



Harder Than It Looks

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As the automotive retail industry becomes the latest darling on Wall Street, private investment firms with a lot of capital are looking to spend it on dealerships but are finding it is not as easy they had hoped.

The difficulty stems from auto makers' concerns about just how big dealer groups should get.

For now, Wall Street appears convinced automotive retail is a viable investment. The evidence is seen in the incredible stock growth of the six public retailers going back to April 2005.

As a group, stock prices grew nearly 21%. Leading the charge is Group 1 Automotive Inc., fifth on this year's *Ward's Megadealer 100* with nearly \$5.6 billion in revenue, whose stock more than doubled in 12 months, from approximately \$24 in April 2005, to about \$51 in April of this year. (See chart on page 17).

In recent years, Wall Street's attitude toward automotive retailing has changed considerably. Just a few short years ago, a tendency among the investment community was to lump dealerships with the rest of the industry, including auto makers and suppliers.

To counter this view, dealership chain CEOs such as AutoNation's Mike Jackson and United Auto Group's Roger Penske went on the offensive, courting analysts, making the argument at various investment conferences that dealerships are insulated from the problems plaguing some auto makers and suppliers.

Not only do dealerships have service repair and used-car businesses that can compensate for declining profits on new-vehicle sales, large dealer groups in particular also can protect themselves by diversifying their brands.

"Investors certainly understand the automotive retail market better today," says Sheldon Sandler, founder and president of Bel Air Partners, a financial advisory and brokerage firm for dealers. "Part of that is because the public companies are doing much better communicating their value."

It is a far cry from two or three years ago when public dealer groups were lamenting Wall Street's lack of confidence in their business model.

The evidence supports the claims made by the public retailers. While the news coming from domestic auto makers and suppliers mostly has been discouraging of late, car sales still remain high buoyed by the demand for imports and luxury models.

Add to that, the *Ward's Megadealer 100* total revenues have continued to increase each year to a 2005 total of \$128.8 billion. Compare that figure with the first *Ward's Megadealer* ranking, in 1987, in which total revenue was a mere \$23.3 billion. Meanwhile, new unit-sales totaled just over 1 million in 1987, and reached 2.8 million in 2005.

Although consolidation has slowed significantly since the late 1990's when the public retailers were acquiring everything in sight, revenue per store continues to increase, proving dealer groups can grow without aggressive acquisition strategies.

All this success has attracted the attention of private investment firms. In what may be the industry's worst-kept secret, computer magnate Michael Dell's private investment firm, MSD Capital, has traversed the country the last couple of years looking for a large dealer group to acquire.

After talking with several private dealer groups, MSD finally set its sights on publicly held Asbury Automotive Group, ranked sixth on this year's *Ward's Megadealer 100* list with \$5.2 billion revenue in 2005. As of press time, no deal had been announced.

“If that rumor is true, it shows the confidence Wall Street has in our industry,” says Russ Darrow, president and CEO of the Darrow Automotive Group, ranked 72 on the *Ward's Megadealer 100* with \$438.2 million in total revenue — up \$5 million over 2004. “And that is a good thing.”

Then, in mid-April, retired automotive analyst John Casesa and former United Auto Group executive, Andrew Shapiro, formed an investment and consulting firm and are planning on investing in automotive dealerships.

In addition, several dealership brokers and consultants, while declining to provide specifics, confirm they are assisting other private investment firms in finding dealer groups to either invest in or acquire.

Likewise, dealer groups, many of them with three to five franchises, are looking for private capital to help them grow quickly by adding as many as 15 to 20 franchises.

“There are some dealers who are looking for funding from outside the automotive retail industry,” says Mark Rikess, president of Los Angeles dealership consulting firm the Rikess Group.

“A lot of dealers are experiencing declines in profitability as the new-car margins are squeezed,” Sandler says. “As a result, they believe they need to aggregate to continue making money.”

And private investment capital may be just what dealers need to expand. It is harder today because dealerships, especially those with attractive luxury and import brands, quickly are being priced out of the market. There are too many buyers and not enough sellers.

For example, the Thomas Friedkin Companies, which owns Gulf States Toyota, recently acquired Lexus dealerships in Cleveland and Las Vegas.

According to one analyst familiar with the deal, Friedkin paid such a high price for the two stores that other Lexus dealerships may have been priced out of the market.

The love fest with Wall Street may be short-lived however — more so with the investment firms than the public retailers. While stock prices are growing, some analysts point out the P/E (price to earning) ratios seem to be lagging. The P/E ratio is a simplified way to calculate the return investors can expect on what they invest.

In April, looking forward to the end of 2006, the P/E ratios for the public retailers hovered around 12.1x, meaning investors are expecting a return of \$12.1 for each dollar they invest. For the previous calendar year, the multiples were measured at approximately 15x.

According to some analysts, the current stock prices and their rapid growth should mean higher multiples.

One reason they are not higher is that the volume of trading of automotive retail stocks is relatively low, mainly because much of the stock is in the hands of a few investors, such as Timothy Collins, the CEO and managing director of Ripplewood Holdings LLC, who controls nearly 50% of Asbury Automotive Group's stock.

Another and more daunting reason is the auto makers which themselves wield a lot of power in determining who gets to sell their brand.

“Until we see a big deal get done with a private investment firm, it might get discouraging for them,” Sandler says.

The dynamic mostly is played out with the Asian import auto makers, which are in the “catbird seat,” Rikess says. “They can pick and choose right now who their dealers are going to be, and they will leverage that.”

OEMs control the acquisition process using framework agreements, a topic nobody in the industry likes to talk about. These agreements can range from setting strict performance levels the buyer has to agree to, to limiting the number of franchises any one dealer can own — ranging from specific to national markets.

For example, Toyota Motor North America Inc.'s Lexus Div. limits dealers to only four of its franchises, which is the number of Lexus dealerships AutoNation owns.

A recent large acquisition almost was scuttled at the last minute due to a framework agreement. Just a few days prior to the scheduled completion of the deal, the auto maker informed the buyer it would have to agree to certain stricter performance levels before the acquisition would be approved.

After a few days of wrangling — not to mention some panic — the acquisition was completed. It does not always work out that way, however.

OEMs throwing a monkey wrench into acquisitions is nothing new. For years, auto makers have been leery of allowing too much dealership consolidation. But they have let it go on to a certain extent, primarily because long-time and successful dealers have been responsible for much of the acquisition activity.

In fact, some auto makers studied the consolidation phenomenon in the late 1990's and concluded the initial round of acquisitions posed no serious problems. However, it was this potential second phase of consolidation, driven by private investment firms, that concerned them the most — and still does.

While OEMs declined to be interviewed for this story, several officials from various dealer groups along with analysts and brokers agree auto makers are intent on limiting the influence of private investment firms in the retail market.

For the most part, the reasons are valid — that is if you are looking at it from an OEM perspective. One, the OEMs realize investments firms are looking to invest in automotive retail with the intention of recouping their investments by selling acquired dealer groups in five to eight years.

The problem? The sale and acquisition of dealerships is a long and difficult process that involves many players, from other OEMs to banks to real estate holding companies and other dealers. It occupies a lot of the auto maker's time and energy, and the prospect of approving the sale of large dealer groups every five or so years is disconcerting.

The industry already is experiencing this as Ripplewood, tries to sell Asbury, after having a controlling interest for almost eight years.

Ripplewood is one of the early private equity firms to invest in automotive retail, and that has contributed to some of the bad blood between Asbury and some auto makers.

In 2003, both Ford Motor Co. and Toyota stopped Asbury's acquisition of the Bob Baker Automotive Group, located in the San Diego market. The dispute with Ford played out publicly in the courts, while the disagreement with Toyota managed to stay under ground.

Ford officials were reluctant to allow the acquisition, claiming the performance levels of several Ford dealerships elsewhere had declined under Asbury management.

Asbury appears to have recovered. Its stock went from \$13 last April to \$21 this April, but has settled back in the \$18-\$19 range.

In a rather blunt interview with Ward's, Asbury CEO and President Ken Gilman argues that OEMs have an institutional bias against dealers, specifically the public retailers.

“The OEMs have dealt with us from a marked deck of cards,” he says.

Gilman's frustration is understandable. In addition to the thwarted Baker acquisition in 2003, last year both UAG and AutoNation considered acquiring Asbury before deciding not to make offers — primarily because they realized OEM approval was less than promising.

And now the possible sale to MSD may be running into a few obstacles. Recently, rumors were flying a deal had been agreed to in principle, but the expected announcement never materialized.

Some analysts speculate certain OEMs do not want to see Asbury's buyer acquire all of its franchises and may want the purchaser, whomever it is, to break the group up and sell some of the franchises to smaller, localized groups.

Ward's has learned MSD officials recently met with Toyota and Honda North America Inc., possibly to talk about the potential acquisition.

Approximately 56% of Asbury's franchises are luxury and midline import brands, which many investors may find attractive. Asbury has 25 domestic-brand stores.

The group is heavily weighted toward Japanese midline brands, with 14 Honda, 12 Nissan and four Toyota franchises.

Eight of its dealerships are highly sought BMW franchises and two Lexus stores in the Atlanta area.

Another driving issue for OEMs is the concern of whether a few dealers will end up with too much power.

“What the OEMs really object to is the consolidation of power in the hands of certain dealers,” Sandler says.

This came to a head last year as domestic auto makers, dealing with overcapacity, began pressuring retailers to take more inventory. That drives up floor plan interest for dealers and increases operating expenses.

Mike Jackson, AutoNation's CEO, began pushing back against pressure to take more inventory — and that is exactly what worries auto makers. Stronger and larger dealers threaten the power OEMs have over their retail networks.

Add to that dynamic, investment firms that are skilled in wringing efficiencies out of companies by implementing strict operating controls, such as inventory management, and, suddenly, dealerships are wielding much more power and unlikely to accept vehicles not selling well.

That is not an attractive scenario for auto makers, says Rikess, who believes OEMs and dealers have an inherent conflict because they have different business goals.

“OEMs are concerned with moving as much metal as possible and having strong customer satisfaction scores,” he says. “Dealers, on the other hand, want to be profitable, and they often can do that without selling more cars. And that does lead to a lack of trust.”

What happens with Asbury likely will have a far-reaching effect on the future of the automotive retail industry. If a deal does not happen, private investment firms lining up to get in the market may see it as a sign they are not wanted and take their money elsewhere.

Sandler believes the OEMs should be careful of what they wish for. While OEMs may want to spread the retail strength among several dealers, the current system is nearly 100 years old.

Right now, auto makers are blessed with some long-time, savvy and entrepreneurial dealer operators who have flourished.

“But what happens when some of these dealers begin to pass from the scene?” Sandler asks. “Will those operations continue to be as strong? If you take your best money out of the market, dealers are going to suffer.

“Now as this business matures, there may need to be a transition into a more professional industry.”

Until the OEMs begin to loosen their grip, private dealers are going to find it increasingly harder to grow and expand their businesses.

The public dealer groups, meanwhile, all have dialed back their acquisition strategies and are looking for add-on points to support existing markets.

For them, the battle possibly will shift from acquiring existing dealerships to opening new points.

Another issue for dealer groups, according to Rikess, is the lack of strong management talent in the dealerships, and that can hinder growth.

Many dealers pass on acquisition opportunities because they lack the personnel to manage the additional stores.

“It is a big problem today,” Rikess says. “We're not developing the general managers of tomorrow. Dealers are asking themselves where do they put their best human resources.”