

Hertz Global Holdings, Inc.

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In the June 7-8, 2014 weekend edition of *The Wall Street Journal*, an article entitled “Accounting Errors Hit Hertz Hard” caught auto industry analyst Abby Devins’s attention. Devins recalled that Hertz had hinted in March about the possibility of having to restate its 2011 financial statements, but by June the situation appeared worse than previously anticipated. “Hertz Global Holdings, Inc.,” read the article, “would have to restate and correct results from the past three years, according to a regulatory filing Friday that indicated more widespread accounting problems at the auto-rental company than had been thought.”¹ The article also mentioned that Hertz’s stock had closed down about 9% in Friday’s trading.

Keenly aware that car rental companies like Hertz provided a significant source of steady demand for automotive manufacturers, Devins was curious whether Hertz’s accounting issues could be related in some way to its large rental fleet and what impact this might have on the company’s future vehicle acquisition plans.

Car Rental Industry

As of 2013, the U.S. car rental industry totaled approximately \$36 billion in revenue, which was divided between leisure travelers, business travelers, and leasing, with rentals taking place both at airport and off-airport locations (**Exhibit 1**). Since the majority of car rental demand came from leisure and business travel, the industry suffered during the 2008-09 recession, with revenue growth plummeting into negative territory (**Exhibit 2**). Revenue growth resumed, however, as the subsequent economic recovery began to take hold.

¹ Michael Calia, “Accounting Errors Hit Hertz Hard,” *The Wall Street Journal*, June 7-8, 2014.

Due to a wave of consolidations, three companies dominated the market with a combined 71% market share — Enterprise Holdings (Enterprise, National, and Alamo brands); Avis Budget Group (Avis, Budget, and Payless brands); and Hertz Global Holdings (Hertz, Dollar, and Thrifty brands).²

Company Background

History

Hertz's beginnings trace back to 1918 when 22-year old Walter L. Jacobs launched Rent-a-Car, Inc. in Chicago, Illinois, with a dozen Model T Fords that he repaired and painted himself. After having generated \$1 million in revenue over five years, Jacobs sold his company to John D. Hertz who renamed the company in his name and made it a subsidiary of his Yellow Truck and Coach Manufacturing Company.

Over the next century, Hertz changed hands several times and was owned on separate occasions by both General Motors and the Ford Motor Company. In 2005, Hertz was acquired by a trio of private equity investment companies, which then took the company public in 2006. See **Exhibit 3** for a corporate timeline.

At the end of 2013, with over 30,000 employees, Hertz had almost 12,000 worldwide car rental locations, spanning 145 countries, and a rental fleet topping 700,000 cars (524,000 in the U.S. and 179,500 internationally).³

Operations and Financial Performance

After going public in 2006, Hertz grew from a single brand with an on-airport focus on business travelers to a multi-brand operation.⁴ The company acquired the \$1.5 billion annual revenue business of Dollar Thrifty in November 2012. Hertz's addition of the rental brands Dollar Rent A Car and Thrifty Car created an immediate leadership position in the budget-friendly leisure market. In 2013, Hertz launched a deep value brand, Firefly, focused on price conscious leisure travelers. That same year, Hertz expanded into the Chinese car rental market by acquiring a 20% stake in China Auto Rental, the largest car rental company in China. U.S. and international car rental revenue in 2013 totaled \$6.3 billion and \$2.4 billion, respectively (**Exhibit 4**).

Through its Donlen subsidiary, acquired in September 2011, Hertz provided a comprehensive array of commercial fleet leasing and management services. Donlen leased car and light- to medium-truck fleets, generally with a minimum 12-month lease term. It also provided additional services during leases, including fuel purchasing and management, preventative maintenance, repair consultation, accident management, and telematics-based location and driver performance reporting. Hertz also

² Zachary Harris, "IBISWorld Industry Report – Car Rental in the US," February 2015.

³ Hertz Global Holdings, Inc., 2013 Annual Report.

⁴ Details of Hertz's operations from Hertz Global Holdings, Inc., 2013 Annual Report.

operated an industrial and construction equipment rental business. **Exhibit 5** provides a breakdown of Hertz's 2013 revenue by business segment.

Hertz stock more or less mirrored the S&P 500 Index from the end of 2006 until the summer of 2012 when it began to outperform the broader market (**Exhibit 6**). The pattern of Hertz's earnings closely tracked its stock price (**Exhibit 7**). Company earnings rose between 2006 and 2007 but turned sharply negative with the 2008 financial crisis as both business and leisure travel slowed. During the ensuing economic recovery, Hertz's earnings rebounded, once again entering positive territory in 2011. The company reported record revenue and EBITDA for 2013.⁵ Mark Frissora, Hertz Chairman and CEO, commented on the company's strong 2013 financial performance on an earnings call with analysts and investors: "We continue to successfully drive both record revenue and earnings growth by leveraging industry leading rental car brands, capitalizing on strategic acquisitions, penetrating new markets in equipment rental, and being relentless on efficiency programs and cost management."⁶

Hertz's 2013 10-K indicated that the company had increased revenue by roughly 30% and more than doubled net income to common shareholders since 2011. Over this same three-year period, depreciation averaged around 25% of total expenses. See **Exhibit 8** for Hertz's 2013 income statement. The relatively high level of depreciation was consistent with the capital intensive nature of Hertz's operations. The company's largest asset in 2012 and 2013 was revenue earning equipment (i.e., cars and trucks), which comprised in excess of 50% of total assets in both years. See **Exhibit 9** for Hertz's 2013 balance sheet.

Calculating Depreciation

Once an asset like equipment is recorded on the balance sheet, its cost must be transferred over time from the balance sheet to the income statement and reported as an expense. This process is referred to as depreciation. Managers have a certain amount of discretion in recording depreciation expense because of the assumptions that underlie the calculations.

Two estimates are required to compute the amount of depreciation expense for each accounting period:

1. *Useful life* is the period of time over which an asset is expected to provide economic benefits to a company, which need not correspond to its physical life.
2. *Residual* or *salvage value* is the expected value of an asset at the end of its useful life.

The depreciable base is computed by subtracting the residual value from an asset's acquisition cost. This amount is then depreciated over an asset's useful life. The most common way for allocating depreciation over an asset's useful life is the straight-line method. **Exhibit 10** provides an example of

⁵ "Hertz Report Fourth Quarter and Full Year 2013 Results," *Hertz Global Holdings, Inc. Press Release*, March 18, 2014.

⁶ Q4 2013 Hertz Global Holdings, Inc. Earnings Conference Call, March 18, 2014.

depreciation of an automobile with a \$50,000 acquisition cost, a \$10,000 residual value, and a 5-year useful life.

The amount of annual depreciation expense for the automobile in this example is \$8,000. As this example also shows, when depreciation is recognized as an expense on the income statement, which has the effect of reducing retained earnings on the balance sheet, the book value of the corresponding asset is reduced by an equal amount with a balancing entry in accumulated depreciation, a contra asset account associated with PP&E.

When an asset is disposed of, any difference between its sale price and net book value is recognized on the income statement as a gain/loss on sale. In the above example, a loss on sale of \$2,500 would result if the automobile were sold at the end of Year 5 for \$7,500, which reflects the fact that its sales price (\$7,500) is lower than its net book value (\$10,000) at that time.

Depreciation of Rental Fleet

Hertz's 2013 financial statements included a footnote disclosure that described how the company accounted for depreciation of revenue earning equipment:

Generally, when revenue earning equipment is acquired, we estimate the period that we will hold the asset, primarily based on historical measures of the amount of rental activity (e.g., automobile mileage and equipment usage) and the targeted age of equipment at the time of disposal. We also estimate the residual value of the applicable revenue earning equipment at the expected time of disposal. The residual values for rental vehicles are affected by many factors, including make, model and options, age, physical condition, mileage, sale location, time of the year and channel of disposition (e.g., auction, retail, dealer direct). The residual value for rental equipment is affected by factors which include equipment age and amount of usage.

Depreciation is recorded on a straight-line basis over the estimated holding period. Depreciation rates are reviewed on a quarterly basis based on management's ongoing assessment of present and estimated future market conditions, their effect on residual values at the time of disposal and the estimated holding periods. Market conditions for used vehicle and equipment sales can also be affected by external factors such as the economy, natural disasters, fuel prices and incentives offered by manufacturers of new cars. These key factors are considered when estimating future residual values and assessing depreciation rates. As a result of this ongoing assessment, we make periodic adjustments to depreciation rates of revenue earning equipment in response to changing market conditions.⁷

⁷ Hertz Global Holdings, Inc. 10-K, December 31, 2013.

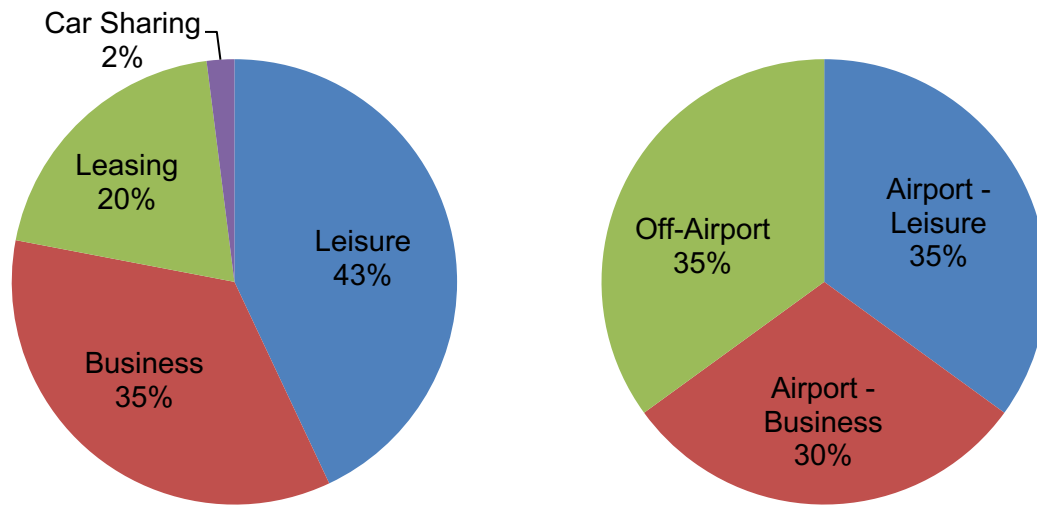
U.S. GAAP also required Hertz to disclose useful life estimates for its major asset classes. **Exhibit 11** provides this information for each year between 2006-13.

Hertz's car rental fleet comprised program and non-program cars. Program cars were purchased by rental car companies under repurchase or guaranteed depreciation programs. Under these programs, automotive manufacturers agreed to repurchase cars at a specified price or guarantee the depreciation rate on cars during a specified time period. Non-program cars, in contrast, were subject to residual price risk at the time of disposal. **Exhibit 12** shows Hertz's program cars purchased as a percentage of total cars purchased for each year between 2006-13 by the U.S. and international operations. **Exhibit 13** provides summary data on used car market pricing trends.

Data Collection

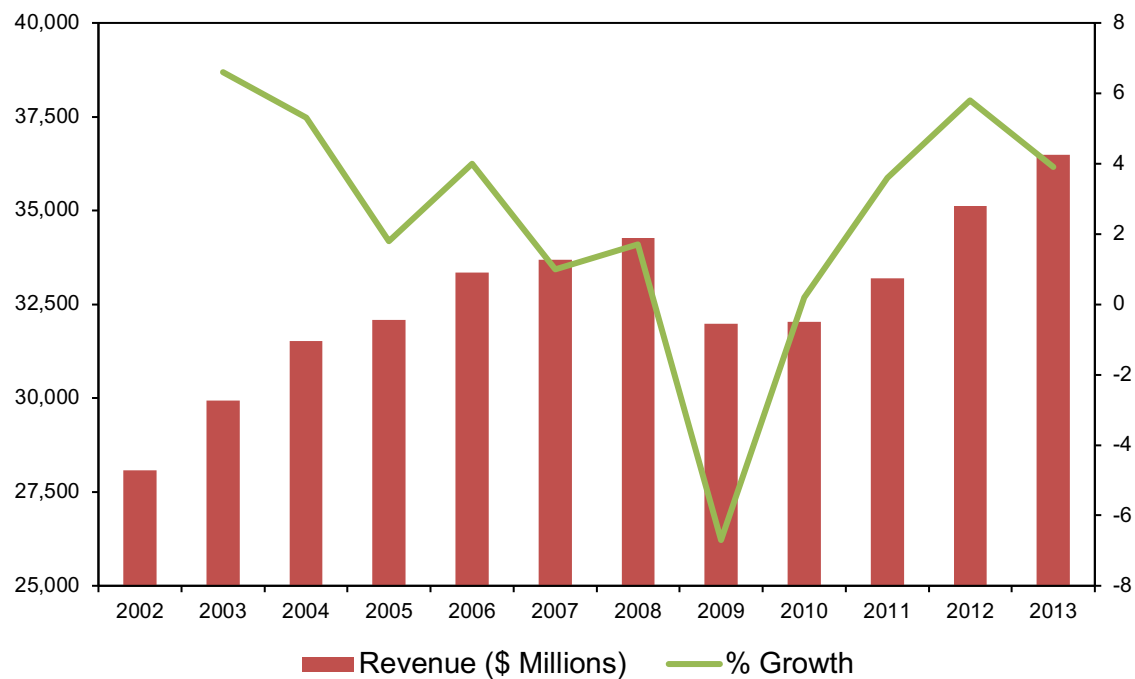
To begin her analysis, Devins pulled together Hertz's revenue earning equipment balances and associated depreciation expense amounts between 2006-13, doing the same for Avis Budget Group, Hertz's main publicly-traded competitor, for comparison purposes (**Exhibit 14**). As she was putting the finishing touches on her spreadsheet, Devins contemplated what significance, if any, depreciation would ultimately have in Hertz's larger than previously announced accounting issues.

Exhibit 1 U.S. Car Rental Demand by Purpose and Location



Source: Andy Brennan, "IBISWorld Industry Report – Car Rental in the US," February 2014.

Exhibit 2 Revenue and Growth Trends in U.S. Car Rental Industry



Source: Andy Brennan, "IBISWorld Industry Report – Car Rental in the US," February 2014.

Exhibit 3 Hertz Timeline⁸

1918	Rent-a-Car, Inc. founded by Walter L. Jacobs
1923	Jacobs sold company to John D. Hertz, President of Yellow Cab and Yellow Truck and Coach Manufacturing Company, who renamed business Hertz Drive-Ur-Self System; Jacobs stayed on to run car rental operations
1926	Yellow Truck sold to General Motors
1953	Omnibus Corporation purchased Hertz from GM and took company public one year later; Jacobs became Hertz's first President and served in that position until his retirement in 1960
1975	O.J. Simpson helped bring Hertz name to American households through advertising campaign that had him running through airport and leaping over counters ⁹
1994	Hertz became a wholly-owned subsidiary of Ford Motor Company
2005	Three private equity investment companies, Clayton, Dubilier & Rice, The Carlyle Group, and Merrill Lynch Global Private Equity, purchased Hertz from Ford
2006	Hertz taken public for second time ¹⁰

Exhibit 4 Hertz Globing Holdings, Inc. Car Rental Revenue (\$ Millions)

	2011	2012	2013
U.S. Car Rental	4,468.9	4,893.2	6,324.4
International Car Rental	2,471.9	2,268.5	2,382.5
Total Car Rental	6,940.8	7,161.7	8,706.9

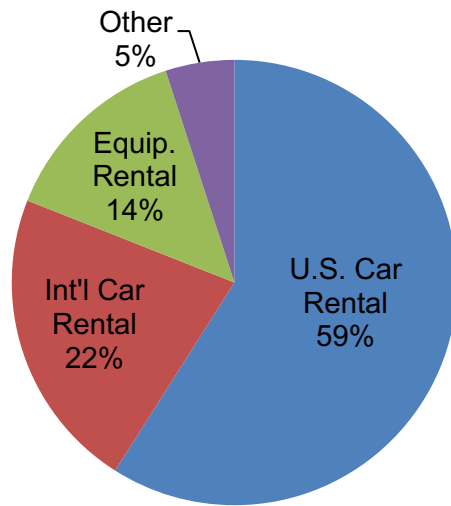
Source: Hertz Global Holdings, Inc. 10-K, December 31, 2013.

⁸ <https://www.hertz.com/rentacar/abouthertz/index.jsp?targetPage=CorporateProfile.jsp&c=aboutHertzHistoryView> (accessed May 2015).

⁹ "Q&A with Stuart Elliott," *The New York Times*, August 25, 2008.

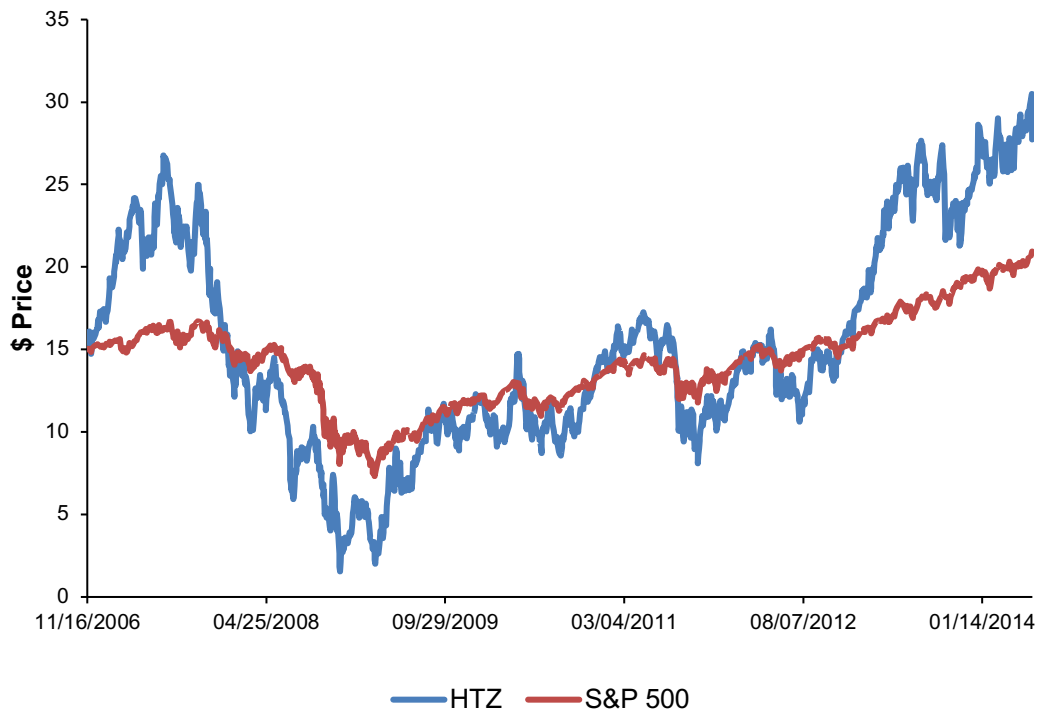
¹⁰ <http://www.nasdaq.com/markets/ipos/company/hertz-global-holdings-inc-710494-50741> (accessed May 2015).

Exhibit 5 Hertz Global Holdings, Inc. Breakdown of 2013 Revenue by Business Segment



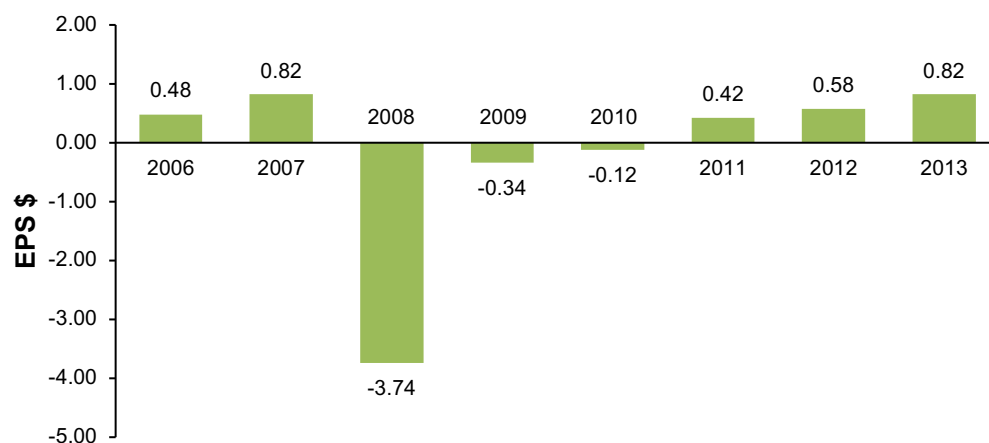
Source: Hertz Global Holdings, Inc. 10-K, December 31, 2013.

Exhibit 6 Hertz Global Holdings, Inc. Stock Performance



Source: Center for Research in Security Prices.

Exhibit 7 Hertz Global Holdings, Inc. Earnings Performance



Source: Compustat.

Exhibit 8 Hertz Global Holdings, Inc. 2013 Income Statement (\$ Millions)

	Year Ended December 31,		
	2011	2012	2013
Revenues:			
Worldwide car rental	6,940.8	7,161.7	8,706.9
Worldwide equipment rental	1,209.5	1,385.4	1,538.0
All other operations	149.0	477.8	527.0
Total revenues	8,299.3	9,024.9	10,771.9
Expenses:			
Direct operating	4,573.1	4,806.0	5,752.0
Depreciation of revenue earning equipment and lease charges	1,896.2	2,128.9	2,525.5
Selling, general and administrative	767.7	968.1	1,022.2
Interest expense	699.7	649.9	716.0
Interest income	(5.5)	(4.9)	(11.6)
Other (income) expense, net	62.5	35.5	104.7
Total expenses	7,993.7	8,583.5	10,108.8
Income before income taxes	305.6	441.4	663.1
(Provision) benefit for taxes on income (loss)	(121.8)	(202.8)	(316.9)
Net income (loss)	183.8	238.6	346.2
Less: Net income attributable to noncontrolling interest	(19.6)	0.0	0.0
Net income attributable to Hertz Global Holdings, Inc.	164.2	238.6	346.2

Source: Hertz Global Holdings, Inc 10-K, December 31, 2013.

Exhibit 9 Hertz Global Holdings, Inc. 2013 Balance Sheet (\$ Millions)

	December 31, 2012	December 31, 2013
ASSETS		
Cash and cash equivalents	545.5	423.2
Restricted cash and cash equivalents	551.6	859.9
Receivables, less allowance for doubtful accounts of \$30.8 and \$29.3	1,879.6	1,512.6
Inventories, at lower of cost or market	105.7	92.3
Prepaid expenses and other assets	489.3	717.2
Revenue earning equipment, at cost:		
Cars	12,548.8	14,456.6
Less accumulated depreciation	(1,850.4)	(2,679.6)
Other equipment	3,240.1	3,512.2
Less accumulated depreciation	(1,041.9)	(1,095.8)
Total revenue earning equipment	12,896.6	14,193.4
Property and equipment, at cost:		
Land, buildings and leasehold improvements	1,288.8	1,362.1
Service equipment and other	1,261.1	1,257.0
Less accumulated depreciation	(1,113.5)	(1,104.8)
Total property and equipment	1,436.4	1,514.3
Other intangible assets, net	4,030.2	3,928.0
Goodwill	1,329.3	1,347.5
Total assets	23,264.3	24,588.2
LIABILITIES AND EQUITY		
Accounts payable	1,003.2	967.9
Accrued liabilities	1,163.1	1,104.7
Accrued taxes	144.6	140.4
Debt	15,448.6	16,309.4
Public liability and property damage	332.2	347.7
Deferred taxes on income	2,686.4	2,947.1
Total liabilities	20,778.1	21,817.2
Equity:		
Common stock	4.2	4.5
Additional paid in capital	3,233.9	3,225.9
Accumulated deficit	(725.0)	(378.8)
Accumulated other comprehensive loss	(26.9)	7.1
Treasury stock	0.0	(87.5)
Total equity	2,486.2	2,771.2
Total liabilities and equity	23,264.3	24,588.2

Source: Hertz Global Holdings, Inc. 10-K, December 31, 2013.

Exhibit 10 Depreciation Example

	PP&E, Gross	Accumulated Depreciation	PP&E, Net	Depreciation Expense	
Year 1	50,000	8,000	42,000	8,000	= (50,000 - 10,000) / 5 years
Year 2	50,000	16,000	34,000	8,000	
Year 3	50,000	24,000	26,000	8,000	
Year 4	50,000	32,000	18,000	8,000	
Year 5	50,000	40,000	10,000	8,000	

Exhibit 11 Hertz Global Holdings, Inc. Useful Life Estimates

	Cars	Other Equipment
2006	5 to 16 months	24 to 108 months
2007	5 to 16 months	24 to 108 months
2008	5 to 16 months	24 to 108 months
2009	4 to 24 months	24 to 108 months
2010	4 to 26 months	24 to 108 months
2011	4 to 26 months	24 to 108 months
2012	4 to 28 months	24 to 108 months
2013	4 to 36 months	24 to 108 months

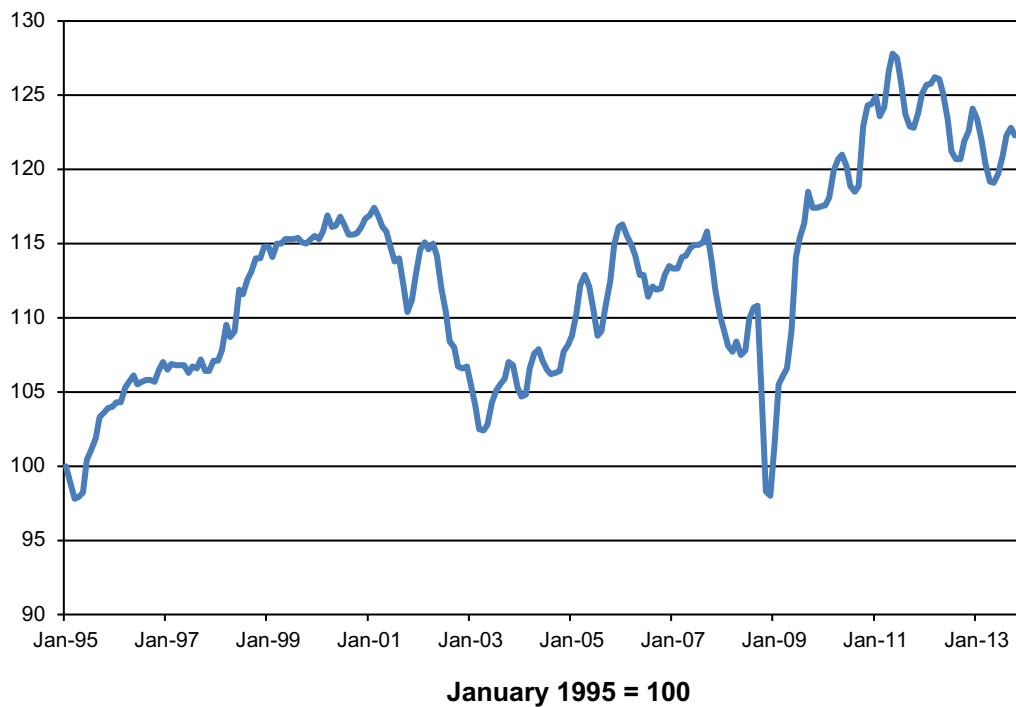
Source: Hertz Global Holdings, Inc. 2007-13 10-Ks.

Exhibit 12 Hertz Global Holdings, Inc. Program Cars Purchased as Percentage of Total Cars Purchased

	2006	2007	2008	2009	2010	2011	2012	2013
U.S.	61%	42%	55%	48%	54%	45%	19%	18%
International	71%	65%	59%	57%	56%	55%	53%	57%

Source: Hertz Global Holdings, Inc. 2007-13 10-Ks.

Exhibit 13 Manheim Consulting Used Vehicle Value Index



Source: http://www.manheim.com/services/consulting?WI.svl=m_hdr_mnav_services_consulting#monthlyIndex (accessed May 2015).

Exhibit 14 Hertz Global Holdings, Inc. and Avis Budget Group, Inc. Revenue Earning Equipment Data (\$ Millions)

	2006	2007	2008	2009	2010	2011	2012	2013
<u>Hertz Global Holdings, Inc.</u>								
Revenue Earning Equipment, Gross	10,876	11,681	10,344	10,788	11,191	12,509	15,789	17,969
Depreciation Expense for Revenue Earning Equipment	1,762	1,906	2,020	1,780	1,747	1,912	2,146	2,408
Gain/Loss on Sale of Revenue Earning Equipment	36	-21	-83	-72	-43	112	97	-37
Income before Taxes	241	389	-1,383	-150	32	306	441	663
<u>Avis Budget Group, Inc.</u>								
Revenue Earning Equipment, Gross	8,042	8,496	8,383	6,912	7,557	9,614	10,619	10,993
Depreciation Expense for Revenue Earning Equipment	1,362	1,565	1,639	1,391	1,277	1,395	1,438	1,678
Gain/Loss on Sale of Revenue Earning Equipment	0	40	-7	30	24	234	97	6
Income before Taxes	-677	-992	-1,343	-77	72	36	300	97

Source: Hertz Global Holdings, Inc. 2007-13 10-Ks; Avis Budget Group, Inc. 2007-13 10Ks.