FINAL TRANSCRIPT

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PRESENTATION

Operator

Please stand by for real-time transcript. Good morning, ladies and gentlemen, and welcome to the Group 1 Automotive Inc second-quarter earnings conference call. Please be advised that this call is being recorded. I would now like to turn the call over to Peter DeLongchamps, Vice President of Manufacturing Relations and Public Affairs.

Peter DeLongchamps - *Group 1 Automotive - Vice President of Manufacturing Relations & Public Affairs*

Thank you, Sara. Good morning, everyone, and welcome to today's call. Before we begin, I would like to make some brief remarks about forward-looking statements and the use of non-GAAP financial measures. Except for historical information mentioned during the conference call, statements made by management of Group 1 Automotive are forward-looking statements that are made pursuant to Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements involve both known and unknown risks and uncertainties, which may cause the Company's actual results in future periods to differ materially from forecasted results. Those risks include, but are not limited to, risks associated with pricing volume and the conditions of markets. Those and other risks are described in the Company's filings with the Securities and Exchange Commission over the last 12 months. Copies of these filings are available from both the SEC and the Company.

In addition, certain non-GAAP financial measures, as defined under SEC rules, may be discussed on this call. As required by applicable SEC rules, the Company provides reconciliations of any such non-GAAP financial measures to the most directly comparable GAAP measures on its website. Participating with me today on the call, Earl Hesterberg, our President and Chief

Executive Officer, John Rickel, Senior Vice President and Chief Financial Officer, and Lance Parker, our Vice President and Corporate Controller. I would now like to hand the call over to Earl.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thank you, Pete. And good morning, everyone. Thank you for joining us this morning. As we announced earlier this morning Group 1 reported record setting second-quarter results. Our second quarter earnings of $1.06 per diluted share is the best second quarter in the second best any quarter result in Group 1's history. Our operating margin of 3.7% matched our best ever quarterly result and our pretax income of $39.7 million is our second highest ever. These results are even more remarkable given that we did it at a time when Japanese brands that represent 62% of our normal new vehicle sales were experiencing severe supply shortages and the SAR averaged 12 million units in quarter, versus 16 plus million SAR levels in prior comparable quarters.

We continue to demonstrate the resilience of our business model and the ability of our operating team to deal with challenging business conditions. Similar to the onset of the economic downturn in late 2008, when we reacted swiftly to maintain profitability when top line revenue declined by over 30% in one quarter, and again last year when faced with a stop sale on 30% of our new vehicle sales volume during the Toyota recall issues, and now in an environment severely constrained new vehicle inventory for 62% of our normalized new vehicle sales volume, we delivered a record quarter. It's a great endorsement of our operating management team and our flexible business model.

In addition to the record results, I'm also pleased to announce that Group 1's second quarter results reflected revenue and gross profit growth in all segments of the business on a year-over-year basis. Total revenues grew 3.9% to $1.5 billion. Perhaps most noteworthy is that new vehicle revenues increased 3.1% on 4% fewer unit sales. Within that result, import brand sales were down 13%, reflecting the supply issues we faced during the quarter. Domestic brand sales were up 11% and luxury brand sales increased 7%.

While July and some part of August will continue to be constrained by supply shortages, the situation is improving weekly as the pace of deliveries for many high volume vehicles begins to increase. We would anticipate being back to normal inventory levels for most models by September. In addition to the strong new vehicle sales results, we also saw 3.8% revenue increase in our retail used vehicle business on 2.5% fewer units. Although we reported lower new and used retail unit sales, our finance and insurance revenues grew 8.8%, primarily due to an increase in vehicle service contract penetration rates and increased finance contract income. Parts and service revenues grew 5.2% with greater management focus, as well as increased investment and marketing efforts, are improving our retention rates.

Total gross profit increased 7.7% primarily on a 20.3% increase in new vehicle profit. On a per unit basis, new vehicle gross profit increased $455 to $2,252 as the operating team did an excellent job adjusting to the inventory constraints. We also recognized the used vehicle gross profit increase of $164 to $2,009 per retail unit. Finance and insurance revenues increased $125 per unit to $1,126, reflecting higher vehicle service contract penetration rates and increased finance income per contract, as lenders have lowered rates, increased loan origination fees, and expanded loan to value ratios.

All segments of our parts and service business grew, including warranty, which had a tough comparison to last year when Toyota had the large recall. Total parts and service gross profit increased 2% from the strong 2010 period. As I stated earlier, we achieved the 3.7% operating margin, matching the best performance in our 14-year history. In addition to generating additional gross profit in the second quarter, we also worked diligently to control costs. SG&A as a percentage of gross profit improved significantly to 75%, the best quarter we have reported in years. The combination of continued cost control and expanding gross profit is significantly leveraging our cost structure.

Turning now to our new vehicle sales mix and inventory. As expected, unit sales in a number of our markets were down during the quarter on a year-over-year basis. However, we did see increases in our California, UK, and Texas markets. Consistent with the inventory constraints, the import brand mix of our second quarter unit sales declined 5.6 percentage points to 52%, with the luxury mix growing to 30%, and domestic brands coming in at 18%. Gaining share were BMW Mini, Mercedes-Benz, GM, and Chrysler. New vehicle inventory fell about 2,800 units to 15,670 from March 31, with the biggest decline in imports. We ended the quarter with 33 day supply of used vehicles. I will now turn the call over to our CFO, John Rickel, to good over our second quarter financial results in more detail. John.

John Rickel - *Group 1 Automotive - CFO*

Thank you, Earl. Good morning, everyone. For the second quarter of 2011, our net income rose to $24.7 million, which is a 39% improvement over the adjusted 2010 results. Per diluted share, net income improved 41% from the adjusted prior year amount, to $1.06 per share in the second quarter of 2011, making this quarter the most profitable second quarter in the Company's history and the second most profitable quarter of all.

As Earl previously mentioned, this was accomplished in a 12 million SAR selling environment that was further complicated by inventory supply shortages in Japanese brands that comprise 62% of our normal new vehicle sales, compared to the prior record that was reported in a 16 million SAR selling environment. On a consolidated basis revenues increased $55.6 million or 3.9% to $1.5 billion compared to the same period a year ago, primarily reflecting a 3.1% increase in new vehicle sales and a 3.8% increase in used retail vehicle sales.

In addition, F&I income for the second quarter rose 8.8% over the prior year. We managed these increases despite significant inventory shortages in many of our import brands. These shortages along with weaker industry sales in May and June contributed to declines of 4% and 2.5% in new and used retail unit sales respectively. We also realized a 5.2% increase in parts and service revenues.

Our gross profit increased $17.6 million from the second quarter a year ago, to $244.2 million, which included increases of 20.3% in new vehicles, 6.2% in retail used vehicles, and 8.8% in F&I. These improvements reflect the emphasis we've placed on improving vehicle margins, particularly in the current environment of constrained import inventory. We are also very pleased to report a 2% increase in our parts and service gross profit.

Overall our gross margin increased 60 basis points in the second quarter year-ago to 16.6% in the second quarter of 2011, primarily reflecting the improvement in our new and used vehicle margins. Sequentially, our second quarter gross margin improved 90 basis points. Our new vehicle margins increased 100 basis points from the second quarter last year to 6.7%. Used vehicle retail margins improved 20 basis points to 9.8%. Parts and service gross margin decreased 170 basis points to 52.5% from the year-ago period.

For the second quarter of 2011, SG&A expense as a percent of gross profit improved 300 basis points from the adjusted results in the second quarter of 2010, to 75%, as the combination of continued cost control and expanding gross profit significantly leveraged the cost structure. All of this translated into a 26.2% improvement in our operating income, and a 70-basis-point improvement in operating margin over adjusted 2010 levels to 3.7%, which equals the best ever achieved by the Company.

Floor plan interest expense decreased $2.1 million, or 24.5% in the second quarter 2011, to $6.5 million as compared with the same period a year ago, primarily reflecting the impact of interest rate swaps that expired in December 2010. Manufacturers interest assistance, which we report as a reduction of new vehicle cost of sales at the time the vehicles are sold, covered 90.3% of total floor plan interest expense, a 19.8 percentage point improvement in the second quarter of last year. Other interest expense increased $2 million, or 31.2%, to $8.2 million in the second quarter of 2011, primarily explained by higher mortgage interest rates. Our consolidated interest expense includes noncash discount amortization of $2.3 million related to our convertible notes.

Now, turning to the same-store results. In the second quarter, we reported revenues of $1.4 billion, which was a 2.7% increase from the 2010 period. Consistent with the consolidated results, we sold 5.3% fewer new vehicles in the second quarter than in the prior year period. This decrease reflects the impact of the natural disasters in Japan that resulted in inventory shortages in a number of our import brands for much of the quarter. Despite the shortage of inventory and declining unit sales, our new vehicle retail sales improved 2.1% to $788.8 million as our new vehicle average selling price increased more than $2,400 to $33,694 per unit. The growth in the average selling price for new vehicles is primarily explained by mix shifts towards luxury brands, and to trucks from cars, as well as manufacturer price increases.

Our used business posted another year-over-year improvement with retail used vehicle revenues increasing 2.1% to $343.8 million, as our average selling price per retail unit improved more than $1,200 to $20,565 per unit. Again this result was despite 4% fewer retail unit sales. Our F&I revenues were up $3.1 million, or 7.4%. A 21% increase in our finance income per contract, 6.9% growth in our vehicle service income per contract, and a 135 basis-point improvement in our vehicle service contract penetration rate to 36.4% of our retail sales, more than offset the impact of decreased retail unit sales. This improvement reflects the focus we've had on our business processes in this area.

Overall, our same store F&I income per retail unit increased $128 to $1,130 per unit for the same period a year ago. As a result of our same store vehicle revenue and F&I growth, as well as improved vehicle margins, our second quarter gross profit improved $14.6 million, or 6.5%, compared to 2010. Our new vehicle gross margin improved 90 basis points in the second quarter of 2011, to 6.7%, compared to the prior year, while used vehicle retail gross margin increased 20 basis points to 9.8%.

Turning to the core of our business, our parts and service operations. We continue to deliver year-over-year growth with same store revenues up 3.1% over the comparable period. This growth included a 1.3% increase in our customer pay parts and service revenue, a 0.9% improvement in our warranty business, despite challenging comparative results for the Toyota pedal adjustments floor mat campaigns that bolstered last year's results. Our customer pay revenues improved in most of the major brands that we represent, as initiatives focused on customers, products, and processes continued to build momentum. We also realized a 5.6% increase in our wholesale parts business, and 10.6% growth in our collision sector, which also continues to reap the benefits of improved business processes. Our wholesale part sales had benefited from the closure of competing dealerships, as well as the impact of the stabilizing economy. This helped to strengthen the credit worthiness of our wholesale parts customers.

Our same-store parts and service margin decreased 100 basis points to 53.3%, primarily reflecting the return to more normalized margins in our warranty parts and service business. As I mentioned in our first quarter call and several times last year, our 2010 warranty margins were bolstered by the higher labor content of the Toyota recalls. The margin decrease is further explained by the mix effect of our growing collision business that represents about a 48% margin, which on a relative basis is lower than our customer pay and warranty parts and service businesses.

With regards to the same store SG&A expense, our cost control efforts continue to provide positive results. And coupled with the leverage provided by higher revenues and profit, same store SG&A expense as a percent of gross profit, improved 270 basis points from the second quarter a year ago to 74.9%. Floor plan interest expense decreased $2.2 million, or 25.3%, in the second quarter of 2011, to $6.3 million as compared with the same period a year ago. This decrease primarily reflects a decline in our weighted average borrowing rate as $250 million of our interest rate swaps at a weighted average rate of 4.8% expired in December 2010, partially offset by higher weighted average gross borrowings of $78.9 million.

Now, turning to liquidity and capital structure. As we previously announced, we successfully amended our syndicated credit facility on July 1, 2011, extending the expiration date to June of 2016. The amended facility continues to provide us with $1.35 billion in total borrowing capacity, consisting of $1.1 billion for inventory financing and $250 million for working capital, acquisitions and other general corporate purposes. We are very appreciative of the 14 lenders who chose to continue to participate in the credit facility, as well as the 7 new financial institutions who decided to partner with us. As a result of the amendment and extension, our mortgage facility has been reclassified as a long-term borrowing on the June 30 balance sheet.

For the second quarter, we generated cash flow from operations of $53.8 million on an adjusted basis. As of June 30, 2011, we had $12.3 million of cash on hand, and another $134.2 million that was invested in our floor plan offset account, bringing immediately available funds to a total of $146.5 million. In addition, we had $230.6 million available on our acquisition line that can also be used for general corporate purposes. As such, our total liquidity at June 30 was $377.1 million.

We used $7.1 million for capital expenditures during the quarter to construct new facilities, purchase equipment, and improve existing facilities. We will continue to critically evaluate all plan capital spending for 2011 and work with our manufacture partners to maximize the return on our investment. We anticipate that our full-year capital spending will be less than $50 million, which includes about $10 million for specific growth initiatives in our parts and service business. We also used $14 million to repurchase 381,610 shares of our stock during the second quarter, at an average price of $36.69 per share, leaving $3.5 million available for future repurchases under our current board authorization at June 30.

At quarter end, our new vehicle inventory stood at 15,670 units with a value of $527.4 million, compared to 15,760 units with a value of $484.9 million a year ago. With regards to our real-estate investment portfolio, we own $419.6 million of land and buildings at June 30, which represents approximately one-third of our total real estate. We've utilized our mortgage facility and executed borrowings under other real estate specific debt agreements to finance the majority of these holdings. We've calculated our debt covenants as were in effect on January 30, 2011, and as revised in the new July 1 credit facility amendment. We're in compliance with all such covenants as of June 30 under both calculations and do not forecast any future compliance issues. For additional detail regarding our financial condition, please refer to the schedules of additional information attached to the news release, as well as the investor presentation posted on our website. With that, I will now turn back over to Earl.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thanks, John. Looking toward the back half of 2011, we're very proud of our record performance in the second quarter, particularly given the inventory constraints of many of our major brand offerings. Production is just beginning to fully ramp up in many high volume Japanese vehicles. We expect it to the take another month or two for industry levels to fully normalized. And for several key models, production is not scheduled to return to full capacity until the September time frame.

Because of these factors, we anticipate some lingering sales constraints well into August. As inventories build, we expect manufacturers to reintroduce incentives and increase advertising to drive traffic into our show rooms. Knowing that there is a great deal of pent up demand to purchase new vehicles, we continue to expect sales to build in the back half of the year, driving full year 2011 unit sales into the $12.5 million to $13 million unit range, in line with industry expectations. These vehicle sales are stable but as new vehicle selling rate improves, we do expect to see used vehicle pricing soften.

Turning to acquisitions, this year we have announced that we acquired 7 domestic and luxury franchises during the year, 3 during the second quarter, adding a total of $340 million of estimated revenues. We'll continue to look for acquisitions that fit our brand and geographic targets, but we'll remain disciplined in what we pay for franchises. That concludes our prepared remarks. I'll now turn the call over to the Operator to begin the Question-and-Answer session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Mark Mandel; ThinkEquity.

Mark Mandel - *Thinkequity - Analyst*

Congratulations on a great quarter. I was wondering if you can give us a little bit more guidance in terms of the sales outlook for the second half of this year. How should we look at the revenues in light of the supply constraints that you and the rest of the industry are facing?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Well, I'll just try to give you my current perceptions, and I can't really quantify much for you. But, I'd actually expected us to have more Toyota receipts here in the last few weeks than we did. Our Toyota inventory is slowly starting to build but not as much as I expected. But our general managers tell me that they expect increasing numbers of receipts this week and certainly in the early part of August. So it appears that Toyota has been producing vehicles for several weeks now, and they should be hitting our dealerships almost immediately.

Checking with our Honda dealerships as recently as yesterday, those lots are still barren, and also drove through Honda lots across Houston in dealerships we don't own, and Honda inventory is extremely light, with the exception of Pilots and Elements. I'm a little more concerned about that. That does not seem to be ramping up quite like Toyota. It seems that certainly into August and maybe September the Honda supply will be much more challenged.

So, August is a very big selling month. It's historically the biggest selling month for us in Texas and Massachusetts where we have another big concentration of dealerships. And it appears that by the end of August, we should be in pretty good shape. But at the beginning of August, still could be a little bit inventory constrained in those Honda and Toyota brands.

Mark Mandel - *Thinkequity - Analyst*

I don't know if you can answer this, but when you look at your same store sales increase in the second quarter of 2% in the new vehicle arena, is it fair to say that when you look at the third quarter that we might see some declines in comps of some magnitude?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

It's hard for me to say that, not remembering exactly how strong third quarter was last year. John, do you have any comment on that?

John Rickel - *Group 1 Automotive - CFO*

Yes, Mark, this is John Rickel. I think we could be plus or minus around that. Third quarter was okay last year. It wasn't exceptionally strong. I think there's a chance it could be on the plus side.

Mark Mandel - *Thinkequity - Analyst*

Okay. I'll let someone else ask some questions. Thanks a lot.

Operator

Aditya Oberoi; Goldman Sachs.

Aditya Oberoi - *Goldman Sachs - Analyst*

Hi. This is Pat Archambault here actually. Can you hear me okay?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Yes, we can.

Aditya Oberoi - *Goldman Sachs - Analyst*

Thanks. Two questions for you. One was actually just on the margins in parts and service. It looks like those have come in just a little bit on a year-on-year basis. Is that due to the business mix? Or is that some deliberate pricing to continue to try and break out customer pay? Is my first question. And then, secondly, on gross profit for the new vehicle side, those numbers held in very, very well. There had been some discussion about dealer specific incentives being layered on in the absence of OE incentives, but that doesn't seem to have happened. Just wondering, how do you think that is likely to be affected in the back half as volume comes back and presumably as promotions come back from the OEs?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

First, Pat, this is Earl. On the parts and service margin, I think the primary factor was, as a very big Toyota retailer we had a massive amount of that Toyota recall business at this time last year. And those recall operations were almost entirely labor. They didn't have very much in the way of parts. And, of course, labor has a much higher margin for us. We returned a little more to the normal parts and labor mix, so that's one factor that pulls the margin down a bit. We also had very nice growth in our collision business this quarter, over 10%. That business is a bit lower margin than your typical service repair shop labor business. And finally, we do aggressively promote and we are more aggressively promoting this year sales of lower margin things like tires and things to increase our retention rate. Some where in those three factors was a little bit of pressure on the margin.

To your question on new vehicle margins, it's certainly a valid assumption to say that as Toyota and Honda, Lexus, Acura, those inventories get back to more typical levels that they'll be a greater push for volume in the market overall. And the new vehicle margins will drift down from what we saw in the second quarter. And that is likely to start to begin in the second half of this quarter. But as I just mentioned, I'm not exactly sure when the Toyota and Honda vehicles are going to hit.

And then I think as we get towards September, we're going to see much more aggressive marketing efforts from the manufacturers. Toyota and Honda have made it clear to all their dealers that as soon as they have the inventory, they are going to work very hard to recapture some of the share they've lost during the last post-March months where they were impacted by supply. I think it's also important, and I don't think most people know this, but there are many other vehicle models outside of the Japanese brands that are in short supply right now. Even in an industry that's only traveling at about a 12 million unit selling rate. Ford is very short of small cars. Chevrolet is short of small cars. Hyundai has been short on inventory all year, which has nothing to do with the post-earthquake issues. Volkswagen is short of cars. So, you know, there are still, as we speak, some supply constraints in the industry beyond just the Japanese brands.

Aditya Oberoi - *Goldman Sachs - Analyst*

And, I'm sorry, kind of in the description of the incentive activity for the back half, the implications for your own margins are neutral or directionally having more OE incentives, does that push dealers to be more aggressive because volumes come back? Or is it a neutral effect?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

I would say, if I had to characterize it, I would say it's a slight negative because it will push more volume and it will trigger competitive response from the different manufacturers. But clearly that volume has financial benefit to us as well. So it's that trade-off between margin and volume that we'll have to try to manage as that occurs. But I would say it's a slight negative from the margins that we realized in the second quarter.

Aditya Oberoi - *Goldman Sachs - Analyst*

Got it. Very helpful. Actually, I'm sorry if you said it earlier, any sense of how on a SAR basis we're tracking for July?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Well, I only can report what I read in JD Power's report recently, and they track it through the month. They believe the retail SAR for July is travelling somewhere around 9.8 million where it's been 9.3 million the previous two months. It seems like they have some data that indicates that July might be a little better. I don't have any Group 1 data that I can confirm or deny what they say, so I tend to listen to them.

Aditya Oberoi - *Goldman Sachs - Analyst*

Okay. Thank you very much. I appreciate it.

Operator

Matt Nemer; Wells Fargo Securities.

Matt Nemer - *Wells Fargo Securities - Analyst*

Good morning, everyone. Great quarter.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thanks, Matt.

Matt Nemer - *Wells Fargo Securities - Analyst*

Just a couple questions. First on the F&I improvement. Could you just talk to what you were able to do to get the penetration up so much on extended service contracts? And then, is there anything in the F&I results that is related to contract experience or charge-backs or something from prior quarters?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Matt this is Earl. Pete's been responsible for our F&I business for the last year or so. So he's been dying for a chance to take credit for our performance so I'm going to let him answer this.

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Peter DeLongchamps - *Group 1 Automotive - Vice President of Manufacturing Relations & Public Affairs*

Matt, I appreciate the question. First, let's answer your second question first. No, there was nothing to do with charge-backs. This was pure operational performance. And, I guess, at the end of the day we took a hard look at some of our dealerships that were performing below average, both on PRU and vehicle service contracts. And those were mainly in lease intensive markets. We redoubled our efforts with those dealerships. We've also taken a very aggressive approach working with our audit and compliance team to make sure that all of our processes with our menu-based pricing and all the things we offered our customers, that all those processes are being followed with financial regulation that continues to face us on a daily basis. It's really made a difference in following up on the process to make sure that the old adage, what you expect, you inspect. And it really does work.

The other thing that we've done I think that has been very helpful and we've talked about it with all of you is that the operational metrics in what we've done providing the operating team with real-time facts and figures to manage the production on a daily basis has really given us the opportunity to address producers who on a daily basis are not meeting budget. And finally, it's been a lot of hard work by the F&I field team and general managers and F&I directors to focus on the numbers. And it's slowly paying off. So kudos to all the folks in the field.

Matt Nemer - *Wells Fargo Securities - Analyst*

Great. Thanks, Pete. Secondly, could you just talk to some of your cost savings efforts? Did you a great job flowing through the incremental profit this quarter. Just wondering if you can talk to some of the things you're doing on the cost side. Then specifically, would the regional restructuring that you've announced have any impact on your cost performance this quarter? And if not, could you just talk to what impact that might have over the course of a longer period, like a year or two?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Yes, sure, Matt. This is Earl. The big driving force for this quarter was the actions we took at the Japanese brand dealerships. I can't remember exactly when, but sometime in the first half of April it became clear that the supply disruptions from the Japanese earthquake were going to be much greater than we would have ever dreamed. And so, within two or three days, we set a plan by dealership, in fact general managers created their own plan. First of all, it was with the gross margin targets, and you can see that that paid off. But then it was to size our marketing expenditures to what we projected to be reduced new vehicle volume. Fortunately, that came through. And that was a big part of the expense savings, but then also those dealerships we realized with less volume that we were going to have to cut every area of expense. So in many of those dealerships, they had attrition during the quarter. They didn't necessarily replace the people. They monitor their overtime and those sorts of things. So we've got a lot of traction on both marketing costs and personnel costs, but driven primarily by the dealerships that represent that 60 plus percent of our business that relate to Japanese brands. So we created very quick plans and they executed them at the field level just like we asked them to do. So that was a real big factor in our success this quarter.

Relative to going from three to two regions, that did not have any impact in the second quarter. And probably won't after great deal in the third quarter. But it's a longer term enabler for us to continue to get more uniform on our systems and practices. And I think that will help us continue to drive costs lower over the long term, the next year or two. So that's more of a strategic move than something tactical that's going to pay dividends that I can quantity in the third quarter or the fourth. But we just think it's good common sense and a good business move for us.

Matt Nemer - *Wells Fargo Securities - Analyst*

If I could sneak in one more quick one. Earl, you mentioned that you expect used car prices to potentially be soft in the second half of the year as the new car market improves. We've been kind of going under the assumption that the new car, that increased OEM prices have been a factor and low supply have been a factor in driving used car prices up and it might be here to stay for a little while. Could you just kind of bridge the gap between those comments and why are you so confident that the prices will sort of overcome the structural supply shortages that are out there?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Yes. Well, I think your general assumption that rising new car prices and lack of new vehicle inventory has supported these record used car prices is completely valid. Used car values on the calendar basis usually peak in March. This year they peaked in June. But, of course, June was getting near the time of peak inventory shortages, particularly for these Japanese brands. But we saw this most recent month, a price decline 3% or 4% on some of the smaller cars that were probably up about 14% year-over-year. And, of course, the fuel prices peaked nationally at $3.99 a gallon a couple months ago also. And that drove some of these compact and mid-sized car, used car prices through the roof also. Used Honda Civics and Corollas were selling at unbelievable prices. Those have started to cool off already. I think when new Camrys and Corollas are being aggressively marketed on the new side again, here in the coming months, I think it will be later this year before the new Civics are ramped up. But I think that has to put downward pressure on used car prices. Now, that's not necessarily from historic prices. That's from current prices and prices we've had. But, of course, we have to be concerned because we buy cars every 30 to 60 days and turn them. So, we have to be very careful about declining values.

But every month there are several hundred thousand customers that go into the market, and they don't know if they're going to buy new or used until they finish the transaction. And, I think recent months, many of those customers have been choosing used just because they've had more choices available. And, of course, there's seasonality every year also. As you start to move to the winter, used car prices drop. We think we need to be very cautious about that in the next couple of months.

Matt Nemer - *Wells Fargo Securities - Analyst*

Got it. Moving to more of a defensive posture on used.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Yes.

Matt Nemer - *Wells Fargo Securities - Analyst*

Okay. That is great. Thanks for your time. Appreciate it. Great quarter.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thank you, Matt.

Operator

Scott Stember; Sidoti & Company. Your line is open.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Good morning, Scott.

Scott Stember - *Sidoti & Company - Analyst*

Most of my questions have been answered already. But maybe on the new car side, could you talk about how some of the German brands performed in the quarter for you versus the industry? And how that might have helped you essentially flatten out your volumes on the near side?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

That's very accurate. That, indeed, was the case. I believe our BMW sales were up somewhere around 20%. And BMW is a bigger and bigger part of our business. We only have a few Volkswagen stores but we've been sold out of their volume models. Mercedes had a good quarter, so I think it's fair to say that German brands had reasonably good supply and are pretty powerful in the market now. And it's a good thing for the Company as well.

Scott Stember - *Sidoti & Company - Analyst*

How did you guys do with Toyota, Lexus, and Honda Acura?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Our Toyota sales were down over 20%. It's the number I remember.

John Rickel - *Group 1 Automotive - CFO*

22.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

22%. John has the exact number.

John Rickel - *Group 1 Automotive - CFO*

Honda/Acura was down 12%.

Scott Stember - *Sidoti & Company - Analyst*

And last question on the pricing environment for acquisitions. I know you get this question every call, but it seems that things are heating up for you guys a little bit. Can you just talk about what you are seeing on pricing?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Some of the prices being paid are fairly ridiculous, but there are a lot of opportunities out there. A lot of things to look at. And we would still prefer to grow our business if we can find acquisition opportunities that meet our return hurdles. So, I think the acquisition outlook is probably above average, pretty good right now. Just a matter of being disciplined in what we pay.

Operator

John Murphy; Bank of America Merrill Lynch.

John Murphy - *BofA Merrill Lynch - Analyst*

Just a follow-up on the supply shortage here at Toyota and Honda. I was just wondering, in the interim, as you're waiting for these cars to come in, what the manufacturers are doing to help retain customers potentially push them into more parse and service or extend leases? Just trying to understand if there's any financial impact, or support you're getting from the companies in the interim.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

We are getting some support. And just a couple of things I'm aware of, and there's probably more, because I'm not into great detail. But I know they're extending leases. Lexus and Toyota have been very good about that. Honda has a program where customers who place orders for vehicles that aren't in stock get the same incentive benefits or whatever is in place at the moment. So, my perception is that both those companies have done whatever they can do to try to keep potential customers on the hook until we can supply the car they want.

John Murphy - *BofA Merrill Lynch - Analyst*

And do you think that's resulted in some pent up demand for these brands that will really snap back in September, October as you get restocked?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Yes, I do. We have pretty decent Lexus order banks, waiting lists, whatever you call them. Things like, Toyota Prius, there are not a lot of alternatives that those people consider yet. So, I do think there's some of that. I couldn't quantity it, but I believe it does exist.

John Murphy - *BofA Merrill Lynch - Analyst*

Just a question on SG&A at 75%. Obviously, it was a tough quarter from the lack of inventory at the Japanese brands. But you performed incredibly well. You highlighted some actions that you took in those dealerships. But, as we go forward and volumes recover, at least we assume they will recover, and your gross profit recovers, can you give us SG&A as a percent of gross profit dive significantly below 75%? I think this was the best quarter in more than 10 years that we've seen from you as a SG&A as a percent of gross profit. Just trying to understand how much further or how far down that can go.

John Rickel - *Group 1 Automotive - CFO*

John, this is John Rickel. We were very proud of the results this quarter. It continues to demonstrate the leverage that we've talked about now really since coming out of the recession. The work we've done, the cost structure that we did anticipate as gross margin dollars start to come back in, that we'd be able to deliver leverage. The estimates that we've provided to you is basically $0.50 to $0.55 on the incremental dollar will flow through. I think we did a lot better than that this quarter, but I think going forward, as we continue to grow, gross margin dollars, you should anticipate seeing us continue to leverage SG&A.

John Murphy - *BofA Merrill Lynch - Analyst*

Great. That's helpful. Then just lastly, as you guys are thinking about capital allocation, and I think Earl, you may have alluded the this. As we look at acquisitions, share repurchases, and dividends, which you are in the market doing all three of those right now. What would be your preference, or your order of preference, as you generate cash flow for those three?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

No doubt acquisitions, John. Relative to share repurchase versus dividend, I have to discuss that with the board at the next meeting. But, we have $146 million of cash right now, and I feel good about that. That gives us flexibility. If the recovery takes a while, we're in pretty good position at the moment. So, I feel very good about our balance sheet. But we do want to grow the Company.

John Murphy - *BofA Merrill Lynch - Analyst*

Great, thank you very much. Keep it up, guys.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thank you very much.

Operator

Rick Nelson; Stephens.

Rick Nelson - *Stephens Inc. - Analyst*

Congratulations as well. Terrific quarter. I'd like to ask you about the gross margin lift in new vehicles. Was that confined to Japanese name plates? Or did you see margin expansion with other name plates?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Actually, it wasn't just confined to Japanese name plates. But the primary driver of our numbers did come from Japanese name plates. As I mentioned to you, or on the call a few minutes ago, there are some other shortages in the market outside of Japanese brands. And they may not necessarily be a big part of our business. Hyundai and Volkswagen and Ford cars, Chevrolet cars, there are some other vehicles that we're able to make better margins on at the moment due to limited supply. But the way our Company is structured with 62% in Japanese brands. That drove that number primarily.

Rick Nelson - *Stephens Inc. - Analyst*

And I realize Toyota inventory levels are coming back a bit slower than maybe we'd like to see. But as they have begun to flow inventory back to the dealerships, have you been able to retain those grosses?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Up to the moment, yes. But I expect that to have pressure on it any time now. Almost any day now.

Rick Nelson - *Stephens Inc. - Analyst*

And that expense ratio we saw this quarter, 75%, a record low, do you think that's sustainable as we see these pressures on new vehicle margins?

Earl Hesterberg - *Group 1 Automotive - President, CEO*

I think it's sustainable. And that's what we get up for every morning, is to make it sustainable. So, it may be a little more challenging as we get back to pushing volume. But we took the tough step when we leaned out the Company during the downturn. So, our goal is to build the sales volume and the gross more quickly than we had a the cost back in. And I think we've done that for the last couple quarters and I think we can do it. I think we continue that trend. That's what we're here for.

Rick Nelson - *Stephens Inc. - Analyst*

Any overall comments on the financing environment as it relates to new and used? And commentary on the subprime arena would be helpful, too.

Peter DeLongchamps - *Group 1 Automotive - Vice President of Manufacturing Relations & Public Affairs*

Sure. It's Pete DeLongchamps. We continue to see our lenders being aggressive within the marketplace. Subprime, depending on what market you're in, anywhere from 10% to 20%, probably 15% being an average depending on which market you look at. We currently are doing business with about 60 different banks and credit unions across the country, and access to credit is not an issue.

Rick Nelson - *Stephens Inc. - Analyst*

Thanks a lot. And good luck.

Peter DeLongchamps - *Group 1 Automotive - Vice President of Manufacturing Relations & Public Affairs*

Thanks, Rick.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thank you, Rick.

Operator

Himanshu Patel, JP Morgan.

Himanshu Patel - *JPMorgan - Analyst*

Good morning, guys. Most of my questions have been answered but just two bigger picture ones. One is, just when you kind of look back over the last three months with the USR having fallen from 13 million pre-tsunami to 11.5 last month, I'm just wondering if you had a just a very qualitative view on how much of that decline was attributable to supply constraints versus a genuine softening in the consumer because of gas prices or whatever other reason it may be.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

There's a third factor I'd like to point out that most people don't completely grasp. And clearly there was some economic impact, whether it was high fuel prices, high food prices, bad unemployment number, so forth, and clearly those supply shortages we talked about. But what a lot of people don't understand is how much the manufacturers and the dealers pulled back on marketing efforts. So, it wasn't just incentives are down, I think 11% for the first half year in the industry, but the second quarter number would be much greater than that. And then if you could get the advertising weight data, I think would you find most of the manufacturers pulled back on their advertising expenditures in the second quarter, knowing that there were supply issues or whatever. And, of course, we weren't the only dealer group to adjust our marketing budget. So there was a lot less promotional marketing activity on the marketing communications and incentive side as well, stirring up traffic, and communicating deals.

So I don't know how you weight those three factors, but I don't think you can underestimate when these big manufacturers pull back on their marketing budgets how immediate the impact is on traffic levels in the market. And that's the change I think we're going to see, almost immediately, certainly by the time we get into the second half of this quarter. I think the manufacturers are going to be back in force, and we'll be right behind them.

Himanshu Patel - *JPMorgan - Analyst*

And I guess just, can you help us, not to slice hairs, but a little bit more on the timing of when you think some of the Japanese OEMs launch major incentive campaigns. Is this stuff that we could see as early as the tail end of August? Or is it more kind of mid-September that you're thinking about? I don't know if you have any refined views on that, but love to hear that if you have it.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

I don't think it's refined. I think it's a guess. But my guess is you'll see some in August. August is a great selling month. I have the feeling, that although Toyota inventories won't be where we want them to be, or they want them to be, that they'll have enough to work with. I think Chrysler increased some incentives in recent weeks, a few weeks ago. I think we're going start to see some activity in August.

Himanshu Patel - *JPMorgan - Analyst*

Great. Thank you.

Peter DeLongchamps - *Group 1 Automotive - Vice President of Manufacturing Relations & Public Affairs*

Himanshu, it's Pete. I would like to add that the new Camry will be launched in September. Production starts the first week of September. As the number one selling passenger car, we really expect and the news we're getting from Toyota is that it will be a substantive launch starting third week of September with massive advertising and incentives. We are excited about that and think that that will certainly drive the market as we head in to the fourth quarter.

Himanshu Patel - *JPMorgan - Analyst*

The marketing launch by Toyota for that is third week of September, you said, Pete?

Peter DeLongchamps - *Group 1 Automotive - Vice President of Manufacturing Relations & Public Affairs*

Yes.

Himanshu Patel - *JPMorgan - Analyst*

Great. Thanks, guys.

Operator

Gentlemen, it appears we have no further questions at this time. Mr. Hesterberg, I will turn the conference back over to you.

Earl Hesterberg - *Group 1 Automotive - President, CEO*

Thank you for joining us today. We look forward to updating you on our third quarter earnings results in October. Have a good day.

Operator

And that concludes today's conference. We thank you all for joining us.
