

# BUY HERE, PAY HERE YEAR-END REVIEW & A LOOK AHEAD!

BY KENNETH B. SHILSON, CPA

Annually, my CPA firm compiles buy here, pay here benchmarks from our database of more than 500 operators nationwide. For 2006, these benchmarks also include operating information on sales, collections and recoveries, and inventory management which were supplied by NCM Twenty Groups based upon a composite of all their buy here, pay here twenty group members. These 2006 benchmarks also include portfolio performance statistics which were compiled electronically by Subprime Analytics, who analyzed more than \$2.1 billion of subprime auto loans to identify loss rates and trends. In the aggregate, these statistics provide a very comprehensive look at the financial and operating performance of the industry for last year. Copies of these benchmarks can be downloaded, free of charge, at the National Alliance of Buy Here, Pay Here Dealers (NABD) website at [www.bhphinfo.com](http://www.bhphinfo.com) in the “News & Views” section.

During the National Buy Here, Pay Here Conference (NABD 2007) in Las Vegas, which was held on May 14 – 16, I discussed these benchmarks and identified some important industry trends as discussed below.

In 2006, industry profitability was adversely impacted by three factors:

- 1) Increases in vehicle acquisition costs,
- 2) Increased bad debt charge-off's, and
- 3) Higher operating expenses attributable to inflation.

The table below compares the resultant changes in gross profit from 2004 – 2006 (The numbers below are compiled from our best performing dealers and are not industry averages.):

	<b>2006</b>	<b>2005</b>	<b>2004</b>
<b>Revenues</b>	100%	100%	100%
<b>Cost of vehicle sales</b>	(64%)	(64%)	(62%)
<b>Subtotal</b>	<b>36%</b>	<b>36%</b>	<b>38%</b>
<b>Financing Income</b>	18%	18%	17%
<b>Bad Debts</b>	(20%)	(19%)	(17%)
<b>Gross Profit</b>	<b>34%</b>	<b>35%</b>	<b>38%</b>

Note: All percentages expressed are relative to revenues.

Source: Shilson, Goldberg, Cheung & Associates, LLP

As noted in the summary above, gross profit in 2006 declined for the second consecutive year! A more careful look at these results provides some important trends that need to be recognized!

- 1) Financing income for 2005 & 2006, even for the top performing operators, was not sufficient to offset bad debts.
- 2) The increase in bad debt expense has risen steadily since 2004 commensurate with higher vehicle acquisition costs and increased cash in deal.

Although these trends are not favorable, I believe the better operators in the buy here, pay here industry are very much aware of these economic changes and will take the necessary steps in the future to reduce and mitigate further losses. In a survey of several clients, they indicated plans to do the following:

- 1) Implement improved technologies that will enhance operating efficiencies and further reduce overhead. Their goal is to offset increased vehicle acquisition costs with less overhead.
- 2) Reduce bad debts by improved underwriting through a better matching of the right customers with vehicles they can afford.
- 3) To further reduce bad debts by improving collection operations and by increasing recoveries.
- 4) Improve cash flow by gradually increasing down-payments and customer payments to offset inflationary increases in costs, without lengthening the term of customer contracts.

Although I agree with all of the aforementioned strategies, some new challenges have recently surfaced which also must be addressed. Gasoline prices at or over \$3 per gallon and inflationary increases are zapping the liquidity of the buy here, pay here customers. Initially, these customers react to these increases by altering their driving patterns or by eliminating other discretionary expenses. Unfortunately, these changes only work for limited periods of time and economists don't agree on whether gasoline prices will go higher or return to levels under \$2.50 per gallon! Will our government control further inflationary increases with additional fiscal moves and will new fiscal controls work? These are questions which will only be answered in the months ahead.

In the interim, prudent operators must do a better job of underwriting. They must gather more customer information at the point of sale and use it to match the right customers with affordable vehicles. Their goal should be to sell vehicles that customers can afford based upon a pre-sale analysis of their cash flow. The industry must learn from the recent subprime mortgage meltdown that if you sell customers more than they can afford, defaults quickly follow! Operators must analyze their bad debt losses to determine what other adjustments must be made in their underwriting to reduce charge-offs and increase collections.

In summary, success in the buy here, pay here industry in the future is achievable only to those who understand and manage subprime portfolio risk prudently. The challenging economic landscape requires operators to work smarter, not harder!

Kenneth B. Shilson, CPA, is a Principal in Shilson, Goldberg, Cheung & Associates, Certified Public Accountants ([www.kenshilson.com](http://www.kenshilson.com)) which provides audit, tax and consulting services to the used car industry nationwide. He is President of Subprime Analytics ([www.subanalytics.com](http://www.subanalytics.com)) which provides computerized subprime portfolio analysis services. Mr. Shilson is the founder of the National Alliance of Buy Here Pay Here Dealers (NABD) which will hold a training conference on Underwriting & Collections on November 11 – 13, 2007, in Houston, Texas. For further information, visit [www.bhphinfo.com](http://www.bhphinfo.com) or call 713-290-8171.