

U.S. Automotive Retailing in the mid 1990's (A)

The United States automotive industry is the largest market for light cars and trucks in the world. In 2001, 22,131 dealerships generated revenues of approximately \$1.0 trillion through the sale of new and used cars (38.5 million units in total), service and parts, and financing and insurance.¹ Sales by automotive dealerships represented approximately 10% of the United States total GDP of \$10.1 trillion; reflecting its major role in the US economy. Directly and indirectly, the automotive industry employed more than 6.6 million people,² or 4.5% of the total US workforce in 2001.³

Industry Structure and its Evolution

In the United States, automobile dealerships are the sole channel for new vehicle's produced by Automobile original equipment manufacturers (OEMs), the GM's, Ford's, Toyota's, and Honda's of the world, with roughly 17.2 new vehicles sold in the U.S. in 2001⁴. In addition, these dealerships serve as a conduit for the buying/selling of used vehicle and other related services.

Also, sales of newer used vehicles have increased over the past five years, primarily as a result of the increased popularity of short-term leases. Franchised dealers accounted for 15.9 million, or 37%, of all used vehicle units sold. Independent lots accounted for 34% with the balance accounted for in privately negotiated transactions.⁵

Franchised dealerships were originally established by automobile manufacturers for the distribution of new vehicles. In return for granting dealers exclusive distribution rights within specified territories, manufacturers exerted significant influence over their dealers by limiting the transferability of ownership in dealerships, dictating the dealership's location, and managing the supply and composition of the dealership's inventory. These arrangements resulted in the proliferation of small, single-owner operations that, at their peak in the late 1940's, totaled almost 50,000. As a result of competitive, economic and political pressures during the 1970's and 1980's, significant changes and consolidation occurred in the automotive retail industry. One of the most significant changes was the increased penetration by foreign manufacturers and the resulting loss of market share by domestic manufacturers, which forced many dealerships to close or sell to better capitalized dealership groups. According to industry data, the number of

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¹ Morgan Stanley, "Downshifting" Automotive Retailing Industry Report, Page 36, July 24, 2002.

² "America's Automobile Industry: The engine that drives the economy," University of Michigan and the Center for Automotive Research.

³ "Occupational Employment Projections to 2010," Monthly Labor Review Online, Daniel E. Hecker.

⁴ Approximately 28% were manufactured by General Motors, 23% by Ford, 15% by DaimlerChrysler, 10% by Toyota, 7% by Honda., 4% by Nissan and 13% by other manufacturers.

⁵ Asbury Group, Inc. Prospectus, March 14, 2002, Pg. 51.

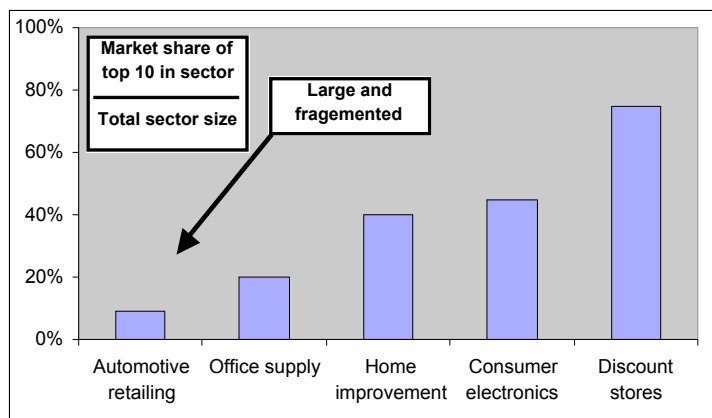
franchised dealerships has declined from approximately 27,900 in 1980 to approximately 22,150 in 2001.⁶

Still with over 22,000 dealerships operating in the United States, the automotive retail industry is extremely fragmented. The top one hundred automotive retail groups account for only 7% of total industry revenue,⁷ leaving the vast majority of the industry’s market share in the hands of smaller regional and independent dealerships. The major public players in the industry include: Asbury Automotive, Autonation, CarMax, Inc., Group 1 Automotive, Lithia Motors, and Sonic Automotive. These major players accounted for about \$42 billion in sales in 2002 [Exhibit B]. However, even with their seeming large sizes, these public automotive dealerships currently have less than 3% share of total industry sales.⁸

The graph below shows the automotive retail industry compared to other U.S. retail sectors. Auto retailing revenue is more than four times greater than the second largest, discount stores, while the market share of the top 10 competitors is well less than 10%:

Automotive Retailing: The largest and most fragmented retail sector⁹

(Percentage market share for top ten players in each sector, size of sector in bns of dollars)



Sources of Industry Revenues

As mentioned, dealerships are the retail conduit for the large automotive industry, generating revenue from four different areas: (1) the sale of new cars, (2) the sale of used cars, (3) sales from service and parts and (4) the sale of automobile financing and insurance.

| Dealership Revenue Channels | | | | |
|---------------------------------------|--------------------|---------------------|--------------------------|--------------------------------|
| | New Vehicle | Used Vehicle | Service and Parts | Insurance and Financing |
| % of Sales | 50% to 60% | 20% to 30% | 10% to 12% | 2% to 4% |
| Gross Margin | 7% to 8% | 11% to 13% | 45% to 55% | 100% |
| Total Size of Market (billion) | \$410 | \$379 | \$118 | \$93 |

⁶ Asbury Group, Inc. Prospectus, March 14, 2002, Pg. 52.

⁷ Stephens Inc., “Automotive Retailing—A Combination of Growth & Value,” Page 10, December 2001.

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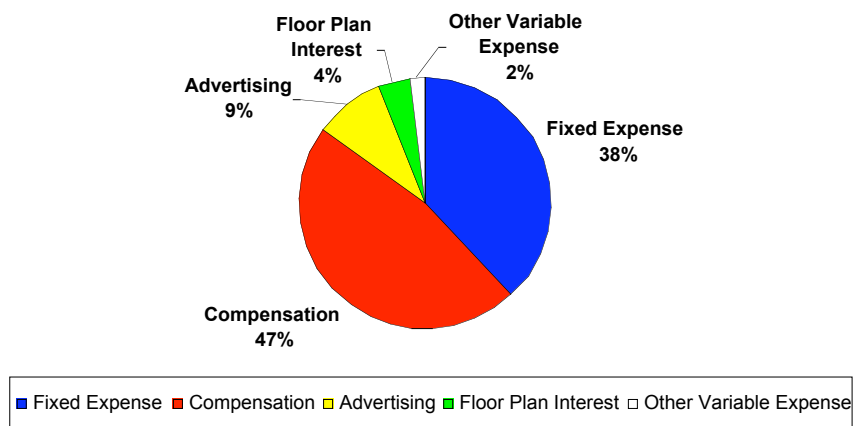
⁹ Goldman Sachs, Asbury Automotive Group new coverage equity report, Page 13, July 22, 2002.

Although a very low margin business, new vehicle sales are a priority for dealers because of the high margin revenue opportunities they generate downstream. The financing and insurance channel (F&I) benefits as approximately 60% to 70% of customers use the dealership to fulfill some portion of their financing and insurance needs—a 100% margin business.¹⁰ The F&I services are not typically provided by the retailer, they simply act as re-sellers marking up the offerings of other vendors. In addition, the propensity of new vehicle owners to bring their cars, particularly while under warranty, to the dealership for servicing and repairs causes business to flow to the service and parts area. Finally, new cars coming off lease provide the used vehicle area with inventory.

Cost Structure

The dealership cost structure is predominantly variable in nature. In fact, it is estimated that 62% of dealer cost structure is variable,¹¹ and thus dealers do have the ability to significantly manage expenses to meet fluctuating demand. The major variable cost categories include: compensation, advertising, and floor plan interest costs:

Average Public Dealer Cost Structure



Source : Stephens Inc., Automotive Retailing industry report, December 2001

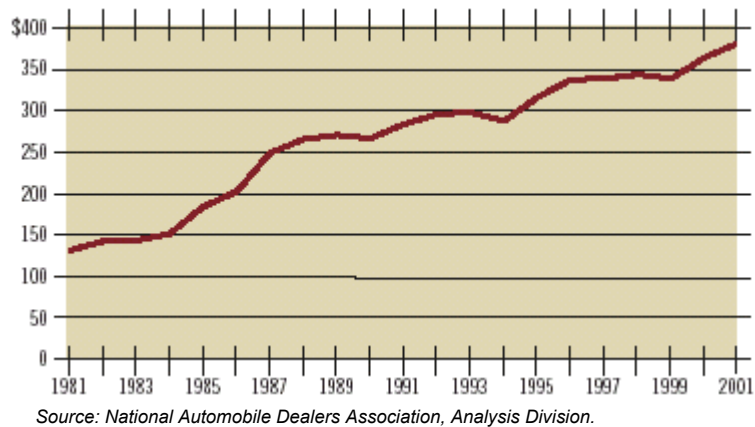
Compensation expense is the largest expense bucket. Sales people, who are typically compensated on commission, comprise the majority of these costs. In addition, the automobile retailer must employ supervisors and general office personnel, and service technicians.

Average advertising expenses consists of print, television, radio, direct mail, and other mediums. These expenses have been growing over time on a per vehicle sold basis:

¹⁰ “Autos & Auto Parts”, Standard & Poor’s Industry Surveys, Efraim Levy, July 13, 2002.

¹¹ Stephens Inc., “Automotive Retailing—A Combination of Growth & Value,” Page 18, December 2001.

Total Dealership Advertising per New Unit Sold¹²



Floor plan interest costs are somewhat unique to this industry. These costs can be considered the cost to finance the working capital necessary to operate the business. In the case of auto retailing, the working capital is vehicles, which must be purchased and sit in inventory until sold. This inventory carries a cost, as the inventory must be financed until it is sold to the customer. This makes it critical for the successful large dealership to turnover its inventory often. Typically, large dealerships are offered “Floor Plan Assistance” by the large auto manufacturers, in the form of discounted financing, providing them a small advantage over smaller players.

Fixed expenses include standard overhead costs, including leases on the property and floor rooms, leases for the service equipment, etc.

Customer Service and Differentiation

The auto retailing industry, characterized by low margins and sales people compensated based on commissions, has been subject to complaints about poor customer service. In fact, a recent survey by the National Association of Consumer Agency Administrators ranked auto retailers as the number one source of consumer complaints in 2001. The financing, insurance and negotiation aspects of an auto purchase can be quite complicated, presenting opportunities for consumers to be “tricked” by unscrupulous salespeople. Attempts at no-haggle pricing schemes and customer friendly facilities and sales people (not compensated on commission) have been made, with limited levels of success. Differentiation through customer service is limited in this business. The primary differentiation point is in location – auto purchasing is typically a local transaction, as it costs consumers to travel away from their home area to purchase and transport a vehicle. However there are still multiple retailers of a given brand in larger metropolitan areas. Furthermore, most people see car purchases as one-off transactions, and since much of the inventory is similar across retailers, consumers are primarily interested in price.

The main dimensions that auto retailers are differentiated along include location and brand. In the case of new car franchises, government regulation and franchise agreements with dealerships grant exclusive rights to individual dealerships for a given franchise/brand (Chevrolet, Lexus, etc) in a given market area.

¹² National Association of Automobile Dealers, “2002 NADA Data,” Page 18, 2002.

Government Regulation & Franchise Agreements

As mentioned, the automobile industry is highly controlled by government regulation and franchise agreements between dealers and automakers. The most important of these center around: (1) exclusive geographic territory rights, (2) mandatory uniform pricing by manufacturers, and (3) restrictions on the number of franchised dealerships owned by a single party.

Both government regulation and manufacturer franchise agreements govern the number and type of dealerships that can be located within a geographic market area. Franchise agreements typically grant exclusive rights for a given line in a particular geographic area. These provisions are meant to provide incentives for the retailer to invest substantially in advertising campaigns and facilities. Related government regulation was instituted to ensure dealers could not circumvent manufacturers' plans to create distribution systems based on exclusive territories. Overall, these geographic restrictions protect dealers from competition, while providing incentives to make investments.

In addition, franchise laws typically govern uniform pricing from manufacturers to dealers. In essence, such regulations dictate that manufacturers cannot give preferential pricing to dealerships; all dealers source vehicles at the same prices. Such regulation was designed to protect small, local dealers from manufacturer price discrimination.

Finally, some auto manufacturers place restrictions on the number of dealership franchises that a single entity can own.¹³ For instance, Ford typically limits ownership to no more than either 15 Ford and 15 Lincoln/Mercury dealerships or 5% of the prior year's total domestic Ford, Lincoln and Mercury sales. Similarly, Toyota prohibits a single entity from acquiring more than 5% of Toyota's annual retail sales volume. Toyota further restricts the number of dealerships that may be acquired in any Toyota-defined region and "Metro" market. For its Lexus brand, Toyota restricts ownership to only three dealerships nationally and two dealerships in any one of four Toyota-defined Lexus geographic areas. Such restrictions are designed to control the size of dealership groups to minimize a shift in power from the manufacturer to the retailer. In many cases, these restrictions can be waived, through special permission from the manufacturer, but nevertheless, they add to the complexity and time associated with acquisitions.

¹³ Group 1 Automotive, 10-K, Fiscal Year Ended December 31, 2001, Pg. 13.

EXHIBIT A – Auto Retailing Market Size

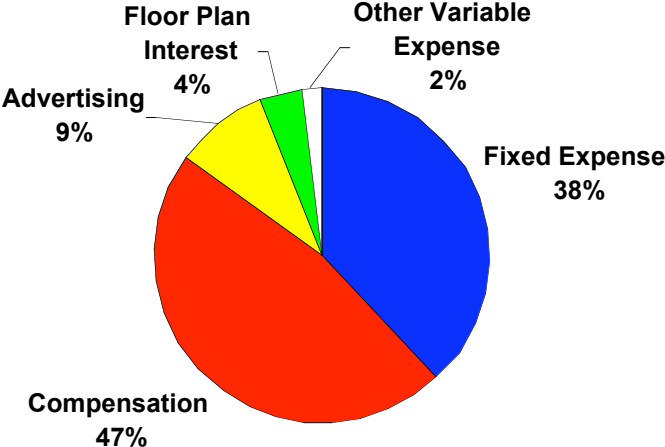
| Automotive retail, industry-wide revenues, 2001 | | |
|---|--------------------|-----------------|
| | <u>\$ billions</u> | <u>% of ttl</u> |
| New vehicles, through franchises | \$380 | 36% |
| Used vehicles, ex-private transactions | 268 | 26 |
| Estimated <i>back-end</i> business: | | |
| Parts & service / Finance & insurance | <u>400</u> | <u>38</u> |
| Total market | \$1,048 | 100% |

Source: National Automobile Dealers Association, Analysis Division.

EXHIBIT B – Major Public Auto Retailers

- Asbury Automotive Group – Operates 127 franchises from 91 dealerships. 2002 Sales: \$4.5B, 2002 Net Income: \$38.1M, Market Cap: \$237.0M (2/25/03).
- Autonation – Operates 386 franchises from 278 dealerships in the U.S. 2002 Sales: \$19.5B, 2002 Net Income: \$381.6M, Market Cap: \$4.14B (2/25/03).
- CarMax, Inc. – Operates 38 used car superstores in 18 markets, and 17 new car franchises. 2002 est. Sales: \$4.1B, 2002 est. Net Income: \$101M, Market Cap: \$1.49B (2/25/03).
- Group 1 Automotive Group – Operates 96 dealerships. 2002 Sales: \$4.21B, 2002 Net Income: \$67.1M, Market Cap: \$237.0M (2/25/03).
- Lithia Motors – Operates 123 franchises from 65 dealerships in the western United States and over the Internet. 2002 Sales: \$2.4B, 2002 Net Income: \$32.3M, Market Cap: \$228.9M (2/25/03).
- Sonic Automotive – Operates 160 franchises at 118 dealerships and 29 collision repair centers, in 13 states. 2002 Sales: \$7.2B, 2002 Net Income: \$115.2M, Market Cap: \$592.4M (2/25/03).
- United Auto Group – Operates 127 franchises located primarily in major metropolitan areas in 19 states, Puerto Rico and Brazil. 2002 Sales: \$6.2B, 2002 Net Income: \$44.7M, Market Cap: 442.5M (2/25/03)

EXHIBIT C – Average Public Dealer Cost Structure



■ Fixed Expense ■ Compensation ■ Advertising ■ Floor Plan Interest □ Other Variable Expense

Source : Stephens Inc., Automotive Retailing industry report, December 2001