



Are You Unknowingly Putting Your Dealership's Financing at Risk?

In today's economy, having a sound relationship with a financial institution is more important than ever as lenders assess risk and manage their portfolios to comply with increased regulatory scrutiny. Dealerships need to be aware of key factors that can affect their relationships with lenders in these difficult times.

The Comfort Zone

Since the last recession that seriously affected the automotive industry was 18 years ago in 1991, most of today's dealers have not focused enough lately on gaining a thorough understanding of their loan documents, their covenants, and the key measurements financial institutions use to assess risk, determine rates, and establish the requirements for oversight.

Moreover, since times had been good, dealers may not have recognized how a lack of understanding or inattention to these important details can substantially affect their cost of business, their access to capital, and their overall lending relationships.

Dealers often say, "I have made every payment on time, never missed a payment, and I am making money. That's what is important; not some formula in the agreement!" But the economic pressure on the automotive industry and regulators' increased focus on financial institutions have become game changers, making it vitally important that dealers have an in-depth understanding of loan covenants, key financial ratios, risk ratings, cash flow, and internal controls. In addition, financial institutions are employing sophisticated tools that offer them better insight into their loan portfolios, making them more efficient in identifying concerns related to financial performance or noncompliance with loan agreements.

If dealers improve their understanding of these factors and incorporate them into their own key performance measurements, they can minimize the "surprise factor" caused by financial institutions' requirements. The goal is to prevent a situation in which their financial institutions propose increasing their rates, collateral requirements, or level of scrutiny or, even worse, announce their intention to exit the relationship entirely.

The Changing Focus:

Financial Ratios

Dealers are accustomed to comparing themselves to industry data to measure their performance. A similar process should be applied to the financial ratios their financial institutions are using to rate the dealerships' risk. Dealers need to understand their performance against the lender's key ratios, their standing against their loan covenants, and their overall. Some of the key ratios include vehicle equity, fixed debt coverage, and debt to net equity. In calculating these key ratios, dealers should ensure that they are using financial data in the same format by which they are computed by their financial institution. This consistency principle applies to all terms used in loan agreements.

Floorplan Audits

Another area where dealers should increase their focus is on vehicle floorplan audits. It is easy to disregard the requests or concerns of the financial institution during the vehicle floorplan audit. In fact, however, failing to proactively address the lack of proper oversight and controls that cause bad audit results can have adverse consequences on the financial institution's risk rating and evaluation. Bad floorplan audit results can also be the trigger for a more in-depth

review of dealer operations. The recent problems in the financial markets and the related investments by the government have also led to increased scrutiny.

The health of the automotive industry is a recurring topic of debate on the nightly news, the weekend talk shows, and in the national newspapers. Meanwhile, financial institutions are being subjected to stress tests by the government, and those with a large portfolio of automotive dealerships are subject to close oversight from regulators to ensure that risk is being managed appropriately. This new environment trickles down to the financial institution's relationship with the dealer. In the past, the lender may not have taken action when the dealership was out of compliance or when the dealer's financial performance was not measuring up to the institution's expectations. This is no longer the case. In this new environment, financial institutions are reducing risk in their automotive sector portfolios by increasing rates and collateral, requiring personal guarantees, or reducing the limits of loans offered. This is having a significant impact on the industry.

An increase in floorplan or mortgage rates has a direct effect on a dealership's cost of business. An escalation in the number of vehicle floorplan audits and the amount of information requested by the lender on a dealership's financial performance is also disruptive to day-to-day business. It redirects management attention to these issues, instead of keeping them focused on improving operational performance.

Capital

Another impact could be seen in a dealership's access to capital and the cost of capital for long-term growth and expansion plans as well as in complying with a manufacturer's image programs. The most severe scenario is one in which the financial institution decides to exit the relationship, forcing the dealer to scramble to find a new source of capital. In these situations, the dealer usually ends up with a capital source that requires much higher rates and imposes more stringent requirements. To put it simply, this is not a position in which dealers want to find themselves.

Looking Ahead

It is clear that understanding, monitoring, and improving the ratios used by a financial institution to establish the dealership's risk ratings need to become the "new normal" for dealership operations. If the financial institution isn't meeting with the dealer to review these measurements, it's up to the dealer to request such a meeting. And if the dealer's key performance indicators do not include a current view of these key ratios, the indicators should be adjusted to reflect them. With this knowledge, dealers may be able to prevent a violation of their loan agreements that could adversely affect the financial institution's cost of capital calculation which, in turn, would force the financial institution to respond with higher rates or tighter controls. Dealers who take positive steps to understand and address their financial institution's key ratios will reap the benefits, including increased profitability from lower cost of capital and better access to funds when opportunities make themselves available.

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