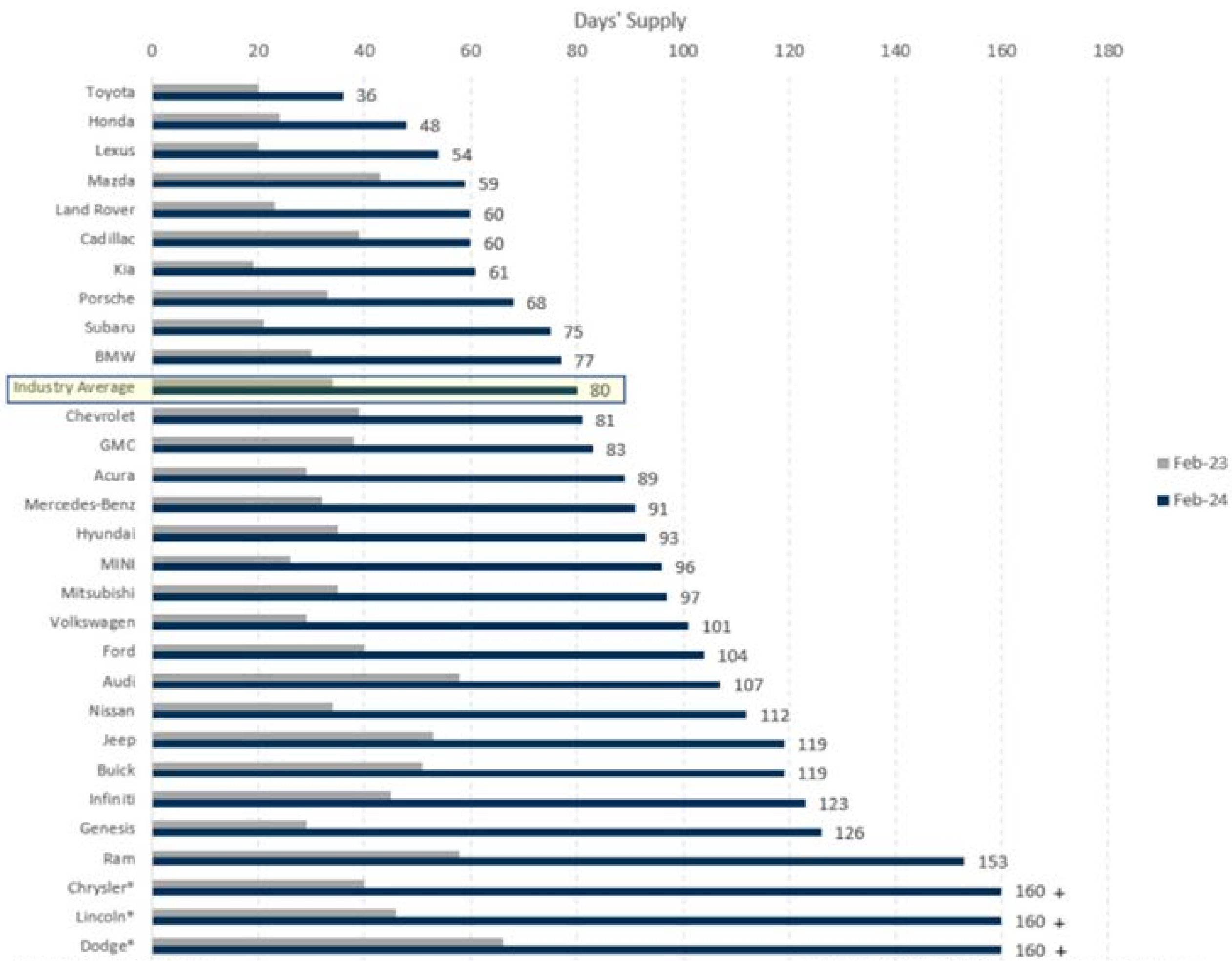
Source: NADA

Toyota and Honda are turning inventory the fastest, Ram, Chrysler, Lincoln, and Dodge are moving slow

The national average days' supply for new units reached 80 days as of February 2024, more than twice the February 2022 average of 34 days. [8]

Figure 15 shows national days' supply by brand according to Cox Automotive, comparing February 2024 to February 2023.

Figure 15: National Days' Supply by Brand



*Chrysler, Lincoln, & Dodge at least 2x industry average

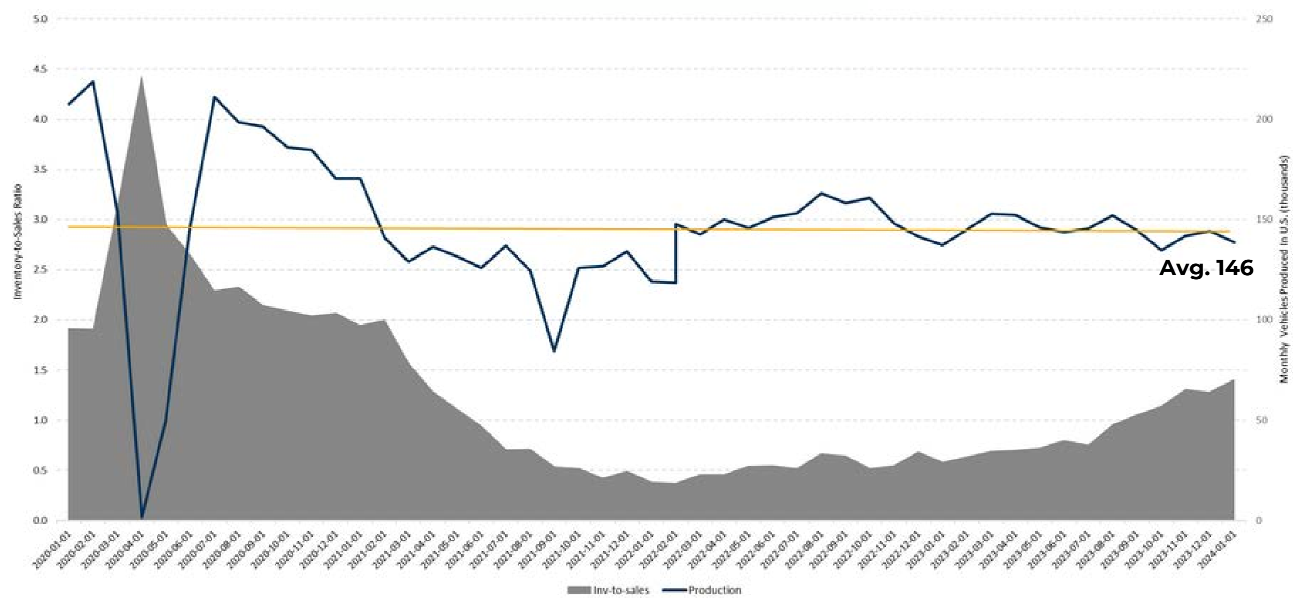
Source: Cox Automotive

The 80 days' supply average is based on 2.61 million new inventory units in the U.S. in February 2024, 50 percent higher year-over-year. Inventory level hit the lowest point since the pandemic in September 2021 at 830,000. Low inventory levels led to record gross margins and profitability, but customers like to buy what's on the lot, so dealers have to figure the optimal inventory level for their dealership. This becomes even more important as the cost to finance floorplan has increased. The optimal structure may vary by target market. For example, some dealers believe that highline dealerships should keep inventories to 20 to 30 days. [9]

EV inventory levels are rising, but hybrid vehicles are selling fast. At the end of 2023, the average days inventory for EVs was 72 days while only 39 days for hybrids. [10] Domestic pickup truck inventories are back after the Detroit Three built up inventories in anticipation of the UAW strike that ended in October 2023 after six weeks. [11] The strike did not have a material effect on inventory levels.

Automakers appear to be keeping good on their commitment to limit inventory in an attempt to maintain margins, as U.S. domestic production has bounced around the 3-year average of 146 units per month. This is demonstrated in Figure 16 that shows the U.S. auto inventory-to-sales ratio compared to the monthly U.S. vehicle production.

Figure 16: U.S. Auto Inventory/Sales Ratio Compared to Monthly U.S. Vehicles Production



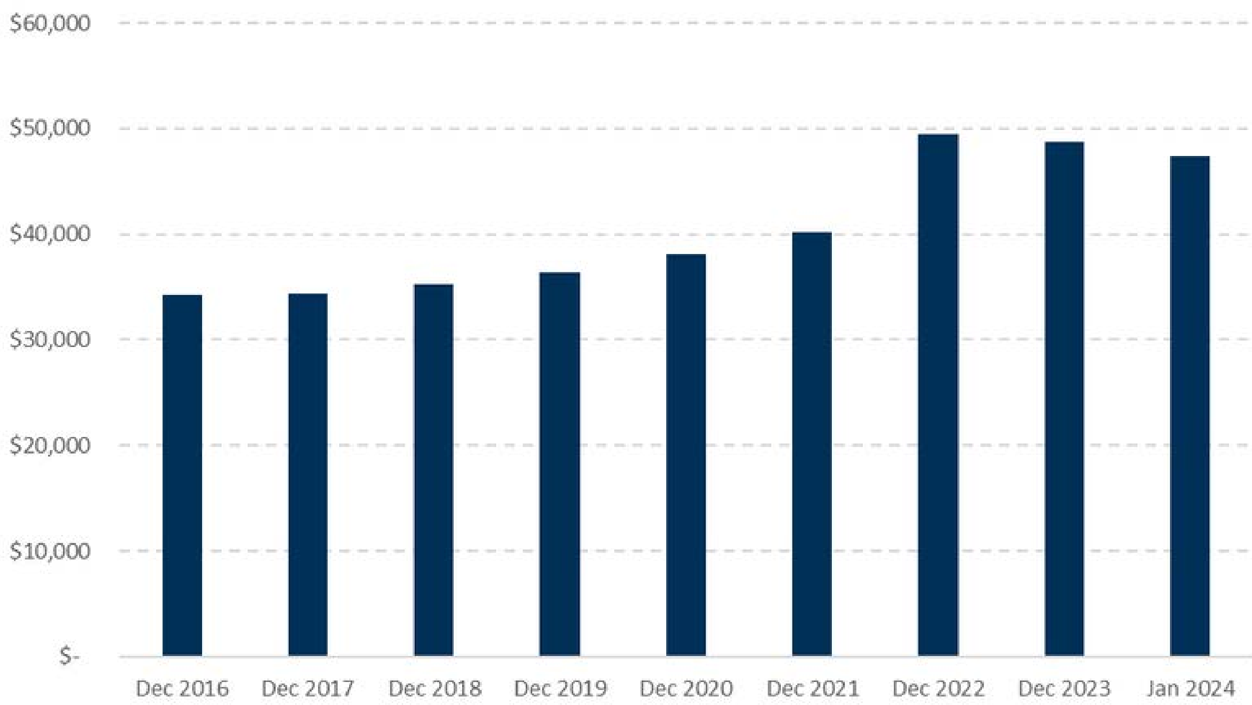
Source: Federal Reserve Economic Data

Vehicle Pricing

After a softening in used vehicle pricing, new vehicle pricing has peaked and is creeping down.

According to Cox Automotive, the average transaction price for new vehicles in January 2024 was $47,401, down from just under $50,000 at the beginning of 2023. Figure 17 shows the average transaction price of new vehicles since 2016.

Figure 17: U.S. Average Transaction Price for New Vehicles



Source: KelleyBlue Book, NADA

According to Cox Automotive and the Moody's Analytics Vehicle Affordability Index, the average new car payment in January 2024 was $751. This is down from February 2023 when the average monthly payment reached $777, nearly doubling from the level in 2019. The average monthly payment amount is equivalent to almost a sixth of the median after-tax income for U.S. households.

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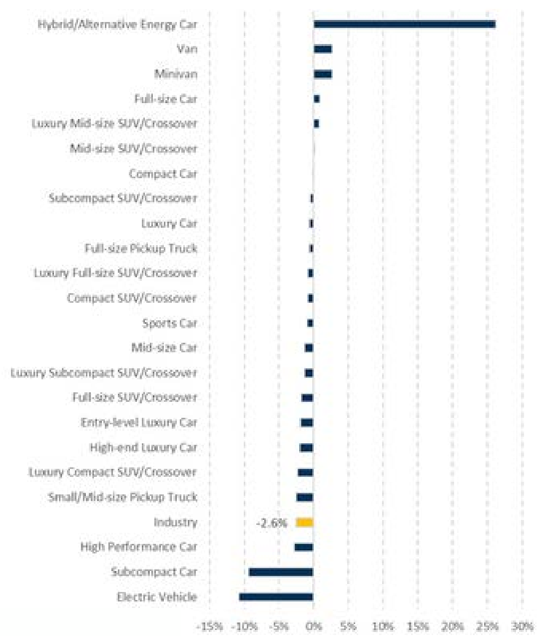
John W. Coker, III, joined HHM in 2014 after 12 years of automotive and professional service accounting. Since then, John has focused on providing tax and consulting services to HHM business clients. He enjoys developing plans and strategies to help clients navigate the complexities of current tax codes. John also plays an important role in advising company owners as they make decisions throughout the business life cycle, from entry to exit. While at HHM, he has supported and trained CFOs and controllers for some of the firm's largest clients.

New vehicle price changes in 2023 by category are shown in Figure 18. The industry average price declined by 2.6 percent year-over-year. EVs, subcompact cars, mid-size trucks and luxury/high performance vehicles had the largest price declines. Demand for hybrids grew in 2023, and the price change reflects the demand, increasing by over 26 percent year-over-year (as of October 2023).

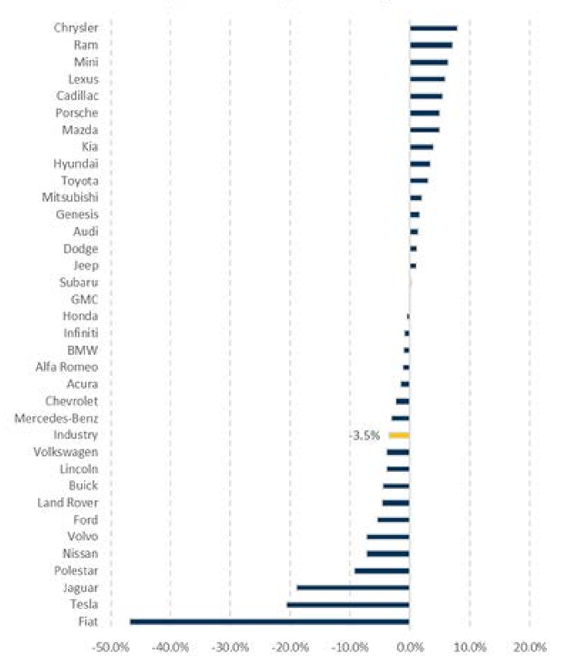
Tesla represents 55 percent of the EV market, so when it cut its average price by 20 percent, reflected in Figure 19, it moves pricing for all EVs. Of note is the price increase of the Stellantis brands, Chrysler and Ram over 2023, that resulted in a significant cut in market share. On the other end of the spectrum is another Stellantis brand, Fiat, skewing the chart with an average transaction price in January 2024 of $17,194, and sold less than one car per dealership in Q3 2023. [12]

Figure 18: Average Price Change in 2023 by Category



Source: KelleyBlue Book, Hybrid price as of Oct 2023

Figure 19: Average Price Change in 2023 by Make



Source: KelleyBlue Book

The industry's lease penetration rate remains below pre-pandemic levels.

In 2019, average new car lease penetration rate was 30.1 percent, and the market penetration rate for the luxury sector was 53 percent. However, during the pandemic, new vehicle lease rates fell to as low as 17 percent, and by the end of 2023, the penetration rate was at 20.3 percent, and 28.2 percent for luxury vehicles. [13] A healthy leasing market is healthy for the industry because fewer first-time lessees means fewer customers coming back to the dealership when their lease is up, and fewer certified pre-owned vehicles for inventory. Additionally, leasing customers are more loyal to a dealership than customers who purchase. [14]

Used vehicle prices are finally softening, but many owners are carrying negative equity in the vehicles.

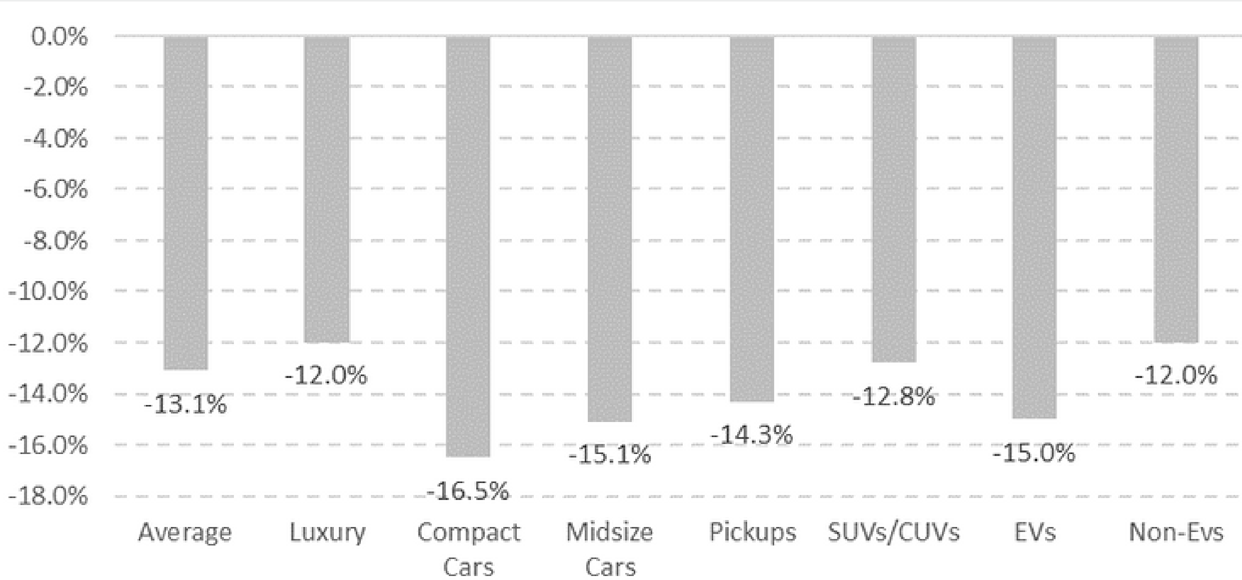
As of February 2024, wholesale used-vehicle prices were 13.1 percent lower year-over-year, and 21.2 percent lower than the peak in December 2021. Figure 20 shows the gradual decline in wholesale used vehicle pricing since the uptick in the spring of 2023. [15]

Used compact cars and EVs show the largest year-over-year declines. Figure 21 demonstrates the price changes by class year-over-year at the end of 2023.

Figure 20: Manheim Used Vehicle Value Index

Source: Manheim by Cox Automotive

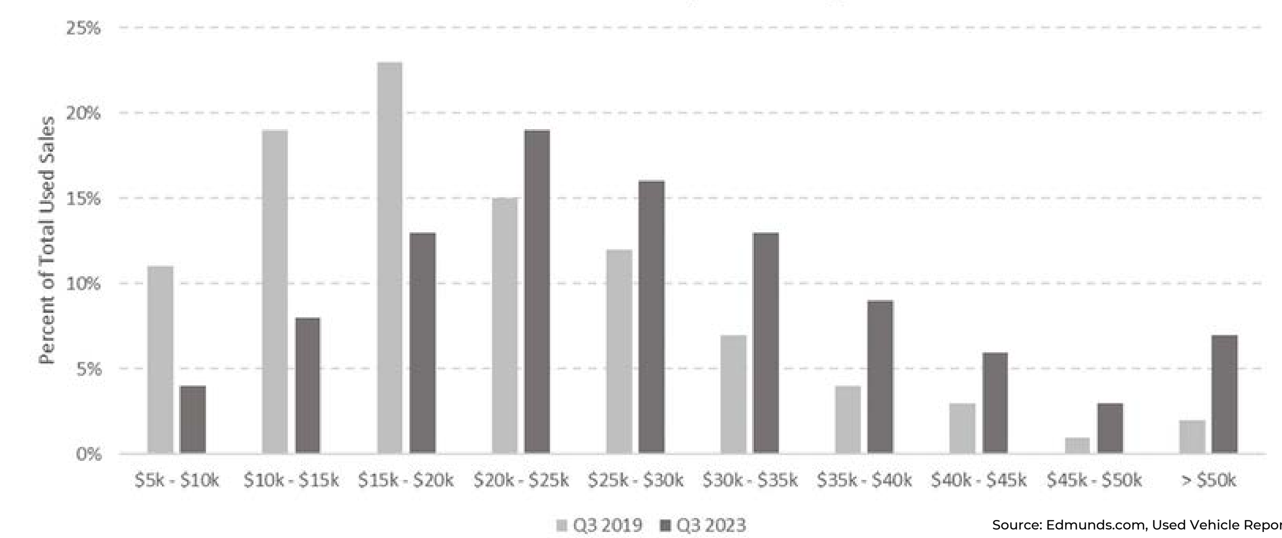
Figure 21: Price Changes for Selective Market Classes



Source: Manheim by Cox Automotive

In its Q3 2023 Used Vehicle Report, Edmunds provides a comparison of the current used vehicle market to the market in Q3 2019. The data shows a big difference in the number of vehicles available for under $20,000. Figure 22 shows the shift towards higher prices for used vehicles and also a more even distribution across price points.

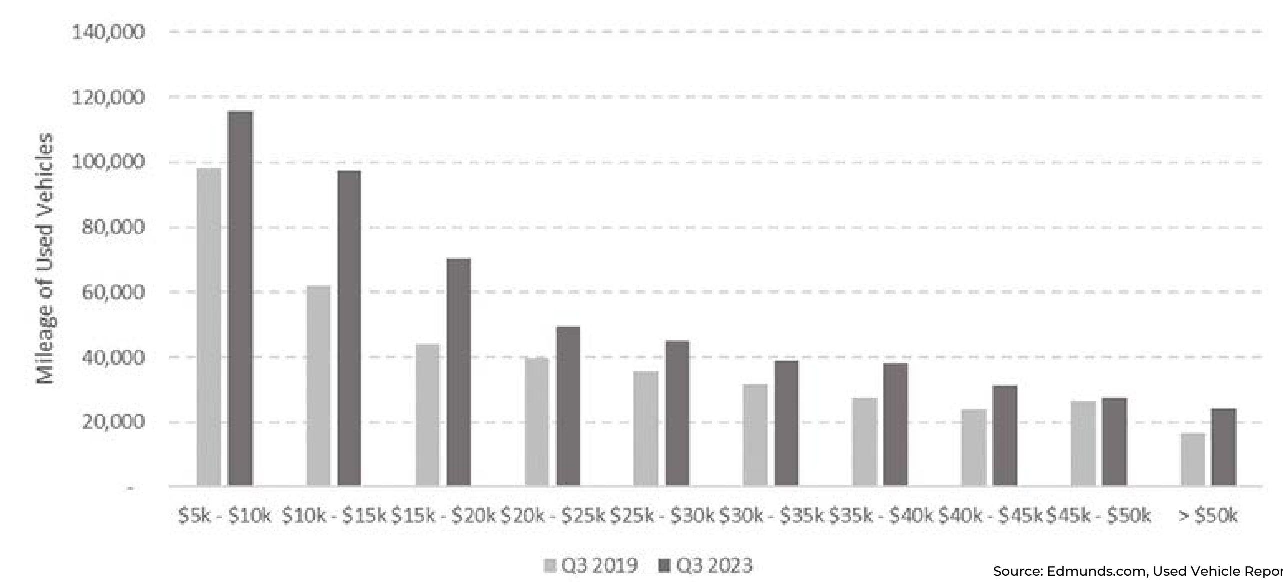
Figure 22: Used Vehicle Sales by Price Range



Source: Edmunds.com, Used Vehicle Report

In 2019 a three-year-old Mercedes-Benz C-Class with 33,000 miles cost $24,000, but by the end of 2023, $24,000 could by a three-year old Camary with 51,000 miles. Prices are higher for higher-mileage vehicles, with the largest differences in vehicles priced below $20,000, shown in Figure 23. [16]

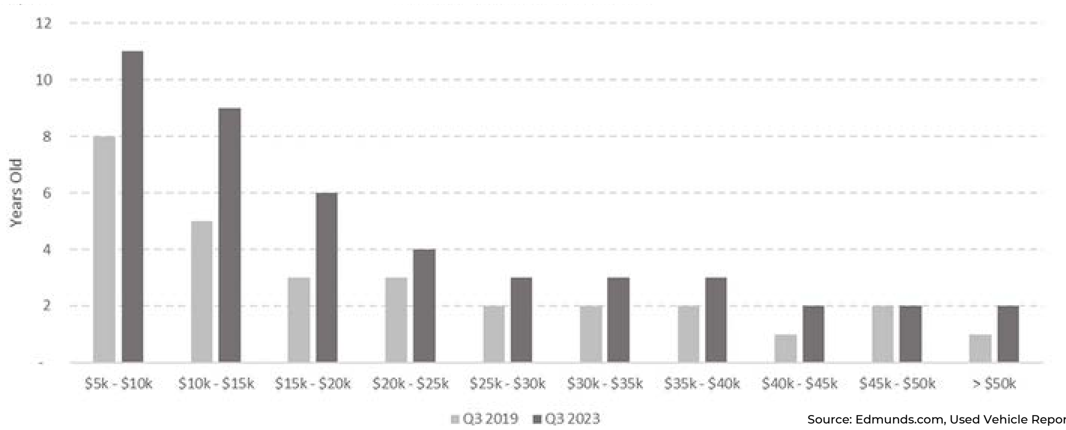
Figure 23: Used Vehicle Average Mileage by Price Range



Source: Edmunds.com, Used Vehicle Report

Figure 24 compares the average age of the vehicles at different price points. Once again, the largest difference is in the vehicles with a price less than $20,000.

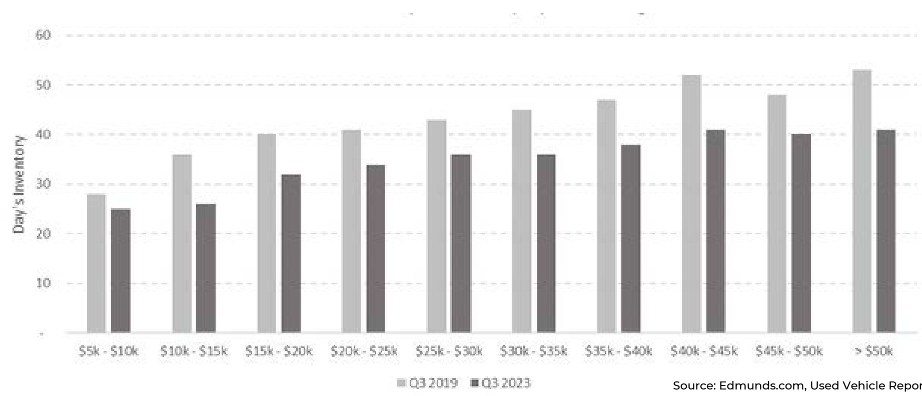
Figure 24: Used Vehicle Average Age



Source: Edmunds.com, Used Vehicle Report

Figure 25 shows that competition is getting tougher, as inventory turns are higher in Q3 2023 relative to Q3 2019 across all price points, the largest differences reflected in the used vehicles priced over $40,000.

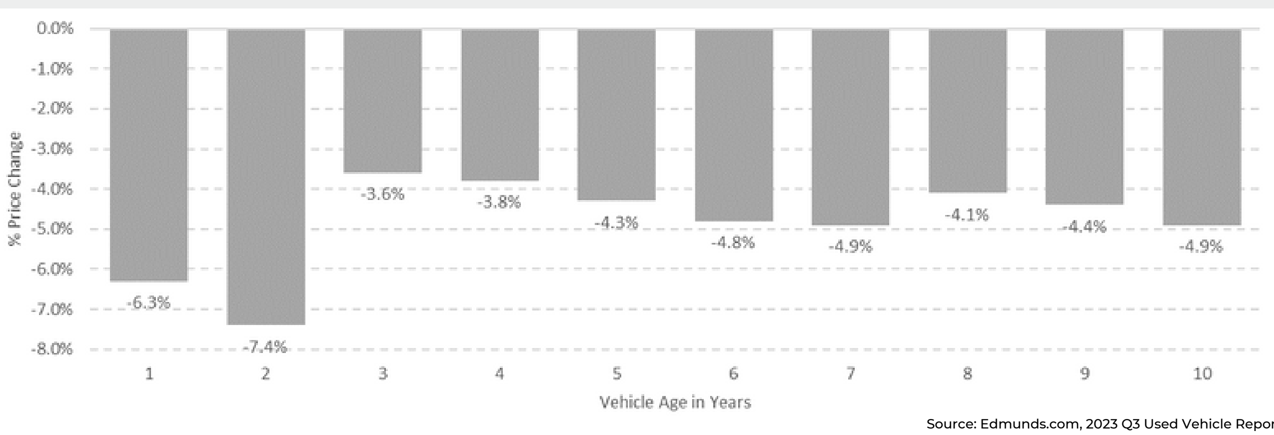
Figure 25: Used Vehicle Day's Inventory by Price Range



Source: Edmunds.com, Used Vehicle Report

The average incentive for new vehicles increased 90.7 percent year-over-year in December 2023 to $2,458. The reduction in overall cost of new vehicles have the most effect on used vehicles that are two years old and newer. Figure 26 shows the price change from Q2 2023 to Q3 2023 by the age of the vehicle. [17]

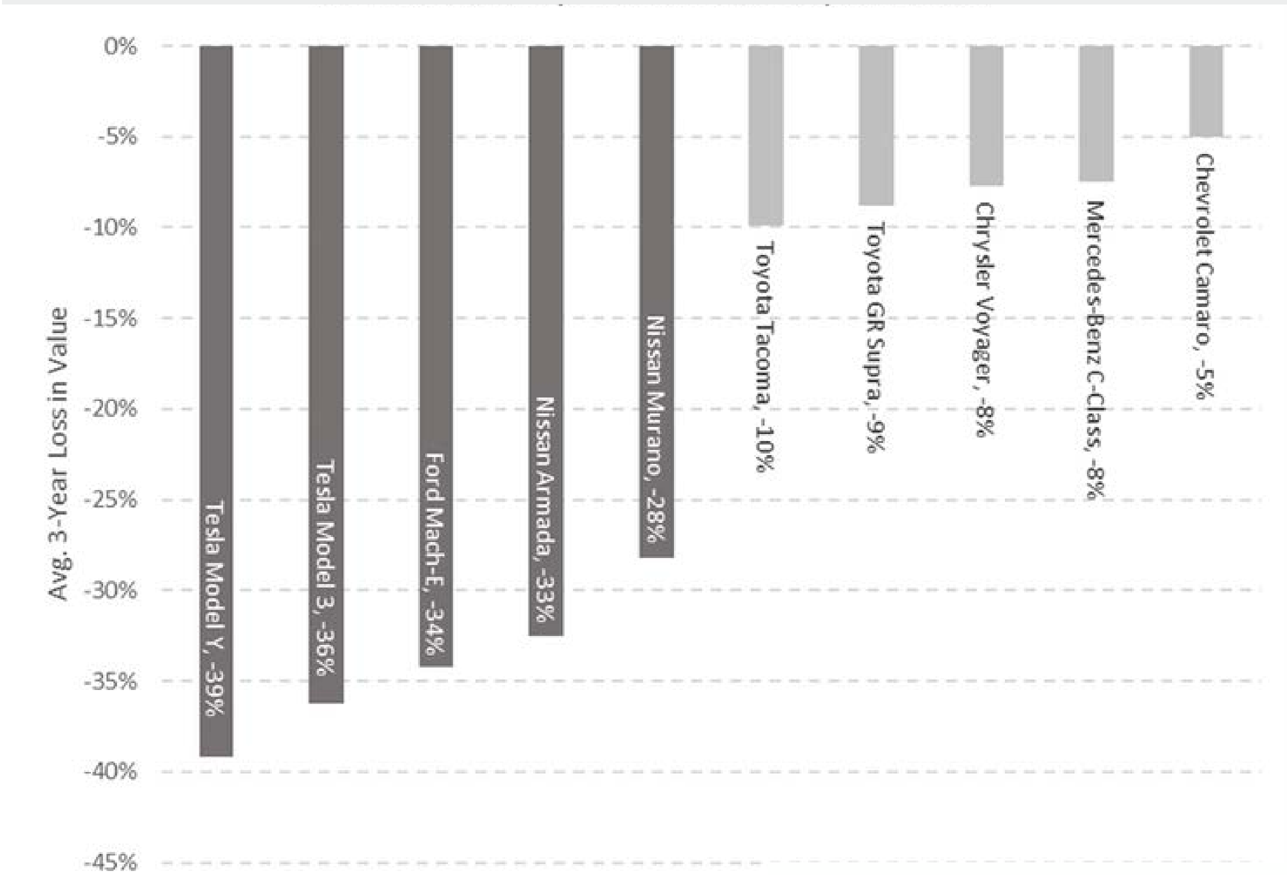
Figure 26: Price Change from Q2 2023 to Q3 2023 by Vehicle Age



Source: Edmunds.com, 2023 Q3 Used Vehicle Report

According to Edmunds, the market is back to normal where vehicles lose value over time rather than appreciate, making valuation estimates more predictable. The values of EVs have plummeted over the last three years as a result of multi-phased reductions in prices for EVs across the industry. Figure 27 shows models with the most and the least depreciation since 2021. [18]

Figure 27: 2021 Models by Most/Least Depreciation



Source: Edmunds.com, 2023 Q3 Used Vehicle Report

In November 2023, Edmunds reported that drivers with negative equity were underwater (debt owed that is greater than the value of the vehicle) by an average of $6,054, the most since April 2020, and 14 percent higher than the average of $5,300 in 2019. The rise in negative equity is a result of a decline in values since prices for new and used vehicles soared in 2022. [19]

Negative equity is an opportunity for the dealer to sell guaranteed asset protection (GAP), an insurance product that covers the difference between the amount owed on a vehicle and the amount paid off by traditional property and casualty insurance in a total loss.

Electric Vehicles

Growth for EVs slowed in 2023 and many automakers are rethinking their EV strategies.

EVs hit an all-time high of 1.2 million units sold in 2023, 7.6 percent of the U.S. market share, but breaking this record involved deep discounts from Tesla, dropping prices by as much as 25 percent. If the Tesla discount was treated like a factory incentive, the incentive would be 35 percent of the average transaction price, roughly seven times higher than the industry average over 2023. Other EV brands are following Tesla in slashing prices, such as Lucid, Ford's Mustang Mach-E, among others. [20]

Consumers don't have to wait until they file their taxes to receive an EV tax credit of up to $7,500, but rather, they get the incentive at the time of purchase from the dealership as a rebate, leaving the dealer with the responsibility to recoup the credit. But even with this incentive provided by the Inflation Reduction Act (IRA), interest in EVs seems to have cooled in 2023. One reason is that the IRA made it tougher for an EV to qualify for the tax credit, putting requirements related to vehicle weight, battery capacity, and minerals sourced for the battery, and the location of final assembly. [21]

In February 2023, Ford announced it was halting all shipments of its F-150 Lightning pickup trucks so it could perform quality checks but could not specify the nature of the checks. This came a month after Ford announced it would reduce production of the F-150 Lightning to about 1,600 per week, half of what was originally planned to be produced. Analysts estimate that Ford lost $36,000 per EV sold in Q3 of 2023. [22]

Ford dealers were able to sell 86.4 percent of their Mach-E inventory within 30 days in the second quarter of 2022 but this figure dropped to 27.7 percent in the same period of 2023, even as the automaker had over twice as much inventory on the market, according to data from analytics firm Cloud Theory. As a result, some Ford dealers are declining allocations of EVs from the factory. [23]

GM's Mary Barra, originally one of the more vocal CEOs to champion the proliferation of EVs, stated in GM's third-quarter 2023 earnings call, that GM has cut its original EV production targets for 2023 and 2024, and she refrained from providing new targets. Mercedes-Benz CFO, Harald Wilhelm, stated on a call with analysts that EVs are "a pretty brutal space" adding, "I can hardly imagine the current status quo is fully sustainable for anybody." [24]

Volvo announced it would not provide further funding to Polestar, the electric car maker it created with Volvo's Chinese owner, Geely. Volvo and Geely founded Polestar as a stand-alone EV maker, separate from Volvo's in-house EV efforts. Geely stated it would continue to provide full operational and financial support to Polestar. [25]

Honda announced in October 2023 that it was scrapping a plan to jointly develop an affordable EV with GM, just a year after both companies agreed to join forces in a $5 billion effort to compete head-to-head with Tesla. "After studying this for a year, we decided that this would be difficult as a business, so at the moment, we are ending development of an affordable EV," Honda CEO Toshihiro Mibe was quoted by Bloomberg as saying in an interview. Honda said there was no change in its plan to sell only electrified vehicles by 2040. [26]

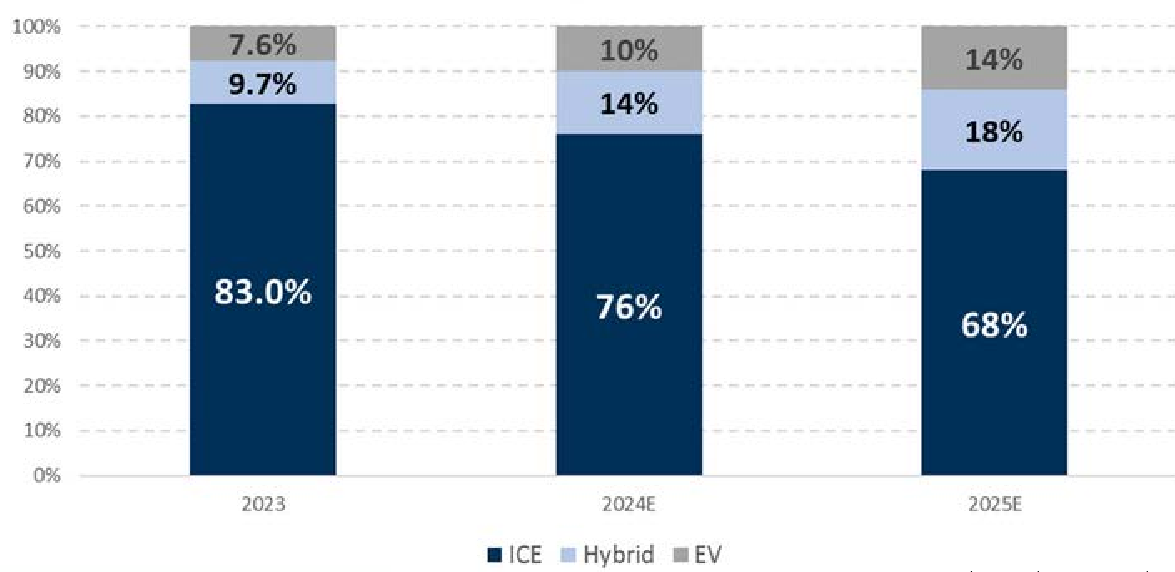
Toyota has been more vocal than other automakers about the challenges EVs face in the near term, including high costs, resource crunches, and limited charging infrastructure.

Toyota's approach to EV production has been to utilize hybrid technology as a bridge to complete EV models, some of which are concepts due to roll out in the latter half of this decade.

In October 2023, Toyota had about a week's worth of Prius hybrids in stock, compared to more than two months' supply of its electric SUV, the bZ4X. Additionally, the best-selling car in America, Toyota's Camry, will be offered only as a hybrid beginning in 2025, along with a few other of its brands. [27]

According to Edmunds data, the market share for hybrids doubled last year to 9.7 percent in November 2023. Over the same time period, EV market share grew only 25 percent. Figure 28 shows projected market share through 2025 between internal combustion engines (ICE), hybrids, and EVs, as reported in a 2024 Market Outlook Report by Kaiser Associates and Dave Cantin Group. [28]

Figure 28: U.S. Market Share



Source: Kaiser Associates, Dave Cantin Group

Multiple Chinese automakers such as BYD, SAIC-MG, and Chery have announced plans to add EV manufacturing capabilities in Mexico to meet the requirements as stated in the IRA and to bypass import tariffs. Having entered the Mexican market in 2017, Chinese companies are building EVs in Mexico for the Mexican market. Once production volumes get high enough, it's conceivable that Chinese EVs will be seen in the U.S., perhaps even by 2025. [29] The impact of a cheap Chinese-made EVs (or ICE) vehicles available in the U.S. has automakers concerned, even Elon Musk, who stated, "Frankly, I think, if there are not trade barriers established, they (the Chinese) will pretty much demolish most other companies in the world." Chinese automaker BYD sold more battery-powered cars in the world in 2023 than any other company, including Tesla. [30]

At least automakers no longer need to be concerned with Apple developing an EV. In February 2024, Apple announced it was canceling its electric car project after 10 years of development and billions of dollars. It was one of the most ambitious projects in the company's history.

The cost of owning an EV is a subject of continual debate. The savings, or lack of savings, generally vary by the sponsor of the various studies. A study issued in January 2024 by the University of Michigan Center for Sustainable Systems found, in general, smaller EVs (200-mile range) saved money if they can be primarily charged from home. However, longer range EVs are costlier per mile than ICE vehicles, even if charged at home. The study noted the results varied greatly by the city's price of fuel and electricity. [31] Another study published by the Texas Public Policy Foundation found that when removing federal subsidies, the cost of operating an EV is equivalent to $17.33 per gallon for an ICE vehicle. The Anderson Economic Group found that an entry-level ICE that cost $9.78 per 100 miles compared to an EV in the same segment that cost $12.55 to charge per 100 miles. That cost increases to $15.97 per 100 miles if charged commercially. [32] In addition to the cost of powering the vehicle, EV owners are learning that their tires last a fraction of the time of ICE tires because of the EV's instant torque, acceleration, and weight. [33]

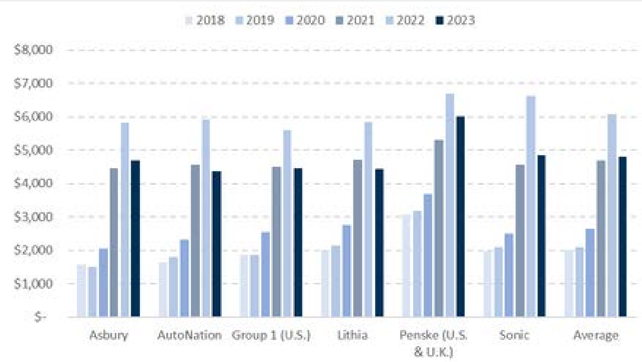
Public Dealership Groups

Profits from public dealership companies are pulling back from previous all-time highs.

In the U.S., publicly held automotive retail groups account for less than 10 percent of total industry revenue, with 90 percent of the market share belonging to smaller regional or independent dealers. While public dealers hold a smaller share of the market, comparing the performance metrics of an individual dealership against the public group can be useful.

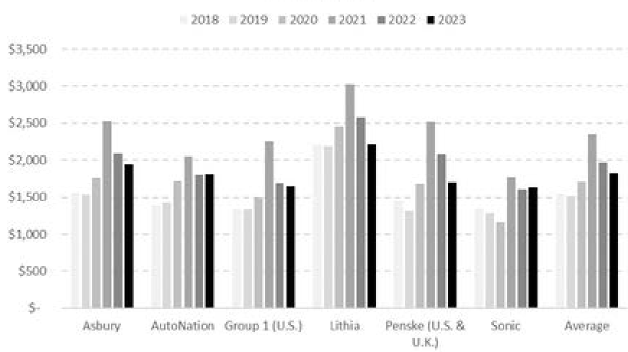
The average transaction price for new units increased year-over-year in 2023 for all of the public dealership companies; but the rate of increase is slowing down. The average transaction price among the group for a new vehicle in 2023 was $53,001, a 2.8 percent increase over 2022's average. In 2022, the average price for a new vehicle increased 10.6 percent year-over-year. Used vehicle prices declined for all except Penske in 2023, with the average price declining by 3 percent year-over-year. The average price increased 12.7 percent in 2022. The average transaction price for new and used units is 33 percent and 39 percent higher than in 2019, respectively. Figure 29 shows the average transaction price of new and used vehicles at public dealership groups since 2018.

Figure 29-A: Revenue per New Vehicle



Source: Annual Reports

Figure 29-B: Revenue per Used Vehicle Franchised Stores Only



Source: Annual Reports

Gross profit per new vehicle was down across the board in 2023, with the average, $4,807, declining 21 percent from last year's average of $6,089. Gross profit per used vehicles declined for some of the public dealers, but not all. Figure 30 shows the trend in gross profit for new and used vehicles.

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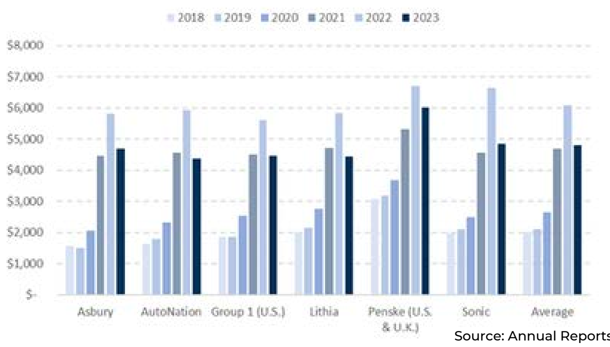
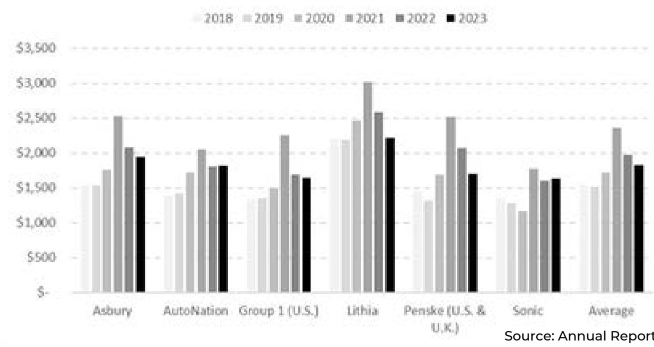
Jon Paul Davis leads the firm's Management Advisory Services department, and recently moved to Memphis to serve as Managing Partner for HHM's West Tennessee location. Jon Paul guides companies through business planning, strategic growth decisions, forecasts, and financial modeling. He also provides business valuation and litigation support services to businesses and attorneys across the country. Call Jon Paul to schedule a consultation by phone or a face-to-face meeting.

Figure 30-A: Gross Profit per New Vehicle Same Store



Source: Annual Reports

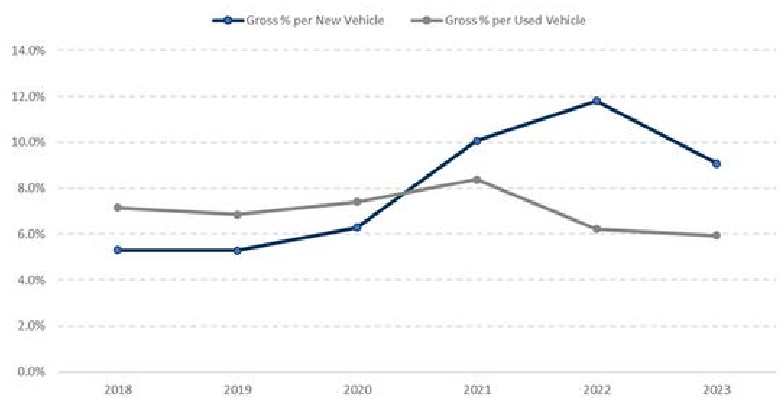
Figure 30-B: Gross Profit per Used Vehicle Franchised Stores Only



Source: Annual Reports

Gross margins on used vehicles historically exceed those of new vehicles; however, in 2021 this dynamic flipped, widened in 2022, and appears to be converging. Also of note, the average gross margin percentage for used vehicles is below the 2019 level. Figure 31 displays the gross margins of public dealerships since 2018.

Figure 31: Public Dealers - Average Gross Margins

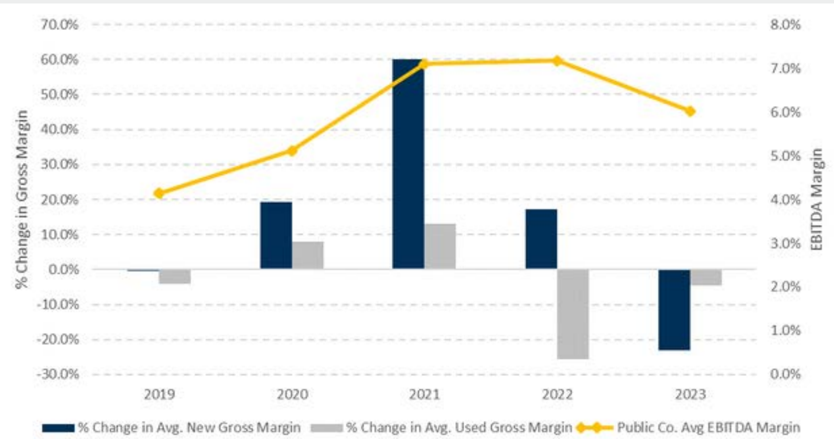


Source: Annual Reports

The change in gross profit margin of new vehicles had a much greater effect on overall profitability of the public dealership group than the change in used gross profit margin.

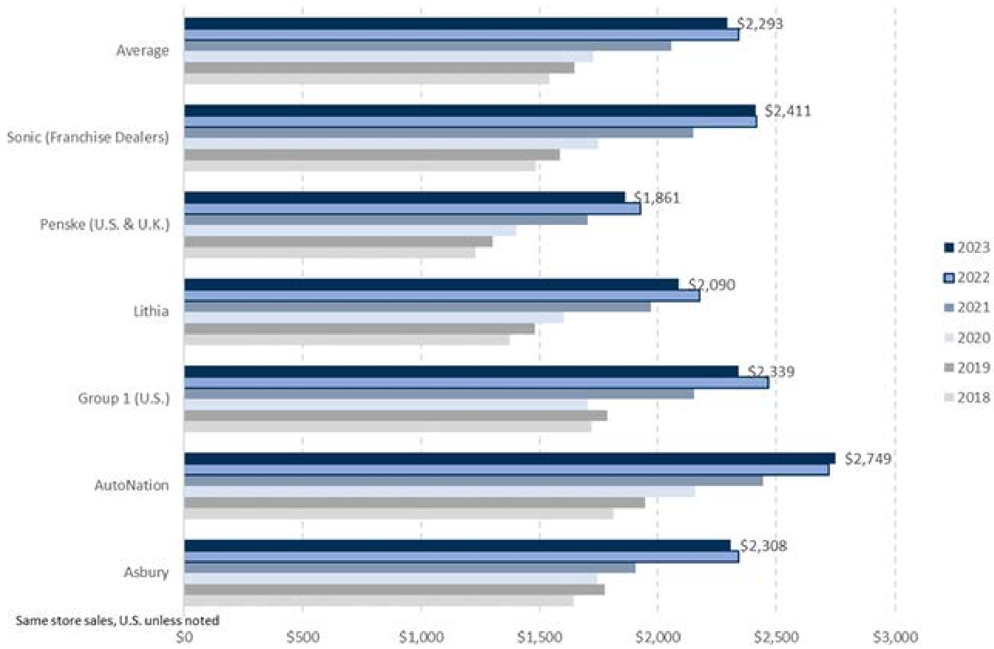
Figure 32 shows a comparison of the gross profit of new and used vehicles and the average earnings before interest, taxes, depreciation, and amortization (EBITDA) as a percent of sales for the group. In 2022, the percentage of gross profit from used vehicle sales fell from 8.4 percent to 6.2 percent (a 25.7 percent decline), but it had no effect on the average EBITDA as a percent of sales. Not until the new unit gross percentages fell in 2023, did it have an effect on EBITDA margin.

Figure 32: Public Company Average EBITDA Margin vs. % Change in Gross Margins



Except for AutoNation, F&I income per unit fell in 2023 at all public dealership groups. The average year-over-year decline was 2 percent. Figure 33 lays out F&I income for the public dealership groups in the years 2018 through 2023.

Figure 33: F&I Gross Profit per Unit (Same Store)



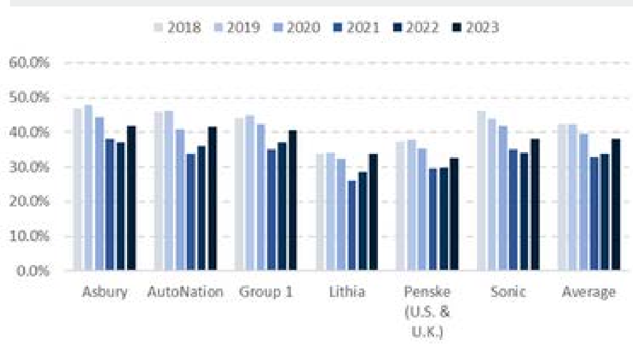
Source: 10-k filings, HHM Research

Backend Operations

Revenue from the parts and service segments, as a percent of total revenue, increased in 2023 for all of the public dealership groups. This trend is likely a result of high vehicle prices forcing consumers to get repairs rather than trade the vehicle in. Gross profit as a percent of total dealership gross profit declined as the gross profits for new and used units skyrocketed in 2021 and 2022, but in 2023 the contribution of gross profit as a percent of total increased. Service and parts contributed to 38.1% of total gross profit on average in 2023, up from 33.7 in 2022. Figure 34 and 35 show the trends.

Figure 34: Parts & Service Revenue as % of Total Company Revenue

Figure 35: Parts & Service Gross Profit as % of Total Company Gross Profit

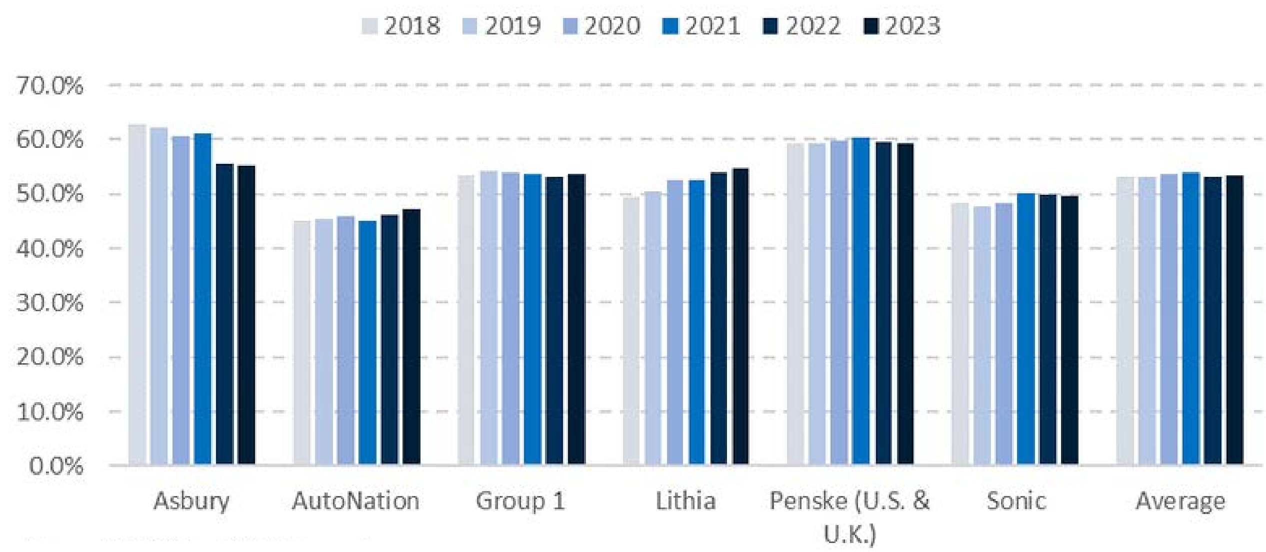


Source: 10-k filings, HHM Research

Average gross profit margin has maintained a consistent level over the observed period, between 53% and 54% for the public dealership groups.

Figure 36 shows historic gross profit margin from service and parts for the public dealership companies.

Figure 36: Parts & Service Gross Profit Margin (Same Store)



Source: 10-k filings, HHM Research

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Paula Mashburn is a partner at HHM CPAs with nearly 30 years of experience in the accounting industry. A key member of the Pensacola office leadership team, Paula is excited to be back in her hometown after leaving in 2012 to embark on a journey that led her to become a valued member of the HHM CPAs team. Paula's passion for helping clients navigate the complexities of financial management is evident in her attention to detail and strategic problem-solving skills. Paula is also a committed mentor within her firm, dedicating a significant portion of her time to guiding and developing new staff members. Her passion for helping others succeed shines through in her work both on-site with clients and within the HHM office.

Carvana

Rumors of Carvana's demise were greatly exaggerated, but Vroom is gone.

The dealership industry has kept watch on direct-to-consumer business models like Carvana and Vroom.

While Carvana appears to have saved its business from demise, Vroom was not as successful.

In January 2024 Vroom announced it was winding down its used vehicle business to focus on financing and analytics.

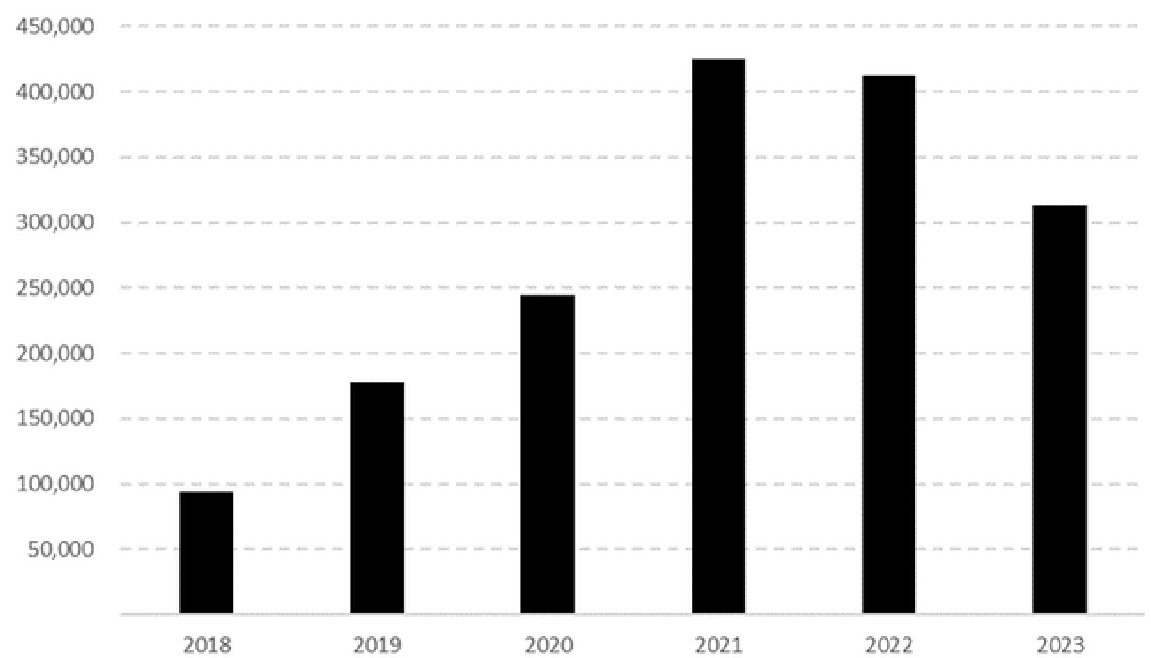
Carvana remains the only truly direct-to-consumer alternative.

Facing the real possibility of bankruptcy under a heavy debt burden, much of which was used to acquire the vehicle auction company, ADESA, Carvana's leadership managed to negotiate a debt restructure in the summer of 2023 that pushed debt maturity to 2028, but doubled its interest expense. Carvana aggressively cut costs over the last year, reducing headcount by more than 4,000 and utilizing artificial intelligence software for streamlining vehicle reconditioning, for sales, and for pricing. The result of the restructuring is a record adjusted EBITDA for 2023. Carvana's stock price is over $78 per share at the time of this writing, up from the most-recent low set at the end of 2022, $3.37. Figure 37 shows the historic stock performance. [34]

Figure 37: Carvana Stock Performance

Carvana's turnaround didn't come as a result of increased sales, but rather, sales declined. Figure 38 shows the number of retail units sold 2018 – 2023. Unit sales declined 24 percent year-over-year.

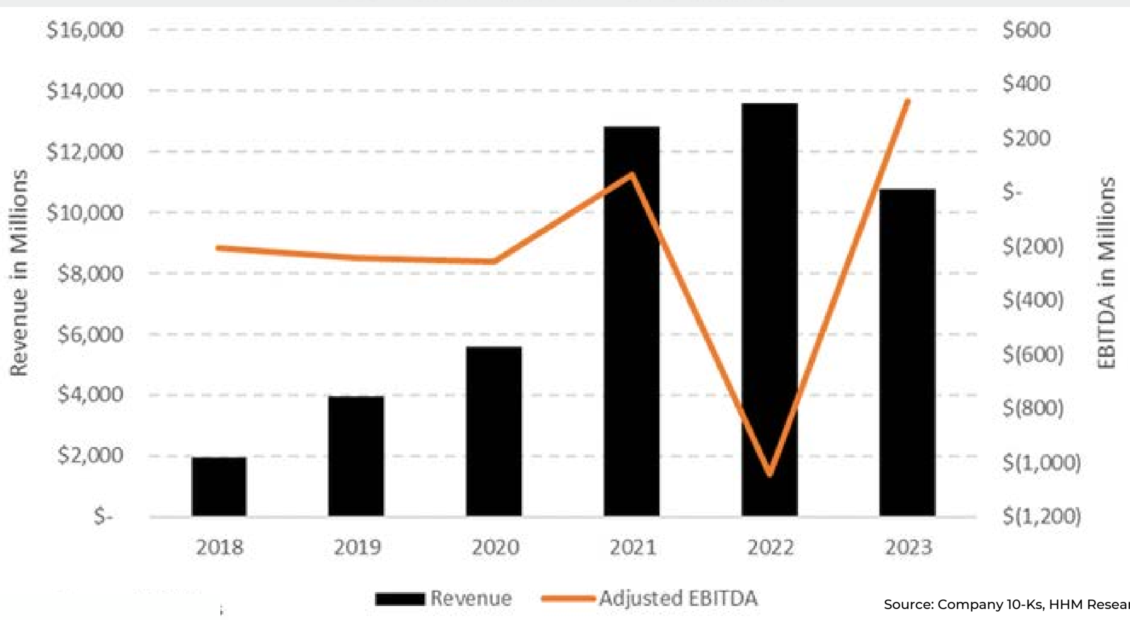
Figure 38: Carvana Retail Units Sold



Source: 10-k filings

Even with a decline in sales, the cost cutting led to a record year of profit for Carvana. This comes after a year where Carvana had a negative EBITDA over $1 million. The dramatic turnaround is highlighted in Figure 39.

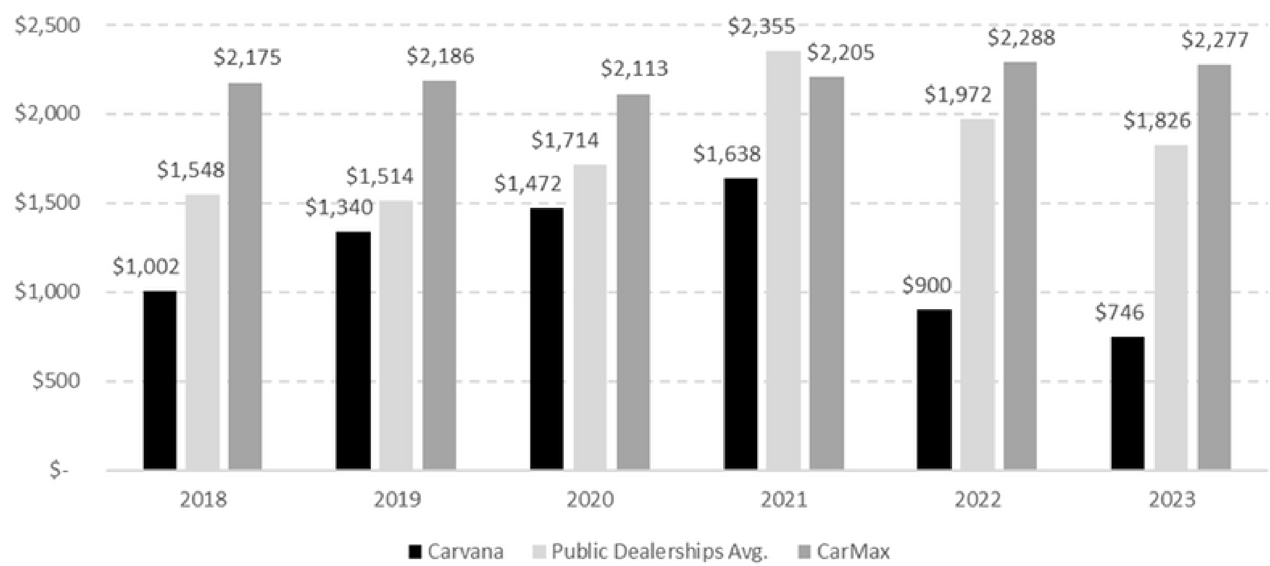
Figure 39: Carvana Financial Performance



Source: Company 10-Ks, HHM Research

With positive cash flow and a delayed debt maturity, Carvana appears to have bought some time, but the company has a long road to improvement, as reflected by its gross profit relative to its competitors'. Figure 40 shows Carvana's gross profit per unit compared to the per unit data of CarMax and the average from the public dealership groups.

Figure 40: Gross Profit per Used Unit



Source: Company 10-Ks, HHM Research

Is Amazon entering the car business?

In late 2023, Hyundai Motor Company announced that it would be the first brand available for sale in Amazon's store in the U.S. in 2024. To be more precise, Hyundai dealers will, for the first time, be able to sell vehicles on Amazon.com. Its nothing new for customers to shop for vehicles on Amazon, but now customers can actually purchase the vehicles from a dealership through Amazon. According to dealershipguy.com, dealers will continue to set the price of the models they are selling on Amazon and determine shipping details. Dealers are still prohibited from advertising prices below the minimized advertised pricing (MAP). Amazon expects to extend this deal beyond Hyundai to other automakers. [35]

The Credit Market

The credit market is tightening as delinquencies rise but lenders see the market normalizing.

The credit market is tightening as delinquencies rise but lenders see the market normalizing.

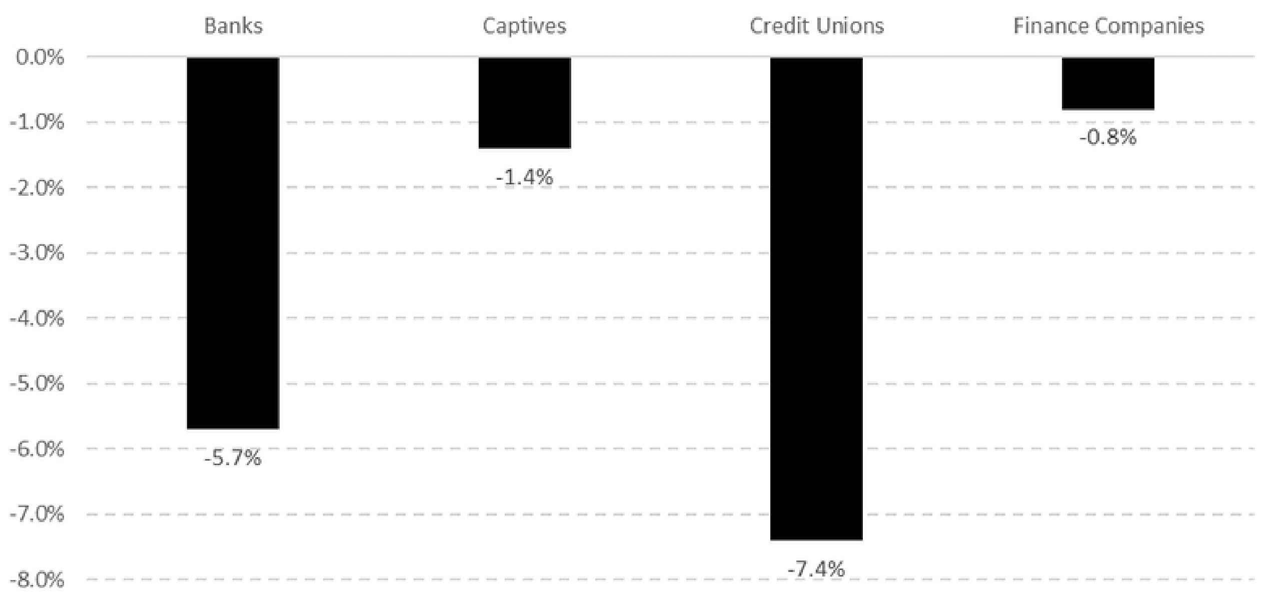
According to Bankrate, half of Americans who applied for loans in the past two years, since the Fed began raising interest rates, were turned down. The automotive industry is seeing a tightening of credit for consumers. Dealertrack's Auto Credit Total Loan Index improved over Q2 and Q3 of 2023, but the gains were wiped out in Q4. By January 2023, the Index marked the lowest level since August of 2020. [36]

Loans for used vehicles tightened the most, and among lenders, credit unions pulled back more than the other lenders. Figure 41 shows the change in the Dealertrack Index year-over-year as of January 2024. [37]

The tightening of credit availability coincides with the rising cost of vehicles and interest rates, along with the rising percentage of loan delinquencies.

The Federal Reserve released a report in February 2024 which stated that the rise in delinquencies "signals increased financial stress, especially among younger and lower-income households." [38]

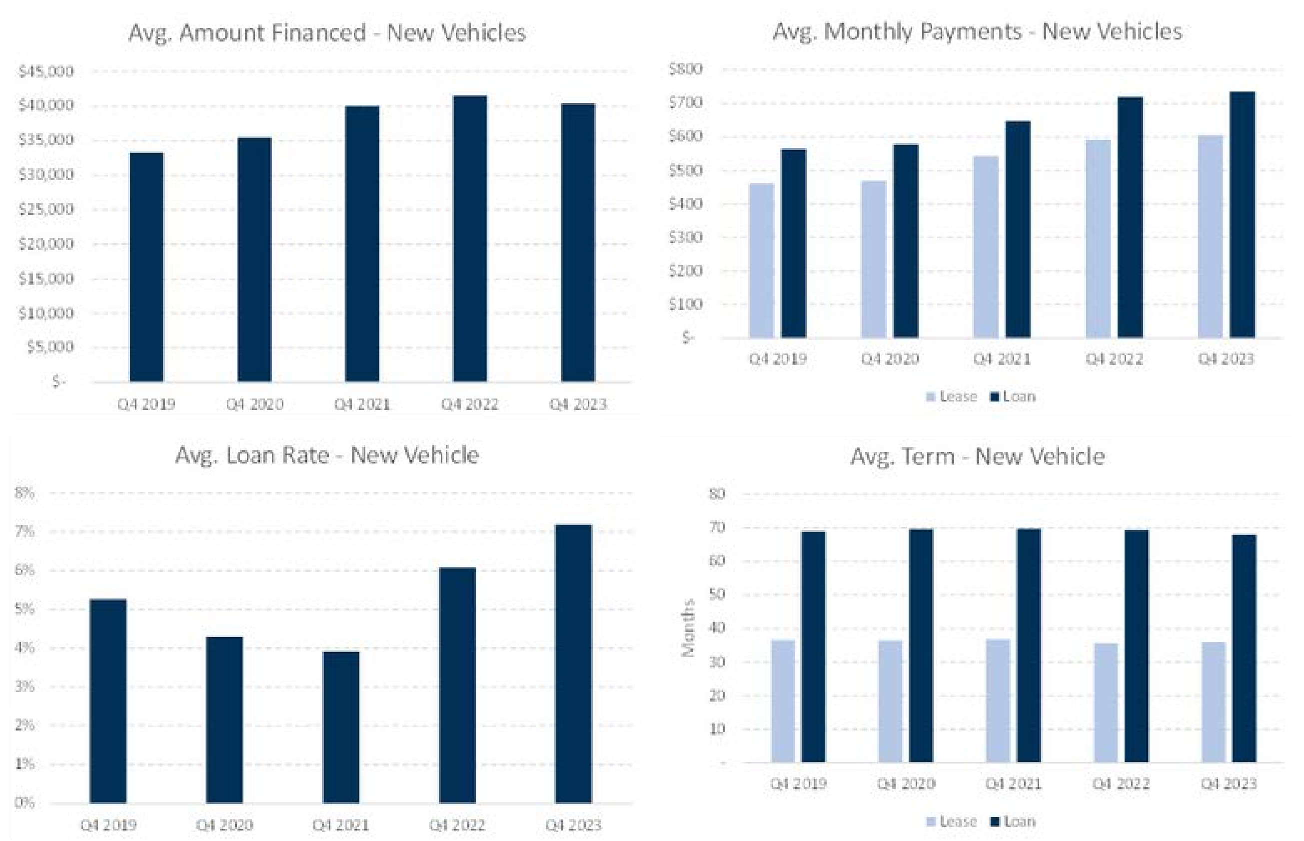
Figure 41: Dealertrack Loan Index Y/Y Credit Availability Changes



Source: Dealertrack, Cox Automotive

According to Experian's State of the Automotive Finance Market Q4 2023, the average amount financed in Q4 2023 for a new vehicle was $40,366, down about 3 percent year-over-year. The average monthly payment for a new vehicle loan was $736 and the average monthly payment for a lease was $606. The average term for a loan on a new vehicle is 67.87 months, the fewest months over the observed period. Figure 42 shows financing trends for new vehicles over the last four years.

Figure 42: Financing Trends for New Vehicles



Source: Experian

The average amount financed for the purchase of a used vehicle in Q4 2023 reached $26,685, a 4.4 percent year-over-year decrease. At the end of 2023, the average interest rate for used vehicle loans reached 11.9%. The average monthly payment was $532. Figure 43 shows financing trends over the last four years.

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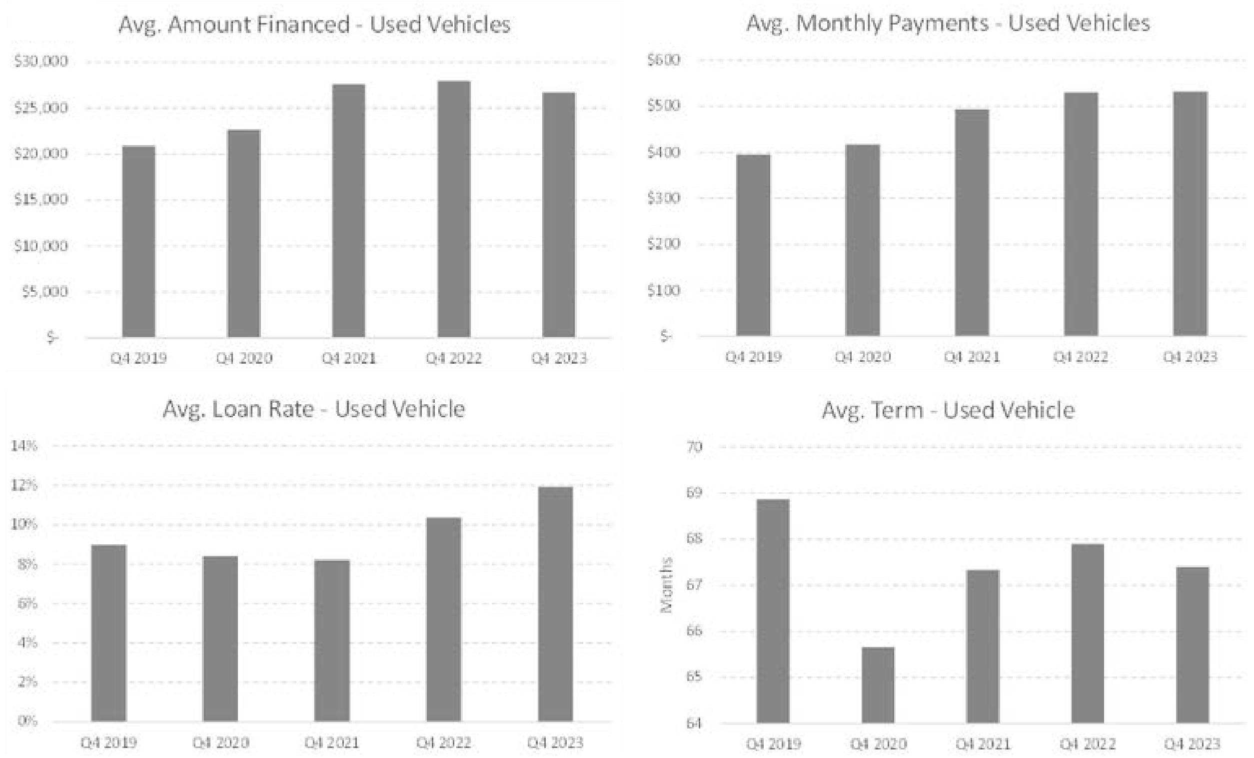
Branden has devoted most of his career at HHM to the firm's dealership services group. He works with a broad range of automotive retail clients located all over the country, ranging from single-point independent and franchise dealers to multi-point dealers and finance companies servicing more than $1 billion in lease and BHPH portfolios. He developed the firm's independent dealers' niche, and has a wealth of accounting and tax knowledge regarding the BHPH sales and financing segment of the automotive industry. He routinely speaks or serves on discussion panels at the various national and state independent dealer associations events.

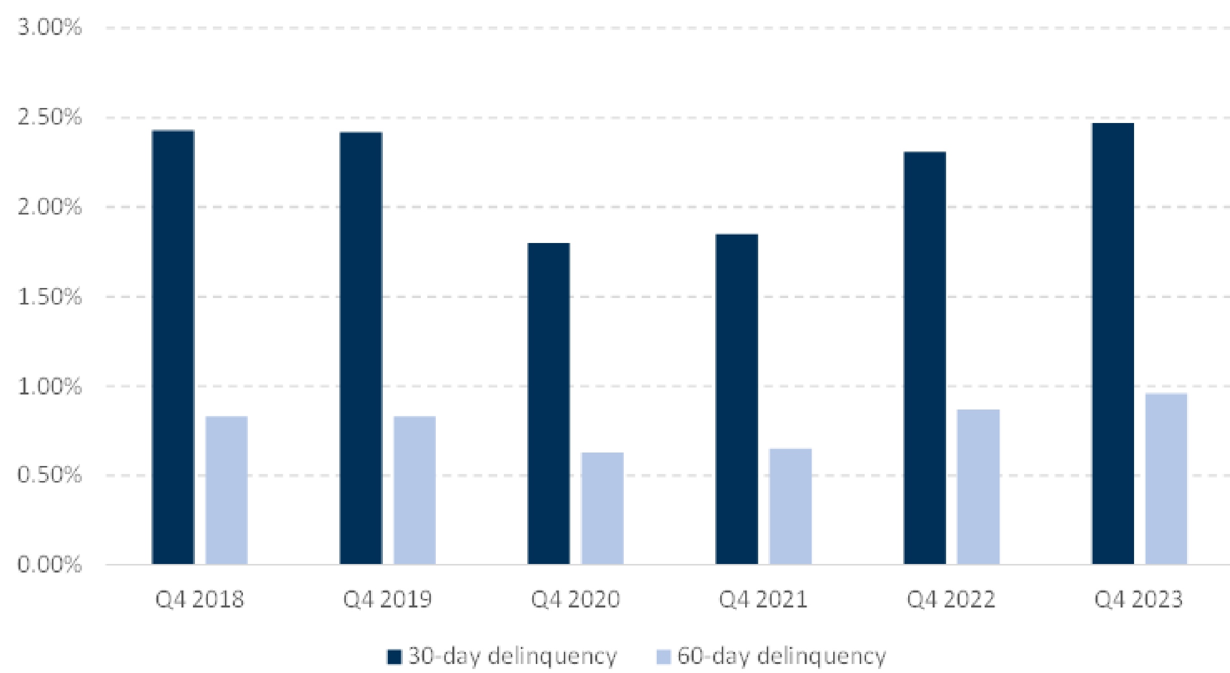
Figure 43: Financing Trends of Used Vehicles



Source: Experian

Delinquency rates are starting to tick up, returning to pre-pandemic levels. Figure 44 shows the percentage of loans 30 days and 60 days delinquent.

Figure 44: Percentage of Loans Delinquent



Source: Experian

Despite the rise in delinquencies, lenders remain cautiously optimistic. According to an article in American Banker, executives at some top U.S. auto lenders have said rising delinquencies are part of a "normalization" to pre-pandemic trends and they believe the credit environment may not get too much worse. [39]

For example, executives at Ally Financial have pointed to signs of a stabilizing credit environment. They noted recently that the yearly increases in delinquencies have been milder for four straight quarters. While charge-offs are now above their pre-pandemic levels, Ally executives have said they expect them to peak by midyear. [40]

WHY US?

OUR CPAS ARE KNOWLEDGEABLE IN ALL AREAS VITAL TO YOUR SUCCESS

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RESPONSIVE
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PROACTIVE
We anticipate obstacles to your success and will constantly look for more ways to boost your profit margins.

Auto Insurance

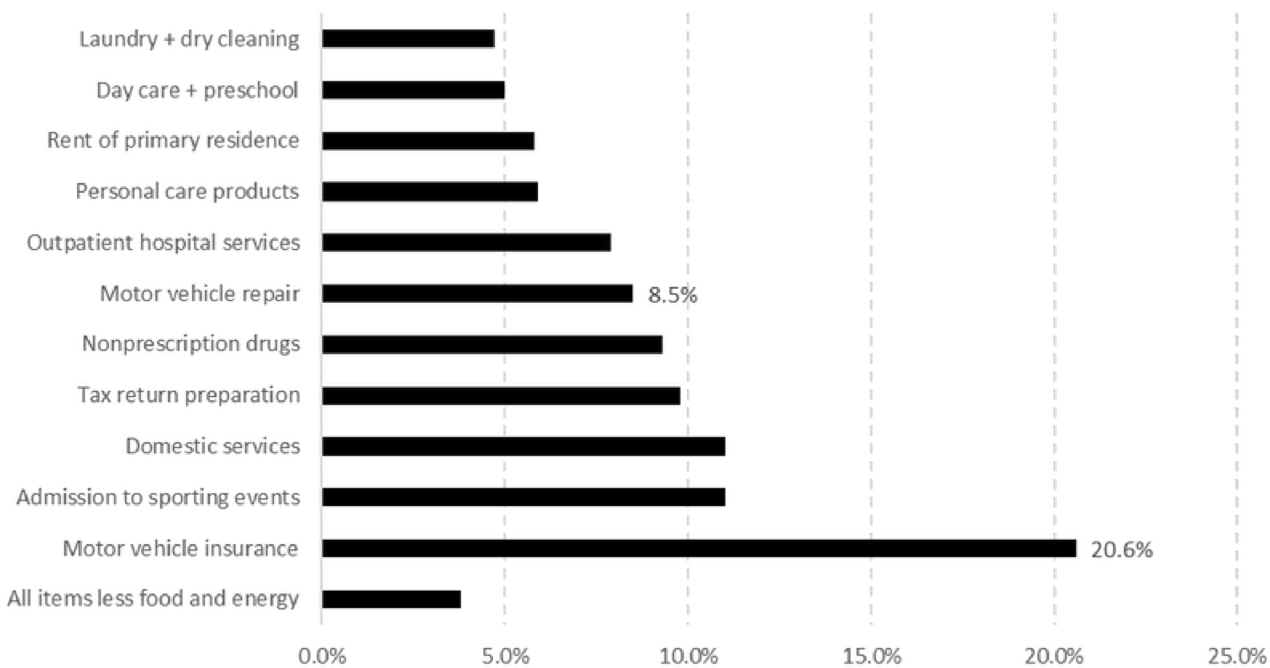
There has been a surge in the cost of auto insurance, increasing total cost of ownership.

Motor vehicle insurance premiums increased 20.6 percent year-over-year in February 2024, representing the largest increase since the mid-1970s.

Auto insurance, rarely an influence on the consumer price index (CPI), accounted for 15 percent of the headline price increases in Q4 2023. Factors driving the cost increase include higher vehicle values and the rising cost of labor and parts to repair vehicles. [41]

Auto insurance varies greatly by state. Auto insurance rates in Michigan average $4,788 a year, the highest in the U.S. and 168% higher than the national average of $1,780, largely due to the state having the highest minimum insurance requirements. Vermont has the lowest at $1,104, 38 percent lower than the national average. Figure 45 shows the consumer price index items of note, less food and energy, showing the surge in the cost of motor vehicle insurance and motor vehicle repair. [42]

Figure 45: CPI - Annualized Price Changes



Dealership M&A Market

Tightening of the credit market and differences in valuation expectations have begun to take effect on the M&A market.

Profits are declining at dealerships but remain much higher than pre-pandemic levels. As a result, buyers and sellers approach pricing based on different points of reference – buyers are looking at pre-pandemic levels and sellers claim business is permanently changed and that operational discipline is the key to holding profit margins. Deals that get done generally involve a reasonable weighting of pre- and post–pandemic profits.

Banks are pulling back on the level of buyout debt offered in a transaction. Many banks are still participating in deals but are requiring buyers to put more equity on the table, and with the strong cash flow of the last three years, buyers are certainly able. Public dealerships have cash for acquisitions. The CFO of Lithia, Tina Miller, stated in a Q3 2023 earnings call, “Our acquisitions completed during the quarter were funded using free cash flows from operations and through our working capital facilities.”

HHM remains very involved in buy/sell activity within the dealership market. Highline and most import brands are holding strong in good markets. However, trends noted by HHM professionals include slippage in value among CDJR and Nissan dealerships, as interest among buyers in these brands fades due to market share loss and challenges with the manufacturers. Buyers are less interested in smaller markets because they tend to rely on larger floorplan and smaller gross margins. Additionally, there is concern over how smaller markets will respond to EVs. Geography matters, as dealerships in states with very pro-business climates, such as Florida and Texas, are generally more desirable.

Interest Rates

Have we landed softly yet and when are interest rates going to be cut?

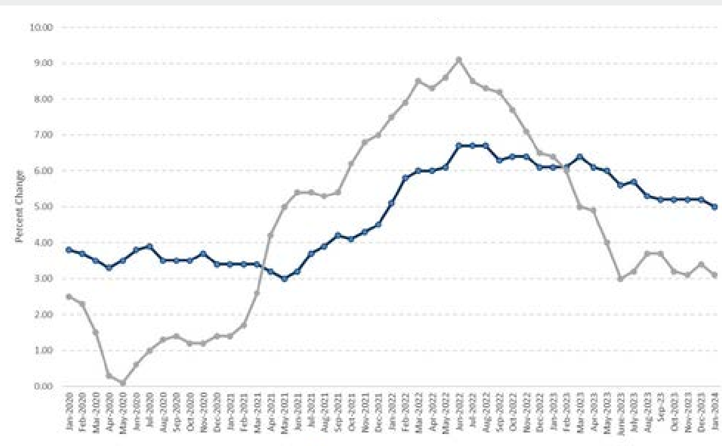
In the beginning of 2023, a survey of 71 economists conducted by the Wall Street Journal put the probability of a recession within the year at 61 percent. [43] About 10 months later, the same source lowered the probability of recession in the next 12 months to 48 percent. By January 2024 the probability had fallen to 39 percent. However, the same economists expect the economy to grow just 1 percent in 2024, far below the economy's growth of 2.6 percent in 2023. [44] Goldman Sachs, in its 2024 Maco Outlook, put a 15 percent probability of a recession in the U.S. and expects GDP growth of 2.4 percent. [45] The Federal Reserve expects to see growth at 1.4 percent in 2024.

As the Federal Reserve began its rate-raising campaign, the economy showed signs of slowing, and prices began to ease. However, as 2024 progresses, there are signs that inflation is being stubborn. The personal consumption expenditure (PCE) index (ex. food and energy) rose by 0.4 percent in January, the largest increase in a year. The price of goods fell 0.3 percent (0.5 percent on an annualized basis) but the cost of services increased 0.6 percent (3.9 percent on an annualized basis).

The Fed is holding to the position that it expects to cut interest rates more than once in 2024. Federal Reserve chair, Jerome Powell has said policymakers wanted to see six months of tame inflation data to be sure that the disinflationary trend isn't fleeting. At the beginning of March 2024, the markets were pricing in a quarter-point cut by the Fed in June 2024. Before the news of an uptick in inflation at the beginning of 2024, markets were pricing in an 81 percent chance that the Federal Fund's rate would be a full percentage point (or more) lower by year-end. After the news, that probability fell to 50 percent. [46]

As of mid-March 2024, the unemployment rate is 3.9 percent, slightly higher than previous months since it fell below 4 percent in February 2022. Wages climbed faster than the rate of inflation in 2023. After several months of wages trailing the increase in inflation, the rate of wage growth surpassed the rate of inflation in Q1 2023. Figure 46 shows a comparison of wage and inflation growth.

Figure 46: Inflation Rate vs. Growth in Wages in U.S.



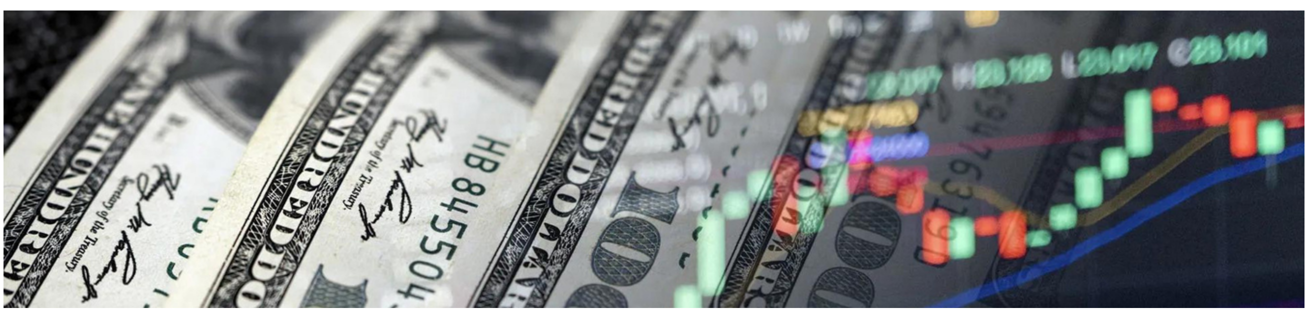
Source: Statisa.com, CPI

The number of available jobs and the number of voluntary "quits" by employees are both reported by the Federal Reserve and are used as another metric to gauge the health and directional trends of the employment environment. Figure 47 shows the available jobs and the quit rate (the number who quit their job during the entire month as a percentage of total employment) since 2000. The data show a clear tightening in the labor market as the number of openings and quitters has declined sharply since the 2022 peak.

Figure 47: Job Openings and Quits as a % of Employment

*Gray bars indicate recession

Source: The Federal Reserve



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Chad Goodman joined HHM immediately after college and worked in all areas of the firm before choosing HHM's dealership services group. He quickly worked his way through the ranks, and is now a partner serving automotive clients. He serves as an advisor to his clients, providing tax compliance and planning services as well as strategic planning and complex mergers and acquisitions. If you need sound guidance for your dealership operations, financing options, or general accounting issues, contact Chad.

Inverted Yield Curve

Long-term rates should provide a higher yield than short term rates so that investors are compensated for a longer wait on return of capital.

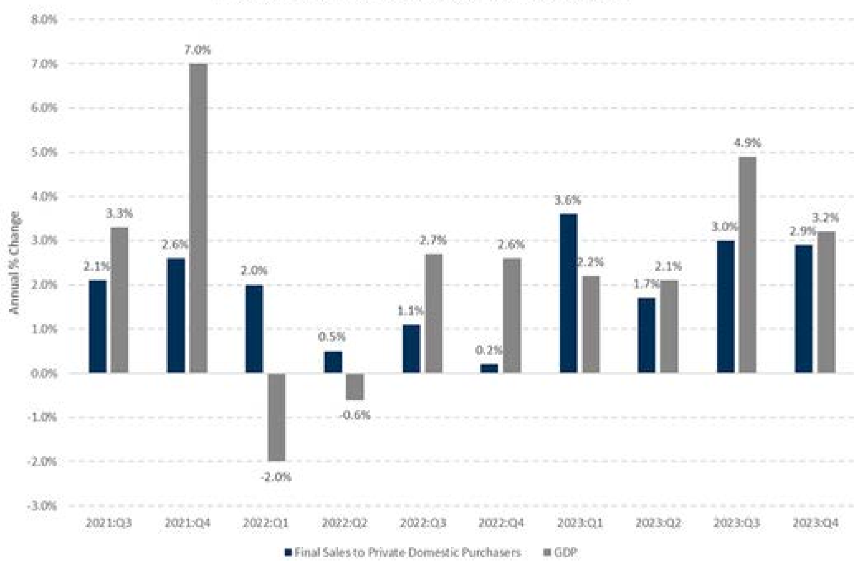
When longer-term rates are higher than short term rates, it is considered a normal yield curve. But since July 2022, short-term bonds have yielded more than longer-term bonds, causing the yield curve to be inverted. Over the last 50 years, this phenomenon has been a consistent sign of bad things on the horizon. Figure 48 reflects the spread (difference) of the 10-year Treasury rate and the 2-year Treasury rate.

When the percent drops below zero, the yield curve is inverted. Since the mid-70s, every yield curve inversion has led to a recession (indicated by the gray bars). Note how, in most cases, the recession didn't begin until after the yield curve normalized, and it appears to be trending toward normalization in Q1 2024.

Figure 48: 10-Year Treasury Rate Minus 2-Year Treasury Rate

Gross domestic product (GDP) growth in 2023 was solid. Another economic metric that is useful in determining the health of the economy – Final Sales to Private Domestic Purchasers, was also strong in 2023. This statistic measures how much U.S. residents are actually spending, where GDP measures what a nation produces. Figure 49 shows positive numbers in 2023.

Figure 49: Final Sales to Private Domestic Purchasers vs. GDP



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Conclusion

In an election year, things have the tendency to get crazy...this election, especially. But while political and economic factors may create volatility in markets and in our lives, Americans will still rely on their vehicles. Barring another shock to the system, 2024 should be a good year for dealerships.

About the Author

Travis Flenniken, CFA, CVA

Travis Flenniken has over 25 years of experience in business valuation, merger and acquisition advisory, investment management, and business consulting.

Travis specializes in automotive dealership valuation having represented buyers and sellers in dealership transactions and has also provided independent opinions of value in tax and litigation matters. He has published articles related to automotive dealership valuation in recognized business valuation periodicals. In addition to franchise dealerships, Travis provides valuations of independent automotive dealerships, including buy here, pay here operations.

Travis is a graduate of the University of Tennessee at Chattanooga and has also earned an MBA at the University of Tennessee at Knoxville. He holds the Chartered Financial Analyst (CFA) designation and is a Certified Valuation Analyst (CVA).

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