

The Auto Retail Informer: November 16, 2006

Written by Jerry Marks

Highlights:

- Today: Economist Milton Friedman passes away, Nissan doesn't think timing is right for American partner, next Auto Retail Informer Monday morning
- Sonic Automotive Upgraded to Buy at Goldman
- Bel Air Partners Elite Dealer
- Dinner with Lexus
- And Breakfast with Honda.

Good afternoon. The autoretailstocks.com index closed up 0.4% today, while the S&P 500 index climbed 0.2%, and the Dow Jones Industrial Average was up 0.4%. Since inception, the Elite 5 (LAD, LKQX, SAH, ORLY, KEYS,) are up 11.5%, the top ten are up 11.3%, and the autoretailstocks.com index itself is up 16% (since July 7, 2006.)

(1) "A major source of objection to a free economy is precisely that group thinks they ought to want. Underlying most arguments against the free market is a lack of belief in freedom itself. . . ." (2) "Inflation is the one form of taxation that can be imposed without legislation. . ." (3) "The power to do good is also the power to do harm." Source: Quotes from Milton Friedman at brainyquote.com.

Today: Economist Milton Friedman passes away, Nissan doesn't think timing is right for American partner, next Auto Retail Informer Monday morning

As you may have heard by now, Nobel prize winner Milton Friedman, who the Wall Street Journal this morning described as "one of the most influential economists of the last century," died last night.

Reuters reports this afternoon that "Carlos Ghosn on Thursday said he is open to expanding the current alliance to include an American automaker, but will wait for the timing to be right for Nissan." I also think it can make some sense, swapping production capacity and distribution (dealerships) instead of making Nissan invest in capacity/distribution while the domestic automakers invest to downsize said items. It's just the cultural clash seems incredibly great. As a technical note, since I will be traveling, absent some major event, the next publication of the Auto Retail Informer will be Monday morning.

Sonic Automotive Upgraded to Buy at Goldman

Sonic Automotive (SAH/ranked #2) was upgraded by Goldman Sachs, which Reuters says is because they (Goldman) expect "the automotive retailer (Sonic) to adopt sharper fiscal discipline under its new chief financial officer and saw Sonic delivering significant improvements in its cost structure." The analysts at Wachovia, Merrill Lynch and I have similarly articulated this view since this summer. It is nice to see Sonic beginning to gain some "respect" in the public markets. But all of that really means nothing over the long run.

Sure, we can give management an "atta boy" now and again, and Wall Street analysts (and even dudes like me) will fall in and out of love with a stock. But what really matters is that management executes on its commitment to deploy shareholder capital prudently and develop a superior store model. It won't be a smooth process with the company exceeding (or even meeting) estimates every quarter (although it is always nice when it works out that way.) So the efforts being undertaken by management to make the company's stores

more cost competitive and customer centric is what leaves me excited about Sonic's prospects.

This is what should drive your investment decision. It doesn't really matter what the "Wall Street Experts Think," we just follow the bouncing ball (just like you.) What matters is trying to see something the "experts" do not see, and therefore generating superior investment returns. And in this regard, I continue to think Sonic's stock affords such an opportunity.

Bel Air Partners Elite Dealer

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Over the last 24 hours I attended the Bel Air Partners Elite Dealer dinner with Lexus and Breakfast with Honda. Obviously I am going to say nice things about the folks from Bel Air because they were kind enough to invite me to the event. And there are a number of groups that put on great conferences/meetings where I learn a lot about the industry. Morgan Stanley puts on a great auto conference every Spring around the time of the New York Auto Show, and as you probably recently read in the Auto Retail Informer a couple weeks ago, Gabelli and Company put on a great investment conference for the automotive aftermarket.

But what I really like (and find so unique) about the Bel Air elite dealer meetings is that they are not the standard public company management presentations. Those are useful, but after a while you start to play little games like "guess the new slide in the presentation" as the presentations only change slightly from quarter to quarter. Instead, since Bel Air caters to private auto retailers, their events bring in industry participants that focus on future trends in the industry. And for someone who tries to take a long term approach in investment research, specifically with a focus on long term structural trends, I think you can appreciate that the elite dealer meetings put on by Bel Air become incredibly valuable.

So I wanted to give you a few thoughts from things I heard (and learned) at the dinner and breakfast. The evening began with a reception and tour of David Wilson's new 300,000 square feet, \$75 million Lexus store (according to Automotive News) in Newport Beach, California. The investment is staggering and certainly makes Roger Penske's (UnitedAuto Group's) ~\$100+ million investment into its North Scottsdale facility (for something like 13 franchises) look less risky. And while the store could have perhaps done without the \$85,000 tree outside the service lane (no really, one tree,) you have to admire the belief management has in the Lexus brand and the ability to capture share in the market.

Over the years I have been critical of dealers for investing too much in facilities. And while sometimes this has been appropriate, I have really learned that it tends to depend on the brand (for that specific market) and the growth potential of the market itself. I will hardly claim to be an expert on the growth trends for the Newport Beach California market and the ability for Lexus to compete (with other luxury dealerships) in the area. So I can only wish the folks at Mr. Wilson's dealership luck in their endeavors.

BUT, I can tell you that I really liked some of the approaches taken at the dealership. Specifically, I liked the "mini" inventory at each service bay, which combined with electronic repair orders and dispatch means the technician never really needs to leave their bay throughout the day. And I liked the "rapid car wash" (I don't know what its formal name is,) that allows the store to wash something like a car every 52 seconds (over 100 an hour!) I think it is a great idea for luxury dealerships to offer free car washes to their customers. It keeps the store "top of mind" when customers think about where to take their vehicle for maintenance (although warranties help with that as well,) the purchase of new vehicles, and even referrals. However, having to wait 2 hours on a Saturday morning to get your car washed can turn a positive "top of mind" experience (relationship) with the store into a negative. And so if you are going to offer a free car wash to customers, the "rapid car wash"

seemed like a pretty darn good way to keep the customer experience (not having to wait forever) positive.

Finally, I liked how well the City (of Newport Beach) worked with the dealership. Far too often I have heard public and private dealers alike discuss all sorts of problems (delays) with zoning. It took a grand total of 288 days to build this facility, which given the size and scale of the project sounds pretty impressive to me. So one of the things I think we (investors) and industry participants can take away from this lesson is that part of the stewardship of shareholder capital depends not only on identifying locations, but including in the site selection process how easy it is to work with the village in getting the facility built.

## **Dinner with Lexus**

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Ok, so now we get to the "main events." Before dinner, Deborah Meyer, Vice President of Marketing for Lexus gave a presentation about their outlook for the future. Now I have to say (as many of you know) that I tend to take a more cautious (dare I say "pessimistic") view versus Ms. Meyer's outlook on the overall industry. Don't get me wrong, I do not think the world is coming to an end. Actually I think global markets (like China) present tremendous opportunities for vehicle manufacturers and even global auto retailers like UnitedAuto Group (UAG/ranked #7.)

And I do not think dealers will be run out of existence. But I do think 1.2 vehicles per licensed drivers are too many in the U.S. so the market has probably become saturated. I also think there are too many dealers (well in certain brands and markets,) and this will need to rationalize. And I think there is too much excess production capacity (the root cause of all of these problems) that has forced automakers to create demand where it does not exist.

As such, at some point or another, this imbalance will need to re-balance, and this is why I tend to think the underlying demand could prove weaker several years from now as either successful union negotiations or bankruptcy protection allow the manufacturers to rationalize capacity bringing greater price stability (and less "artificial demand creation") in the marketplace. But industries often go through structural shifts, and those participants focused on creating superior (more efficient) store models will prove the winners and likely generate significant market share gains and attractive returns for the owners (public or private.) Challenges usually bring opportunity. You have heard all of this from me before.

Nonetheless, it was nice to hear the "other side of the coin." The reason why the U.S. vehicle market may continue to remain robust, with somewhat compelling data to back up their view. Specifically, Ms. Meyer said the folks at Toyota think the industry will reach ~18 million units annually sometime around the turn of the decade (2010 ish.) She attributed the rather positive outlook to favorable demographics, particularly the baby boomers entering their peak spending years. For example, did you know that people tend to buy 13 cars over their lifetime? But over half (~7 of the vehicle purchases) occur after they are 50. Ms. Meyer was very blunt: "we love older buyers." And what is most important, something like 60% of the U.S. population will be over 50 by 2009.

Now I've already run a series about the Baby boomers, Gen X, and Gen Y, and while her numbers (and years) were slightly different than mine, it was pretty similar so I won't rehash the size and scope of the various generations. But what I didn't realize, at least according to the Toyota view, is that U.S. population will have the fastest growth rate in the world, with a new person born into the economy every 10 seconds. Something we all need to keep in mind when we think about the tremendous growth coming out of China (my thoughts not hers,) is that they restrict their population growth to one child per family. So if we think the U.S. is going to face some challenges with an aging population over the next

decade or so, our problems may pale in comparison to the “demographic” problem China will face a few decades from now.

Nonetheless, I continue to think there are too many vehicles on the road in the U.S. and so faster growth (in vehicles) will come from outside markets like China. However, where I think Ms. Meyer makes a really good point is that the luxury market should continue to grow in a robust nature. Specifically, she said the U.S. luxury market (all goods not just cars) is ~\$440 billion compared to \$400 billion for the rest of the world combined. And Toyota expects the luxury market to grow ~22% by 2015. A somewhat sad outlook that I tend to agree is very possible, although in part it may be accompanied with a further widening in the “rich/poor” gap in the United States. Once again, making it imperative auto retailers and investors don’t ignore the buy here, pay here market entirely. Economic returns, and (more importantly) real value is added to the economy by spotting a need and filling it, and it really appears the high end and the low end are areas where retailers will need to fill said needs. In other words, either focus on the high end or the low end of the market, and the middle may be shrinking.

Finally (well sort of,) Ms. Meyer discussed two areas the company (Toyota/Lexus) was focused on in order to better serve the customer: 1) a growing strength of women in the market, and 2) the growing influence of corporate responsibility. As far as the growing strength of women in the market, she said women influence more than 60% of all car buying decisions. An industry participant chimed in saying it is more like 95%. We all chuckled. But clearly women have a tremendous influence in the purchase of a vehicle, and so manufacturers (like Toyota/Lexus) are including input from women into the design of the vehicle. She also pointed out that surveys suggest women still leave auto retail establishments because they do not feel they are getting the attention they deserve, so they will go to another place where they are treated as a primary decision maker.

Corporate responsibility is somewhat a vague term and mostly seemed to come down to energy efficient vehicles. In fact, she said more than 50% of people refused to make a purchase over a political or social reason. And 70% of people are concerned about the environment. Naturally, energy efficient vehicles are going to be a major focus in the future, but I think most automakers recognize this dynamic (as I also discuss from the Honda presentation below.) And it seems to be as much driven by economics (i.e. higher input costs like fuel) as it is politically or socially.

But beyond energy efficient vehicles, I think she raised a good point that the standards (consumer expectations) are increasing with the growing influence of Generation Y. She said, “Scion has the lowest customer satisfaction in the industry, and I don’t believe it is because of the service, but the standards of this younger generation” (that constitute more of their buyers for this brand.) I agree, and go back to the quote the head of Scion said a couple years ago at JD Powers: “they have the expectations of Lexus customers, but the pocket books of Saturn customers.”

And Breakfast with Honda.

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At the Honda breakfast (this morning,) John Mendel, Senior Vice President, Honda Motors presented the company’s thoughts about the future. A lot of it was product specific, which I will leave out. But, I did want to share a few key things he discussed. Introducing him, Don L. Keithley (of Bel Air Partners,) said JD Powers and Associates reports Honda vehicles 3 years old retain ~68% of their transaction price (amazing residual!) So Mr. Mendel jumped in (with one of his first slides) explaining why the company’s vehicles are able to hold their residual values so well: it stems from “a disciplined marketing approach.” Specifically, he said they offer no direct cash rebates, they do not sell to fleets, and this preserves the brand image and the customers’ investment (i.e. residual value.)

Throughout the presentation Mr. Mendel emphasized that there are two ways to play the market: 1) discount, or 2) differentiate, and clearly they have chosen the path of differentiating. I also appreciated Mr. Mendel's more pragmatic view of the market. He did not give an industry forecast, but he was very clear that Honda has benefited from entering product segments (specifically light trucks and SUVs) where they had not competed before so "the low hanging fruit is gone." As someone who is constantly trying to look for the risks of investments, I appreciated this candid view of the market, and like I said, Mr. Mendel's emphasis therefore on trying to create differentiated product to remain a considerable force in the industry.

He outlined the company's core strategy of providing (1) clean (fuel efficient,) (2) safe (for everyone,) and (3) fun (to drive) vehicles. I guess when Mr. Honda founded the company, the vision and approach to the business was that they need to leave the world a better place than where they found it, and this is why they continue to focus on fuel efficient vehicles. Although like I said with Ms. Meyer's comments (from Lexus above,) I think most automakers recognize the need to produce more fuel efficient vehicles.

Finally, Mr. Mendel talked about how the notion of luxury was evolving. Specifically he titled the slide: "the evolution of luxury." He said idea of luxury is changing with the younger generation. "Old luxury" he said was an "end game." It was a sign of "arrival" a status symbol, if you will. The "new luxury" is a "means to an end." Luxury is a way of enhancing your life. It is experiential. And I think he makes a very valid point, and retailers and investors should take note of this shift occurring among the generations. Successful auto retailers and even manufacturers will need to be able to demonstrate to the customer the product enhances their life, not that it just puts them in with the "elite" because they can afford a \$90,000 vehicle. Just something to chew on over the weekend. Have a great one, and I will talk to you Monday morning.