Company Name: Group 1 Automotive
Company Ticker: GPI US
Date: 2017-07-27
Event Description: Q2 2017 Earnings Call

Market Cap: 1,288.78
Current PX: 60.02
YTD Change($): -17.92
YTD Change(%): -22.992

Bloomberg Estimates - EPS
Current Quarter: 1.935
Current Year: 7.195
Bloomberg Estimates - Sales
Current Quarter: 2839.778
Current Year: 10761.818

Q2 2017 Earnings Call

Company Participants

- Lance A. Parker
- Earl J. Hesterberg
- John C. Rickel
- Daryl A. Kenningham

Other Participants

- Aileen Smith
- Irina Hodakovsky
- Rick Nelson
- David Tamberrino
- David H. Lim
- David Whiston
- Derek J. Glynn

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Group 1 Automotive's 2017 Second Quarter Financial Results Conference Call. Please be advised that this call is being recorded.

I would now like to turn the conference call over to Mr. Lance Parker, Group 1's Vice President and Corporate Controller. Please go ahead, Mr. Parker.

Lance A. Parker

Thank you, Jamie. Good morning, everyone, and welcome to today's call. The earnings release we issued this morning and the related slide presentation that include reconciliations related to the adjusted results we will refer to on this call for comparison purposes have been posted to Group 1's website.

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 the Safe Harbor provisions of the Private Securities Litigation Reform Act of 1995.

Forward-looking statements involve both known and unknown risk and uncertainties, which may cause the company's actual results in future periods to differ materially from forecasted results. Those risk include, but are not limited to, risk associated with pricing, volume and the conditions of markets. Those and other risk are described in the company's filings with the Securities and Exchange Commission over the last 12 months. Copies of those filings are available from both the SEC and the company.

In addition, certain non-GAAP financial measures, as defined under SEC rules, maybe 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 in today's call are Earl Hesterberg, our President and Chief Executive Officer; John Rickel, our Senior Vice President and Chief Financial Officer, and Daryl Kenningham, our President of U.S. Operations. Please note that all comparisons in the prepared remarks are to the same prior-year period, unless otherwise stated.

I'll now hand the call over to Earl.

Earl J. Hesterberg

Thank you, Lance, and good morning, everyone. Group 1 earned $39.8 million of adjusted net income for the second quarter. This equates to second quarter adjusted EPS of $1.87 per diluted share, a decrease of 13% from last year. Although we had another record performance in U.S. F&I per unit retail and a further rebound in Brazilian profitability, these factors were not enough to offset continued weakness in vehicle sales in our U.S. energy price impacted markets. Combined new and used retail unit sales dropped 7% in Texas and Oklahoma during the quarter.

Our largest market, the U.S. Energy Capital, of Houston, had an industry new vehicle sales decline of 10% in the first half of the year and a very weak close to the second quarter with June sales down 24% from June 2016 levels. This followed a double-digit year-over-year increase in May and created problems in both inventory levels and volume target achievement at quarter end.

Turning to our business segments. During the quarter, we retailed over 40,000 new vehicles. Total consolidated new vehicle revenues decreased 5% on a constant currency basis, as the average new vehicle selling price increase of 1% was more than offset by 6% fewer unit sales. As has been the case since the beginning of 2016, the volume weakness was predominantly seen throughout the oil-dependent markets in the United States. Same store new vehicle unit sales also decreased by 1% in the U.K., which I will address shortly.

Consolidated new vehicle gross profit was down 6% on a constant currency basis, as gross profit per unit remained flat. Our new unit sales geographic mix was 76% U.S., 19% U.K., and 5% Brazil. Our new vehicle brand mix was led by Toyota/Lexus sales, which accounted for 25% of our new vehicle unit sales. BMW/MINI represented 13% of our new vehicle unit sales, VW/Audi represented 12%, Ford represented 11% of our new vehicle unit sales.

U.S. new vehicle inventory stood at 30,300 units, which equates to a supply of 88 days, essentially flat from first quarter, but still far too high due in some degree to the weak Houston market industry sales in June previously mentioned.

Domestic branded inventories remain the biggest challenge with GM, Chrysler and Ford, all over 100 days. We need to adjust some of our production orders further, especially in our Texas and Oklahoma markets.

During the quarter, we retailed over 32,000 used retail units. Total consolidated used vehicle retail revenues decreased 2% on a constant currency basis, as the average used vehicle selling price increase of 1% was more than offset by 3% fewer unit sales. This sales result was driven by an 8% decline in our Texas and Oklahoma markets.

Used vehicle retail gross profit decreased 6% on a constant currency basis, as average gross profit per unit declined 3%. This per unit decline is primarily explained by overall weakness in used sedan industry pricing as well as lower trade-in volumes. Trade-in units generate our highest used vehicle retail margins. U.S. used vehicle inventory stood at 12,600 units, which at a 32-day supply is consistent with our historical levels.

Total consolidated after-sales revenue and gross profit both increased 5% on a same store constant currency basis, driven by increases in warranty of 16% and collision of 5%, while wholesale parts and customer pay were up 2%.

U.S. same-store after-sales revenues increased 6% despite some softness in the key energy markets there as well. We maintain our guidance of mid-single-digit same-store revenue growth for the remainder of 2017.

Finance and insurance gross profit was flat on a consolidated constant currency basis, as an increase in F&I per retail unit of 5% offset the decline in retail unit sales. U.S. F&I per retail unit delivered yet another quarterly year-over-year increase, up $86 per unit to an all-time record of $1,688.

Regarding our geographic segment results, our U.S. same-store operations saw a total revenue decline of 3%, driven by a 6% decline in new vehicle unit sales. As previously mentioned, sales were once again negatively impacted in the Texas and Oklahoma markets due to weakness in the oil industry, with decreases of 6% in Texas and 11% in Oklahoma. We remain optimistic that sales in these markets will at least level off by the end of 2017.

U.S. same-store total gross profit was flat, as the growth in after-sales and F&I per retail unit, previously mentioned, offset the new vehicle revenue decline.

U.K. industry sales were down 10% in the second quarter, largely due to the March pull ahead that contributed to record sales in the first quarter. Our U.K. operations outperformed the industry with same-store new vehicle unit sales decline of only 1%. Total same-store revenue grew 3% on a constant currency basis, as an 11% increase in total used vehicle revenue and an 11% increase in F&I revenue more than offset the decline in new vehicles.

In Brazil, we generated a significant increase in quarterly profit despite a 9% decline in same-store new vehicle unit sales, which was weaker than the overall industry, reflecting both our luxury mix and our focus on increasing margins. Our new vehicle margins increased 7% on a local currency basis, which offset most of the volume decline.

We increased overall profitability by growing same-store used vehicle gross profit 35%, after-sales gross profit by 31% and F&I gross profit per unit by 32%, all of which are on a local currency basis.

We were also able to leverage the growth in gross profit via continued cost control as SG&A as a percent of gross profit improved 440 basis points to 88.3%. We're very pleased that our local team has been able to continue to drive profitability growth in an unstable political environment. With our dealership and brand portfolio optimization now complete, we're well-positioned to take full advantage of the future recovery in the local market.

I'll now turn the call over to our CFO, John Rickel, to go over our second quarter financial results in more detail. John?

John C. Rickel

Thank you, Earl, and good morning, everyone. For the second quarter 2017, our adjusted net income decreased $7.6 million or 16% over our comparable 2016 results to $39.8 million.

On a fully diluted per share basis, adjusted earnings decreased 13.4% to $1.87. As Earl mentioned, our earnings were once again negatively impacted by the ongoing weakness in our U.S. oil markets as well as exchange rate headwinds related to the British pound that have now lapped heading into the back half of 2017.

Starting with the summary of our quarterly consolidated results. For the quarter, we generated $2.7 billion in total revenues, which was a 4% decrease from prior year. On a constant currency basis, which ignores the change in foreign exchange rates, total revenues decreased 2.4% for the quarter.

Our gross profit decreased $5.2 million, or 1.3% in the second quarter a year ago, to $404.9 million, but was roughly flat on a constant currency basis. As a percent of gross profit, adjusted SG&A increased 130 basis points to 73.5%, due largely to pressures in our U.S. oil markets.

Floorplan interest expense increased by $1.6 million, or 14.1% from prior year to $13.2 million, which is more than explained by higher LIBOR interest rates versus the second quarter last year. Other interest expense increased $600,000 to $17.3 million, also due to higher interest rates.

Our adjusted consolidated effective tax rate for the quarter was 36.4%. We expect our full year tax rate to be between 35% and 36%.

Turning now to our geographic segment, starting with the U.S. market on a same-store basis. For the quarter, total U.S. same-store revenues decreased 2.7% to $2.1 billion, reflecting a decrease of 3.9% in new vehicles, 4.2% in total used vehicles, and eight-tenths of a percent in F&I, driven by decreases in both our new and used retail unit sales of 5.7% and 4.9%, respectively. These decreases were partially offset by a 5.6% increase in after sales, which consists of increases of 15.8% in warranty, 5% in collision, 2.8% in customer pay and 2.7% in wholesale parts.

We reiterate our guidance for mid-single-digit same-store revenue growth for the remainder of 2017. The 5.4% decrease in total retail units sold that drove a slight F&I revenue decrease was mostly offset by an F&I PRU increase of $78 or 4.9% to $1,682 per unit. This PRU improvement can be largely attributed to continued improvements in penetration rates for most of our major product offerings and represents an all-time quarterly record for us.

Total same-store gross profit decreased 2.7%, driven by decreases of 7.3% in total used and 6.6% in new vehicles, primarily reflecting volume declines, partially offset by a 5% increase in after sales gross profit.

Our after sales gross margin decreased 30 basis points to 53.8%, due to less internal reconditioning work, which we reported as 100% margin business. As Earl previously mentioned, our used vehicle business in the U.S. oil markets was negatively impacted by both demand softness and the lack of trade-in supply, which forced our dealerships to purchase more expensive inventory at auction, negatively impacting our retail used vehicle gross profit and margin.

Although we have experienced new vehicle volume pressure, it should be noted that the change in year-over-year total U.S. new vehicle gross profit per unit has either been positive or about flat for six consecutive quarters. When combined with our performance in F&I, total new vehicle profit per unit growth has averaged $239 or 7.1% over the last six quarters, with an increase of $159 or 4.5% this quarter.

Our adjusted SG&A as a percent of gross profit increased 130 basis points to 71.3%. In response, we're continuing to work on resizing the business to reflect current market conditions. I would point out, however, that about half of the increase in U.S. cost represent investment in our after sales, personnel and training that we believe will pay dividends in the near future.

Related to our U.K. segment, on a same-store basis, with percentage change metrics on a constant currency basis. For the quarter, total revenue decreased $39.7 million to $422.7 million, but increased 2.5% on a constant currency basis.

Total gross profit for the U.K. segment was up 2.6% from prior year. After sales gross profit improved 4.2%, and our F&I income increased 10.6%, but was partially offset by decreases in new vehicle gross profit of 2.1% and total used gross profit of 3.1%. The decrease in new vehicle gross profit was caused by a 1.4% decline in unit sales, largely due to the pull ahead into the first quarter as Earl mentioned.

With the overall industry declining 10% in the quarter, this represents impressive out performance by our U.K. team. The 3% decline in total used gross profit was due to an 8% decline in margins, as we worked our way through the unusually high-level of trade-ins from March.

In addition, as consumer demand has shifted away from diesel engines, we've begun to reduce our used diesel inventory, which also negatively impacted our gross profit and margins this quarter.

Related to our Brazil segment, on a same-store basis, with percentage change metrics on a constant currency basis. As Earl mentioned, our team did a tremendous job increasing used, after sales and F&I gross profit by double-digits to generate total gross profit growth of 18%. This was despite a 2.4% decrease in new vehicle gross profit, which was the result of weak sales in our luxury brands, consistent with the overall industry.

Our SG&A as a percent of gross profit, also improved, declining 440 basis points to 88.3%, driven by a reduction in head count, reduced outside service spending and renegotiated lease terms for several of our dealership properties. As Earl mentioned, we are well positioned to take full advantage of the further recovery in this market.

Turning to our consolidated liquidity and capital structure. As of June 30, we had $26.6 million of cash on hand and another $76.6 million that was invested in our floorplan offset accounts, bringing immediately available funds to a total of $103.2 million.

We used $39 million during the quarter to repurchase roughly 630,000 shares of our common stock at an average price of $62. These repurchases represented 3% of our total outstanding common shares at the end of the first quarter. We have $50.7 million remaining on our board-authorized share repurchase program.

Finally, during the second, we used $5.1 million to pay dividends of $0.24 per share, an increase of 4.3% per share over the second quarter a year ago. 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'll now turn it back over to Earl.

Earl J. Hesterberg

Thanks, John. Related to our corporate development efforts, we're pleased to announce this week's acquisition of a Land Rover, Jaguar dealership in Albuquerque, New Mexico and a Land Rover dealership in Santa Fe, New Mexico. These are our first Land Rover and Jaguar dealerships in the U.S., and expands our global network to seven Land Rover and seven Jaguar franchises with three additional franchise add points having also been awarded in the U.K.

These New Mexico dealerships are expected to generate $40 million in annual revenues, and are the only Land Rover, Jaguar dealerships in the entire state. As previously announced, in early July, we acquired the Beadles Group in the U.K. consisting of 12 dealerships that are projected to generate $330 million of annualized revenues. This will increase our U.K. annual revenue base to over $2 billion. Year-to-date, we have acquired $435 million of annualized revenues.

This concludes our prepared remarks. I will now turn the call over to the operator to begin the question-and-answer session. Operator?

Q&A

Operator

[Operator Instructions] And our first question today comes from John Murphy from Bank of America Merrill Lynch. Please go ahead with your question.

<Q - Aileen Smith>: Good morning, guys. This is Aileen Smith on for John. Getting into some of the commentary that you made on your inventory levels at the beginning of the call, if we were to look at the inventory levels by automaker, besides GM, some of the supply imbalances appear most acute at the Japanese and the Europeans. And I know that you noted that your domestic inventory remains the biggest problem, but how would you characterize the supply levels for the other brands and are there any other automakers who are being particularly aggressive in pushing inventory on to you?

<A - Earl J. Hesterberg>: Well, the only three brands that are somewhat reasonable for us at the moment are Mercedes Benz, which is our lowest, and Toyota and Honda. But other than that, we have too much of everything. I don't know that anyone really has been pushing too much inventory but, in particular, this June drop in the Houston market caught us by surprise. Actually at the end of May, we had our inventory levels almost where we wanted them. And so it was June that kind of put us back behind the April. But we have to make some further adjustments and I believe the OEMs will also.

<Q - Aileen Smith>: And with respect to the bulleted domestic levels, is this primarily just an oversupply of passenger cars or are you also seeing the elevated levels for trucks and SUVs?

<A - Earl J. Hesterberg>: I would say it's everything. Little more on the car side as you might expect, but it's not just cars. We can have over 100 days with just cars these days.

<Q - Aileen Smith>: Okay, great. And can you talk about the trends you are seeing in off-lease returns and trade-ins of your customers that are coming in to trade-in their vehicles? Are you seeing a notable pickup in those that are coming in with negative equity or underwater?

And for those consumers who are coming back off-lease to potentially get into another lease, how materially are the monthly payments changing from an old lease to a new lease, especially if used vehicle pricing comes under pressure?

<A - Earl J. Hesterberg>: Okay. I'm going to let Daryl Kenningham, our President of U.S. Operations take the majority of this one. But it is a fact that with lower used car values, there is some increase in negative equity, there is no doubt about that. Daryl, do you want to make some comments?

<A - Daryl A. Kenningham>: Yes. Negative equity is getting to be a larger challenge. And stepping into new models, we stagger between the lease and finance payments between the trade-in and the new models is a challenge in some brands. There is – some of the incentive pressure that's on the new cars is creating some pressure on us trying to trade for more used cars as John indicated earlier.

<Q - Aileen Smith>: Okay, great. That's very helpful. Thank you.

Operator

And our next question comes from Irina Hodakovsky from KeyBanc. Please go ahead with your question.

<Q - Irina Hodakovsky>: Thank you. Good morning, everyone.

<A - Earl J. Hesterberg>: Good morning, Irina.

<Q - Irina Hodakovsky>: I wanted to ask you a little bit about your SG&A leverage in the U.K. market. You did quite well in the used vehicle side. Would have thought that you would have offset some of the decline on the used side, which you actually also outperformed your overall market there. So I'm wondering what drove up the SG&A as a percentage of gross profit so much?

<A - Earl J. Hesterberg>: There are three factors that come to mind. First one is, actually, every five years, you get your property tax reevaluated in the U.K. and we got a bit of a property tax hit in the quarter. I'd say the second factor is some increased demo costs. We're running some bigger demo fleets and had to take some actions to hit some of our manufacturer sales targets, which is something we need to work through. And then the third issue I'd say is just overall staffing levels as the market has turned down, we're probably going to need to adjust our staffing levels and head count as we move forward.

Also, we had a big acquisition last year where we inherited some broken stores that aren't fixed and we probably haven't addressed some of the staffing levels in those stores based on what they are producing at the moment. S, I would say those are the three areas and it's fair to say we have some work to do.

<Q - Irina Hodakovsky>: Thank you. A follow up on that. If you were to break them into buckets, the parts of it that you believe you can adjust versus the property tax increase, which is clearly going to continue, how would you break up the impact of that? Is that a third or half of the increase?

<A - Earl J. Hesterberg>: I think property tax is only 10% to 15% of it. The majority of it we should be able to dent, I would say, and address a bit.

<Q - Irina Hodakovsky>: Great. Thank you. I appreciate that detail.

Operator

Our next question comes from Rick Nelson from Stephens. Please go ahead with your question.

<Q - Rick Nelson>: Thanks. Good morning. I'd like to follow-up on the Houston market, the weakness that you cited in in June. Is that continuing into July and your expectations, I guess, as we look at the back half of the year?

<A - Earl J. Hesterberg>: On volumes, I don't see anything different yet, Rick. I don't see anything worse, even though we were somewhat surprised by the Houston year-over-year drop in June. I think that data might be a bit choppy month-to-month. But I certainly don't have any indication that the energy-impacted markets have any lift in sales volume yet, if that's the gist of your question.

<Q - Rick Nelson>: Yeah, that is. What, Earl, are the time – oil prices are higher year-over-year, what do you think it's going to take to turn from an auto sales standpoint?

<A - Earl J. Hesterberg>: I think for us, Rick, the key is when the energy companies start to hire people again. Actually, markets like Huston have replaced most of the lost jobs, there really isn't a net job loss, but the new jobs tend to be in the restaurant, hotel, hospitality industry. The jobs we lost are energy and construction jobs, high-paying jobs.

So not only are there fewer customers buying a car that there's probably a mix issue there too. The new jobs are probably supporting a lower mix and more used cars or low end volume brand cars and we probably have been hit disproportionately in the midline imports and luxury brands. But I think it's just a function of hiring again in the energy industry.

<Q - Rick Nelson>: And the inventory, the 88 days supply, 100 plus with some of the manufacturers, how do you get yourself out from under that inventory?

<A - Earl J. Hesterberg>: Well, we have to cut our orders back further, but as we're nearing the end of the model year, it's also quite likely that we'll get some more aggressive incentive support from some of the OEMs to move the last 2017s of the lot. So, hopefully, we'll have a little more support from the OEMs.

<Q - Rick Nelson>: And then on the acquisition front, you've been active in terms of the U.K., a fairly sizable acquisition with the Beadles Group. If you could discuss your strategies, where you see the opportunities as we push forward from an acquisition standpoint? Some of the multiples maybe that you are seeing?

<A - Earl J. Hesterberg>: Yeah. Rick, actually, we are still receptive to expanding in all three of our markets. We actually need to get bigger in Brazil. We've now turned that business down to all solid performing businesses, but given the need to have a support infrastructure we can benefit from growth there. So, we're looking to expand in Brazil if we can find good opportunities. The U.K., we need to digest this last acquisition a bit as well as the previous one, but we have a nice infrastructure in the U.K. and some very good businesses there. So we would also consider further expansion in the U.K.

And in the U.S., I think, most of our desires in terms of expansion would be outside the oil patch footprint. As you can tell, we have a heavy enough concentration there right now. I wouldn't say we turned down the good business in Texas or Oklahoma, but our long-term performance will benefit from more geographic diversification in the U.S. I do think that there is some adjustment in the acquisition market. It's become clear I'd say for the best part of the year that both near-term sales and profit levels just aren't going to be the same as they were from 2014 to 2016. And to make any kind of deal, things have to adjust. So I don't know that the multiples have adjust, but clearly the price levels can't be the same.

<Q - Rick Nelson>: Thanks a lot and good luck.

Operator

And our next question comes from David Tamberrino from Goldman Sachs. Please go ahead with your question. Mr. Tamberrino, your line is open. Is it possible your phone is on mute.

<Q - David Tamberrino>: Good morning, gentlemen.

<A - Earl J. Hesterberg>: Good morning.

<Q - David Tamberrino>: So I just wanted to dig a little bit further into Brazil. As we think about the market rebounding there, as we see volumes come back up, how much from a cost perspective have you taken out? Is there further room or how much room for leverage is there as we see volumes rebound? Is there anything from cost being added back into the business?

<A - Earl J. Hesterberg>: No. I would say that there is always more cost we can squeeze out of any business. But generally speaking, the real leverage point for us in Brazil now is to add scale. And we have an infrastructure there that could handle 10, 12, 14 more dealerships than what we operate today.

<Q - David Tamberrino>: And, again, I mean, is there an opportunity for you to add from an acquisition standpoint or multiple cheap within the region? I know you just did another acquisition in the U.K., whereas we look at that market with the Brexit headwinds we might just be seeing volume come down, was it just that compelling of a price in the U.K. relative to the rest of the regions that you're in? I'm just trying to understand some of the strategic refootprinting or growth in the different regions?

<A - Earl J. Hesterberg>: Yeah, relative to the U.K., it was no doubt the return on investment proposition that attracted us to the most recent acquisition as well as the opportunity to become more significant in the Jaguar/Land Rover network in the U.K. and to join the Toyota network in the U.K. And, I guess, I should also say, it's our first meaningful foray into the Volkswagen network. We did have commercial vehicles, but this puts us into the passenger car network, which Volkswagen is quite a strong near premium brand in the U.K.

So, I would say it was a combination of strategic brand expansion and return on investment opportunity on our recent U.K. acquisition. Acquisitions are more difficult in Brazil. You have to be careful in terms of various liabilities that you inherit. But we are looking at several opportunities, both to expand some of the businesses we have in terms of capacity, but also trying to expand some of our key brands down there such as Audi and Toyota.

<Q - David Tamberrino>: Got it. And just, secondly, I think we saw another one of your competitors who had entered into the used market exit the used market as the standalone business. Is that something that you've looked at and considered? And from your viewpoint, why isn't it a good idea or what would be the difficulty in China to run a standalone used business side-by-side with your new franchise dealers and what kind of holds you from going into that market – hold you back from going into it?

<A - Earl J. Hesterberg>: Yeah. Sure. We've looked at it many times over the years and our impression has always been that the critical factors to success is to be the bank also. I think that's an important component in CarMax's success is being the retailer and the lender and we haven't been interested in becoming a bank yet. So there are lots of other ventures into the dedicated used car retail business that we'll watch closely and if somebody else can crack that nut, then maybe we'll take a go at it as well. But, right now, those things we just discussed in terms of expansion opportunities within our current business model seemed to make a lot more sense for us.

<Q - David Tamberrino>: Yeah. Got it. That makes sense. And then just lastly from a customer standpoint on the new side, we talked to Ford Motor credit early in the quarter and you see the headline, there is more folks that are coming back with negative equity from vehicles that they bought two, three years ago. Are you seeing that coming through your dealerships customers again with just, not a growing amount of negative equity, but more in a negative equity position and then how is that being handled? Is that being rolled into the new loan balance so your LTV starts out a little bit worse off for this next go around as you refresh the vehicle or is it just – do you have guarantors put on as there is more conditioning on the loan, trying to understand some of those dynamics from a financing perspective and what you are seeing on the ground?

<A - John C. Rickel>: Yes, we're seeing pressure on more negative equity around customers coming back and I would say we deal with that in a combination of all the things you mentioned and we have to rely heavily on our lenders to help us with that. So we have to get more creative and ask for more cash down and then the way we structure the deals is very important.

<Q - David Tamberrino>: Okay. So more cash down, not more loan to value?

<A - John C. Rickel>: There is more loan to value. I would say it's not any one thing that we do.

<Q - David Tamberrino>: Okay.

<A - John C. Rickel>: Definitely rely on all of the things that you mentioned with higher loan to value as well.

<A - Earl J. Hesterberg>: Yeah. This is Earl. Just one more point. I think you'll see the OEMs adjust their incentive tactics a bit. One of the variables in the marketing mix and the changing market relative to used cars has been a bit less lease support, particularly in the luxury brands, because of the residual value impact stemming from the used car market, used car valuations. So I would think we may see a repackaging of some of the OEM incentives to work types of cash that will help transact those deals as Daryl was describing, typical finance deals.

<Q - David Tamberrino>: Interesting. Was there a pull back on that in the first half of the year or the second quarter?

<A - John C. Rickel>: In residual value support for leases, or let's just say general lease support...

<Q - David Tamberrino>: Yeah. What has been the dynamic?

<A - Earl J. Hesterberg>: Absolutely. Absolutely.

<Q - David Tamberrino>: Okay.

<A - Earl J. Hesterberg>: Yeah. And that's just financial realism by the captive companies or the sales companies who are involved with these lease programs. They just can't put the same level of support into leasing that they could have a year or two ago.

<Q - David Tamberrino>: Understood. I appreciate the time. Thank you both, John and Earl.

Operator

Our next question comes from David Lim from Wells Fargo. Please go ahead with your question.

<Q - David H. Lim>: Hi. Good morning, Earl, John and Daryl. Just had a couple of questions. When you talk about resizing of the business, can you give us a little bit more color in what your plans are and what you're specifically referring to?

<A - Earl J. Hesterberg>: Well, it's three things. People is our biggest cost, so if you're selling less vehicles you need less people to transact that business. Now, of course, that doesn't apply into the parts and service end of the business, that's more of a new and used car showroom resizing. And advertising and inventory, those are the three big cost buckets and all of them need to be plexed when you're not generating as much gross profit.

<Q - David H. Lim>: So I wanted to follow up on that advertising piece. In this kind of environment, Earl, where you have a lot of inventories, et cetera, I mean, would you guys prefer – I think I already know the answer, but would you prefer OEMs providing more ad support, or is it more, like, lower funnel incentive support that you guys would be asking for if you had a choice between the two?

<A - Earl J. Hesterberg>: I'll let Daryl take a shot at that one.

<A - Daryl A. Kenningham>: Well, I think the OEMs are putting more into lower phone market-based advertising, I see that in several OEMs. It's more deal-based. In terms of the advertising we do, we're taking a hard look at what is most effective between our digital and our traditional spend, and then within digital how we can move some of those dollars around to generate as much traffic as possible, as cheaply as possible.

<Q - David H. Lim>: Got you. And then finally, looking more to like 2018, et cetera, I mean, assuming that the SAAR is in the $16 million or so, the upper $16 million, what are the levers, John, that you guys could pull in order to still generate hopefully a double-digit EPS growth into 2018. If you could dimensionalize that. And then, is sensitivity, if you would, on maybe every 500 or 1 million units down on the SAAR, how would that impact your earnings?

<A - John C. Rickel>: Yeah, I'll start with the second one last. A million-unit SAAR sensitivity is somewhere around, I think, $0.50 of EPS. David, we haven't updated it for a while. The last time we looked it was kind of in that ballpark. So I think that's still a directional number for you.

Basically, if you're talking high 16 million for SAAR, that's probably not going to be too far off where we're going to be at the end of this year. We had called 17 million and the market right now is kind of 16.9 million. So if you're in an environment where you have flat sales, I would also assume that we're going to start to come into an easier set of comps with the Texas and Oklahoma markets. The new vehicle declines ought to be basically behind us if you're in a flat SAAR environment. Then it's executing on the areas that we've always focused on.

It's being good with used cars. We think there's opportunities there and it's continuing the track record in parts and service. As I indicated in my comments, we deliberately put some cost in this quarter to support and to grow our parts and service capabilities, and we think that that will continue to pay dividends. So, I think, on a same-store basis, you could probably get half of your growth out of that and then the rest of it comes from either acquisitions or share purchases, and that gets you into double-digit EPS growth for next year.

<Q - David H. Lim>: Great. Thanks, gentlemen and thank you, Sheila [Roth].

Operator

Our next question comes from David Whiston from Morningstar. Please go ahead with your question.

<Q - David Whiston>: Thanks. Good morning. I wanted to start necessarily by jumping into the future a bit with the U.K.'s proposal on internal combustion that was announced this week. I'm not going to ask you to predict what consumers want in 2040, but could you at least comment on what are your thoughts on maybe over the next five years or so assuming gas prices stay cheap, would consumers over there want to increase their purchases of hybrids and pure electrics?

<A - Earl J. Hesterberg>: Yeah, actually, I am already seeing a little bit of increase in electric vehicles in the U.K., more than I probably expected, certainly more than we're seeing in the U.S. I was a little surprised with that. In the last couple of weeks, I was over there and Jaguar introduced the E-Pace to quite a bit of fanfare and Audi has got vehicles coming and BMW, we saw quite a few more i-vehicles there than we do in the U.S. So it seems to all stem from this diesel publicity crisis and the emissions issues that are now spread across both continents at least. In March, for example, in the U.K., a high percentage of our trade-ins were diesels and the people were driving off a lot in petrol engines.

And you've seen the values of used diesel vehicles drop quite a bit in the U.K. So I think it's all emanating from that, and these statements by Volvo by 2025, in the U.K. by 2040, those would just seem to be statements of strategic intent and very much in tune with the consumer psychology at the moment. It's driven by all this negative press about diesels. But, clearly things are headed that direction and if there's more offerings from the powerful OEMs, I think it will continue to head toward materiality in our business.

<Q - David Whiston>: That's helpful. Do you think there's a lot of demand though in the more mass market consumers, because all the brands you mentioned before like Jaguar and BMW are obviously premium?

<A - Earl J. Hesterberg>: I think there is more demand, what?

<Q - David Whiston>: Will the mass market consumer want an electric vehicle is what I'm asking.

<A - Earl J. Hesterberg>: I would think that will be later in the evolutionary process. You have the discretionary income of these luxury brand customers and you also have some education level differences and so forth. So, I think the luxury brands will be the early adopters on that technology.

<Q - David Whiston>: Okay. And moving to the Toyota with the new Camry coming, just curious do you think there is lot of demand for that sedan or do you think the Toyota customers are just going to still want a RAV4 or a Highlander?

<A - Earl J. Hesterberg>: Let me let Daryl answer that.

<A - Daryl A. Kenningham>: The new Camry is terrific. I saw it yesterday at one of our stores, and the reaction so far from consumers that have seen it, the inventories are very, very, very low right now. But it is very positive. And so we expect that the new Camry will do well. And the sell down from our view, the sell down of the 2017 model year Camry is going well.

<Q - David Whiston>: Okay. My last question is on F&I in the U.S. I was just curious what's really driving that growth there. This is obviously performing well, but also supplemental insurance and warranties?

<A - John C. Rickel>: Yeah, this is John Rickel. Basically, the F&I growth in the U.S. is basically been driven by improved product penetration across most of the insurance products.

<A - Earl J. Hesterberg>: Yeah. Our vehicle service contract and maintenance penetration were noticeably higher last quarter.

<Q - David Whiston>: Okay, great. Thanks, guys.

<A - Earl J. Hesterberg>: Thank you.

Operator

[Operator Instructions] Our next question comes from James Albertine from Consumer Edge Research. Please go ahead with your question.

<Q - Derek J. Glynn>: Yeah, hi, thanks for taking my question. This is Derek Glynn on for Jamie. Just a follow-up there on F&I. I mean, given used vehicles typically transact at lower prices than new, we understand there could be a negative mix impact in F&I generally speaking. But wondering if this increased product penetration more than makes out for that impact. And perhaps asked another way, if used sales are growing, do you guys think F&I PVR could remain relatively stable going forward?

<A - Earl J. Hesterberg>: Yes. At the moment, the product penetration particularly on extended service contracts and maintenance does make up for that. And our finance penetration was down a little bit last quarter, but not very much. So I think we're still pretty steady. We've been saying for a long time, we don't think we can grow penetration much higher and we keep making ourselves out to be liars. But this business still seems very stable to us. And a lot of lenders still are competing very aggressively to our business.

<Q - Derek J. Glynn>: Got it. And then for parts and services, so there's differences in mix across your regions between customer pay, warranty, wholesale, how do you see that mix shift changing over time for the U.K. and Brazil businesses? Would you expect that to become more similar to the U.S. as you continue to gain scale there?

<A - Earl J. Hesterberg>: Yes, and quite frankly the ability to grow our parts and service business in the U.K. and Brazil is staggering in my opinion. And our luxury brand businesses in the U.K., there are virtually none of them where if we had a bigger shop or more technicians, we wouldn't be doing more business immediately. Land is much more of a premium in the U.K., particularly around London, where we operate in many instances. But there is huge ability for us to grow parts and service in the long-term in both Brazil and the U.K. And we are making some transfer of processes and practices from the U.S. to both those markets.

<Q - Derek J. Glynn>: Okay. Thanks, guys. Best of luck.

<A - Earl J. Hesterberg>: Thank you.

Operator

Our next question is a follow-up question from David Lim from Wells Fargo. Please go ahead with your follow-up.

<Q - David H. Lim>: Hi. Just quickly, more longer-term from a dealer development standpoint like the requirements that OEMs are requesting for the dealerships. As the digital aspect of the business becomes more and more prevalent and people are, I think consumers are only going to maybe visit 1, maybe 1.5 dealerships at the most during their shopping process and most of it's done on their Internet. I mean does it really require all the brand imaging that's going to be necessary or that they want going forward? And do the OEMs realize that it's actually possibly a financial burden for the dealer body. I just wanted to get your thoughts on that, thinking about CapEx going forward?

<A - Earl J. Hesterberg>: Well, you're preaching to the choir on that one David. No, it doesn't require much of the brick-and-mortar we have today. We actually had one of the top OEM executives with us last Saturday who toured all of our different brand dealerships in Houston and we made the point to him that the two most important things to us today and I think, all dealers, are service bay and a parking space. Everything else is interesting, but we always need more parking spaces, which are very costly when you are in metro areas where the land is expensive. And a service bay is valuable and generates gross profit. And show room size and offices and all those things are interesting, but we can sort those out on our own. So we hope we'll enter an era soon of more realism in that area, but I can't say where they are yet.

<Q - David H. Lim>: Got you. Thank you.

Operator

And ladies and gentlemen, with that, we'll end today's question-and-answer session. I'd like to turn the conference call back over to management for any closing remarks.

Earl J. Hesterberg

Okay. Thanks, everyone, for joining us today. We look forward to updating you on our third quarter earnings call in October. Have a good day.

Operator

Ladies and gentlemen, that does conclude today's conference call. We do thank you for attending today's presentation. You may now disconnect your lines.