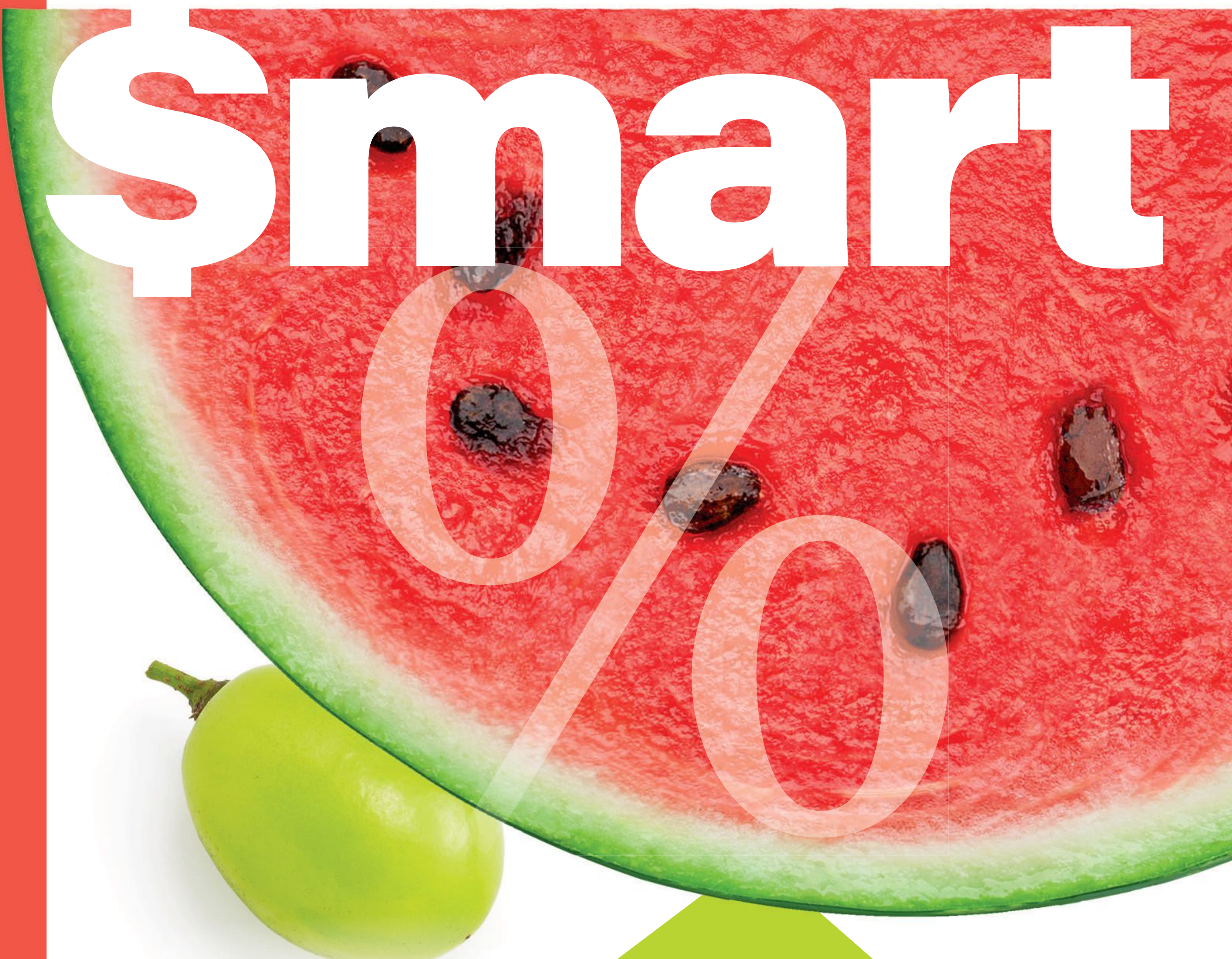
Grow $mart

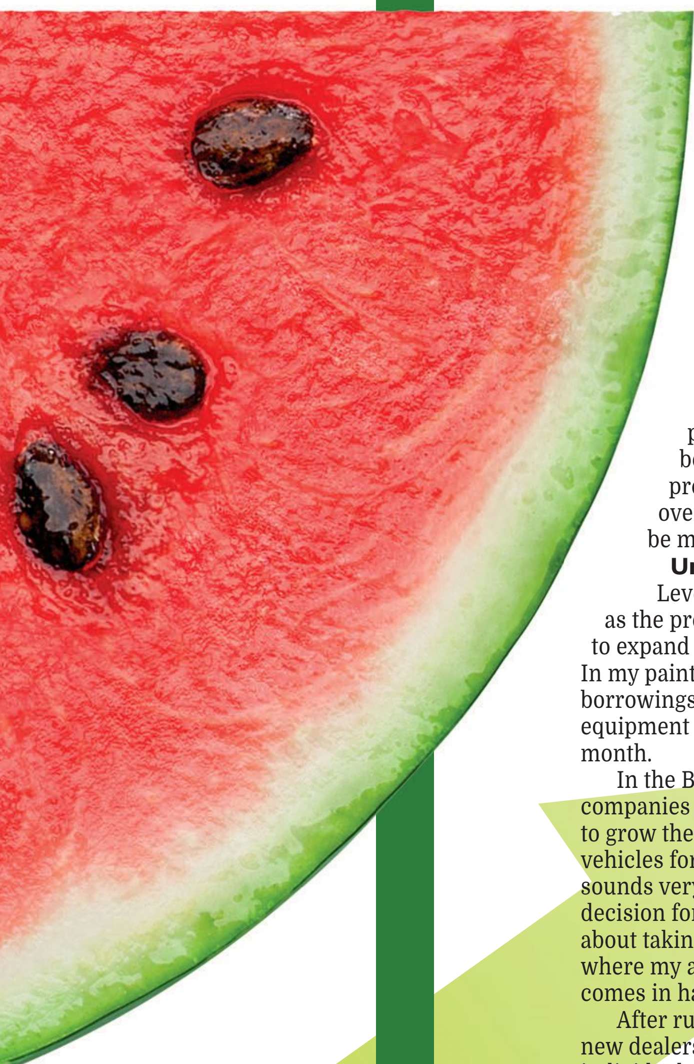


BY GARY PAGE

Mastering How to Use Leverage

During High School, I started painting houses in my neighborhood during the summers. I would hire my unemployed friends and soon I had several crews working. My supportive father greatly assisted in my entrepreneurial venture's growth.

As I added employees, I also needed to spend money on ladders, scaffolding, paint sprayers and insurance. I saved money to reinvest in the business but I really needed outside capital to fuel my growth and this is where my father stepped in. I soon realized the importance of having access to capital and managing leverage.



This business continued to grow as I spent my summers during college and graduate school running the painting business. I learned quickly that being capital constrained really slowed my growth plans. I realized that I might make a little less on each project due to the expense of borrowed money, but with more projects and employees, the overall company would expand and be more profitable.

Understanding leverage

Leverage in this context, is defined as the process of using borrowed capital to expand the asset base to further profits. In my painting business, I was using the borrowings from my dad to purchase more equipment to complete more projects each month.

In the Buy Here-Pay Here industry, companies provide dealers capital in order to grow their business and purchase more vehicles for their lot. Although this concept sounds very simple, it is often a tough decision for dealers as they are worried about taking on additional debt. This is where my analogy of the painting business comes in handy.

After running some numbers for new dealers, I show the profits of each individual account and the profits of the entire dealership. I create two models — one showing the profits with leverage and one without. As you might expect, the leveraged dealership is significantly more profitable and here is why.

Without leverage, dealers wait till each account can make enough payments to generate cash to purchase another vehicle. Industry averages suggest a dealer will need to wait 78 weeks before they break even on their current account and have enough cash to purchase the next vehicle. In simple terms, if you start a new dealership with five vehicles and sell them all the first month, you won't have anything else to sell for 78 weeks. The dealership will have to survive off the down payment and payment cash flow during this period.

This approach does maximize the profits on each vehicle as there is no added interest expense from outside capital. However, the dealership profits are constrained as there is no available funds for purchasing new vehicles for 78 weeks. And this cash constraint is a given as overhead items such as rent, payroll, and utilities are a constant.

For simplicity, imagine a dealer with just one vehicle and access to outside capital. Within a few days after selling the vehicle, the dealer can use the account as collateral to secure additional funding to purchase more vehicles. Our experience is that it takes about four weeks to purchase and prepare a vehicle for sale, sell it, and secure outside funding using the existing installment agreement and title as collateral.

Sample BHPH Leverage Multiplier:

Average Number of weeks to Breakeven (78)

Average Number of weeks to Purchase, Prepare, Sell Vehicle (4) = Opportunity (19.5)

In summary, you can sell about 19.5 vehicles in the time it takes to break even on one. The math simply takes the 78 weeks to break even divided by the weeks to cycle through and sell another vehicle. Your numbers may differ, but the process to calculate it is the same.

This leveraged approach does impact the profitability on each account as there is now cost of capital that has to figure into each vehicle. Although the profits per vehicle may be lower, the profits for the dealership are significantly higher.

Let's assume the average profit per vehicle drops from $8,000 to $6,000 when outside capital is leveraged. Using the above multiplier, the options are to make $8,000 on one vehicle or let the dealership earn $117,000 (19.5 vehicles times $6,000 in the same time period). Now imagine if you have 10 to 15 accounts you are collecting on that you could use as collateral. The numbers get much bigger.

Simply put – the BHPH business is a leverage model. As I often tell dealers, would you rather own half a watermelon or a whole grape.

Remember to GROW SMART! ■

Gary Page is the CEO of SDA, a capital provider for the Buy Here-Pay Here industry, which has helped thousands of dealers grow their receivables and build wealth.

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