WHERE THE RUBBER MEETS THE ROAD

2016 Annual Market Profile of the Automotive Dealership Landscape

“Here in my car
I feel safest of all
I can lock all my doors
It’s the only way to live
In cars”

-Cars, Gary Numan
CONTENTS

Letter from the Presidio Team 3
Driving with Brodie Cobb 4
About The Presidio Group 4
Small Store Discounts 5
Measuring Return: EBITDA v. EBITDAR 6
Presidio’s Brand Listing 6
The Rise of Right of First Refusal 7
General Motors’ Investment in Lyft 8
Presidio’s Auto Team 9
Contact Us 10
LETTER FROM THE PRESIDIO TEAM

We are pleased to present The Presidio Group’s 2016 Annual Market Profile of the automotive dealership landscape which we have entitled, *Where the Rubber Meets the Road*.

We chose that title because our goal through this communication is to provide you with real, actionable, and value-added information, rather than inundate you with pages of charts and statistics.

The big takeaways in this edition are:

**These are historic times:**
- The current all-time low for the cost of capital results in all-time highs in U.S. dealership valuations.
- Borrowing costs are the lowest ever, allowing investors to pay a higher price and receive targeted returns.

**New capital sources:**
- New investor entrants into U.S. dealerships include Berkshire Hathaway and numerous $1 billion+ family offices, both investing long-term capital.
- More buyers and investors results in more competition for the acquisition of great dealerships.

**Values may be peaking:**
- If history repeats itself, time is of the essence because further increases in Federal Reserve rates would increase borrowing costs and decrease prices in order to maintain targeted returns.

This issue once again opens with a casual, yet informative, Q&A with Brodie Cobb, who not only is the founder and the head of our automotive advisory practice, but also has decades of experience to understand the ins and outs of the dealership marketplace. His thoughtful comments address some of the thornier aspects of investing in a dealership at today’s all-time high valuations.

As always, we stand ready to answer any questions you may have and look forward to keeping in touch. So reach out for a free consultation and let us know how we can help you. The incredible market we are currently enjoying will not last forever!
Q: How have dealership valuations fared over the last year? Have valuations peaked?

Through the first half of 2016, we have heard some buyers comment that valuations have peaked or that they are expecting to see price declines. However, Presidio continues to see transaction prices consistent with those seen over the last three years, which are all-time highs in U.S. dealership valuations. Buyers continue to see their costs of capital decline with the U.S. Treasury Note’s 10-year yield (www.treasury.com) averaging around 1.55% since the Brexit vote on June 23, 2016. This level is around 0.65% lower than this period one year ago in 2015. As a result, lenders continue to extend credit at prices and terms which makes acquisition funding very attractive. Further, the cost of equity remains low with the high stock prices and price/earnings multiples of the public auto retail consolidators, although at levels lower than 2015’s all-time highs. We have also seen the private consolidators become even stronger buyers as the public consolidators have focused on repurchasing their own shares over acquisitions. Lastly, most dealerships’ pre-tax earnings are near all-time highs, which drives valuations even higher.

Q: What sort of value does Presidio’s principal investing capabilities provide?

Presidio has always been passionate about the car business. We have worked with many fantastic entrepreneurs over the years and have been able to help them monetize their dealership businesses or grow their existing platforms. At times, we are fortunate enough to have the opportunity to invest alongside these great businesspeople in a dealership acquisition.

Presidio has many years of experience in family office and private equity fund management and is the only auto-focused investment banking firm with principal investing capabilities. Our firm’s seasoned professionals create client relationships based on mutual respect and a commitment to durable, long-term results. As such, buyers often see Presidio’s investment interest as a signal regarding the strength of the business. For a seller, this additional capital source helps drive demand for the deal to maximize terms. Buyers also welcome us as a passive financial partner who allows them to put less of their own equity into a transaction without losing operational control to keep “dry powder” available for the next opportunity.
SMALL STORE DISCOUNTS

At Presidio, we stay in constant contact with dozens of the most active buyers in the industry. These relationships provide us a deep buyer knowledge to understand which brands, markets, and transactions are right for which buyers. In recent years, we have seen buyers discounting groups of small dealerships and preferring investments in large, single point dealerships.

All else being equal, a buyer will likely prefer an investment in one store with $10 million in profit versus a five-store platform in which each store earns $2 million in profit. Buyers will require a higher return from the five-store platform although both investments generate an equal amount of profit and the franchises represented may be identical. Additionally, including a less desirable franchise in the five-store platform generally has a magnified, negative effect on the total valuation. Buyers may overlook the same less desirable franchise if included with the one dealership that earns $10 million.

All else being equal, a buyer will likely prefer an investment in one store with $10 million in profit versus a five-store platform in which each store earns $2 million in profit.

Additionally, buyers may sometimes try to “cherry pick” franchises to purchase from a group of dealerships. Buyers often try to avoid the aggravation of turning around an underperforming dealership or closing a less desirable franchise. This can potentially result in the seller retaining a single unattractive dealership. Selling these franchises individually may be difficult given that the store may be underperforming and that buyers do not like to give the franchise back to the manufacturer. Further, multiple stores need several operators and often a platform president to run those dealerships. Buyers could have a hard time recruiting talent to work in smaller dealerships in that many talented operators will not want to work at a smaller dealership with limited earnings potential if a similar opportunity exists at a larger dealership.

We have also recognized geography as a major driving factor in this buyer preference. Buyers may find small stores more abundant on the East Coast versus the West Coast and in smaller versus larger markets. Dealers understand that effectively managing several stores over a large geography creates logistical challenges. Several small stores of the same franchise may be very close together. Thus, there is a risk of greater intra-brand competition among stores.

Finally, certain operating expenses can marginally burden smaller stores versus larger stores. Facility requirements and upgrades are more expensive with multiple smaller dealerships versus one large dealership. These frequent capital expenditures may discourage investment in a platform of several small dealerships, particularly if some of the stores are not image compliant. Personnel and management costs are also multiplied with more stores. One large dealership may require a couple hundred people to run operations, but a platform of dealerships with the same profit could require many more.

<table>
<thead>
<tr>
<th></th>
<th>GROUP OF FIVE SMALL DEALERSHIPS</th>
<th>ONE LARGE DEALERSHIP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brands</td>
<td>Luxury import</td>
<td>Luxury import</td>
</tr>
<tr>
<td>Pre-Tax Profits</td>
<td>$10 million ($2 million per store)</td>
<td>$10 million</td>
</tr>
<tr>
<td>Management</td>
<td>Platform President and five General Managers</td>
<td>One General Manager</td>
</tr>
<tr>
<td>Number of Employees</td>
<td>350</td>
<td>150</td>
</tr>
<tr>
<td>Investor Required Return Range</td>
<td>20%-25%</td>
<td>15%-20%</td>
</tr>
</tbody>
</table>
MEASURING RETURN: EBITDA V. EBITDAR

In past Annual Market Profiles, we have highlighted that the single biggest mistake owners can make in evaluating their businesses is spending too much time thinking about multiples. We discussed the gaps in valuations between multiple-focused groups and groups with outside private financial backers focused on Cost of Capital / Return on Invested Capital (ROIC).

Recently, we have seen an increasing number of private buyers analyzing return with Earnings Before Interest, Taxes, Depreciation, Amortization, and Rent (EBITDAR), similar to public buyers. In the past, the return metric quoted was based almost exclusively on Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) or EBITDAR after subtracting rent expense.

Why do financial and strategic buyers and investors analyze earnings before these expenses? Both analysis methods use either EBITDA or EBITDAR as an approximation for the business’s cash flow independent of capital structure. Interest and taxes are added back to normalize for the business’s current debt levels and related tax shields, which would likely be different than those of a buyer or investor. Depreciation and amortization are added back as non-cash expenses associated with past capital expenditures. An EBITDAR analysis takes an extra step in adding back rent expense.

EBITDAR analysis is most typically seen in:
- Extremely high rental or leasing expenditure industries such as airlines or shipping companies
- Analyzing store-level profitability to determine if a store can be made profitable or is a candidate for closure
- Comparing two companies in the same industry with different asset structures: one company rents its facilities and the other owns without paying market rent

Valuing a target dealer group independent of its asset structure is the most common reason given by buyers for analyzing EBITDAR. While an EBITDA analysis approximates the cash flow of only the operating business, an EBITDAR analysis projects the return of the entire equity investment, both operating business and real property. This analysis method seems valid at face value as most buyers now prefer or require purchasing real property with a dealership. However, the operating business and the real property have different ROIC requirements in that the rental income from real property would have a lower ROIC requirement than the EBITDA from the more volatile operating business. Commingling these two ROIC levels in an EBITDAR analysis can cause different valuation results than an EBITDA analysis, particularly with very low or very high real property value dealerships.

In Presidio’s analyses, we prefer to stick with an EBITDA-based ROIC. Of course, some sellers charge their dealerships below-market rent while others charge above-market rates. To normalize for these differences in asset structures, Presidio adjusts rent expense and the resulting EBITDA up or down to a market rent capitalization rate based on market conditions and on levels that a real estate investment trust (REIT) would be willing to pay. This analysis also allows for different ownership structures between the operating dealership business and the real property. However, we continually encourage clients to align ownership in both dealership operations and in real property to avoid conflicts between owners in rent factors, leasehold improvements, and allocation of sale proceeds.

Presidio’s Brand Listing

Based on the current buyer demand that Presidio has observed, we have classified certain franchises into three categories listed below. The accompanying percentages represent the Return on Invested Capital (ROIC) demanded by a buyer or an investor on the EBITDA-based analysis discussed in the accompanying article. ROIC is the total annual return for each dollar invested in a dealership. Category A represents brands that currently have the greatest demand, and thus the highest value and the lowest required return, while Category C represents brands which are currently less desirable and require the highest return. Be aware, this list is not set in stone and the desirability of each brand can fluctuate based on other value drivers.

A Brands
ROIC Requirement 15%-20%

B Brands
ROIC Requirement 20%-25%

C Brands
ROIC Requirement 25%+
THE RISE OF RIGHT OF FIRST REFUSAL

We have seen a number of developments in recent years with the use of a manufacturer’s right of first refusal (ROFR) to supersede a buyer of a dealership in a proposed transaction over the buyer selected by the current ownership or seller. Strategically, manufacturers have been shifting from the use of framework agreements to ROFR to limit the aggregate or geographic market influence that a dealer group can exhibit over the manufacturer’s retail channel. A number of courtroom battles have resulted in legal decisions and allegations. Such cases include Mercedes-Benz USA, LLC v. Star Automobile Co., et. al., which ruled that a manufacturer can exercise a ROFR over an individual franchise in a multiple franchise transaction, and North American Automotive Services Inc. et. al. v. Long Island Automotive Group Inc. et. al., which alleged the use of the original buyer due diligence by the manufacturer selected buyer. Perhaps most surprising is the number of family offices and private equity groups approved by manufacturers without significant issues. The key factor in the approvals of such financing sources continues to be a strong Dealer Principal who has voting control over operations.

In any transaction, understanding the ROFR process is important for both the buyer and the seller. Early in considering a sale of a dealership, sellers should review and understand their Dealer Agreement(s) and the notification process required of each manufacturer. Upon executing definitive agreements for the sale, the seller will be required to formally notify each manufacturer. Manufacturers typically have up to 90 days to review a proposed transaction resulting in either approval or ROFR exercise.

We typically see three motivations from manufacturers in buyer selection:

1. The manufacturer obviously desires to maximize operational performance to sell the most new vehicle volume.
2. The manufacturer seeks to maintain or advance the goals of its diversity dealer development programs.
3. The factory seeks to increase intra-brand competition by breaking contiguous point ownership or decrease competition by bundling area point ownership under a single dealer or small group of dealers.

The seller is often thought to be ambivalent regarding the manufacturer’s ROFR exercise in that the manufacturer selected buyer is required to match the terms of the original buyer. However, we see several motivations from sellers to maintain the original buyer selection:

1. Sellers want to see their management and employees continue with a strong and reputable new employer.
2. Sellers want to see their dealer group brand and family legacy, which they have generally spent the majority of their lives developing, continue and grow under new ownership of their choice.
3. A ROFR exercise will delay the transaction closing timeline.

What can a buyer do to minimize the probability that the group that they worked so hard to win is not ultimately purchased by another buyer?

It is important for a buyer to understand and to be ready to address each of the manufacturer’s potential concerns. Operators that are already volume leaders for a brand and have solid, high-level manufacturer relations typically expect and receive expedited approval. However, solid operators have had their transactions delayed or ROFR exercised due to recent issues on the manufacturer’s scorecard in even a single location. The current dealership or area diversity dealer development program status is an important consideration. We have seen acquirers exert a competitive advantage with internally developed diversity dealer management candidates, who are ready to add to their target dealership’s team. Lastly, understanding the manufacturer’s intra-brand competition and point configuration goals before entering a transaction is key. Discussions immediately after notification also further help to relieve manufacturer concerns regarding potential decreases or increases in competition.

The seller relationship with the buyer is also key to the ROFR process since the buyer does not have legal standing to challenge the manufacturer’s ROFR as found in Rosado v. Ford Motor Company. If the seller is, in fact, indifferent between the original buyer and the manufacturer selected buyer, the original buyer generally does not have a legitimate opportunity to challenge the ROFR. However, a meeting among the seller, the buyer, and the manufacturer to introduce the strengths that the buyer brings to the brand and to reinforce the seller’s commitment to the transaction with the buyer can help to eliminate the manufacturer’s interest for a ROFR fight.

We have also seen buyers strategically use additional legal and transaction structuring tactics. Understanding state law is important as is indicating to the manufacturer that both the buyer and the seller intend to protect their rights. Within the definitive agreements, the buyer and the seller have also sought to add structures that an alternative buyer would not be able to or would find prohibitively expensive to replicate. However, manufacturers have started to challenge such structuring tactics and the courts have not yet determined their legal validity.
GENERAL MOTORS’ INVESTMENT IN LYFT

In January 2016, General Motors announced a $500 million investment in the popular ride-sharing app Lyft, the main competitor to Uber. As the largest investment by a major auto manufacturer in a technology company, this transaction has many potential implications for the auto industry.

GM and Lyft are already starting a new initiative called Express Drive, which is currently being tested in the Chicago and Boston markets. The program allows drivers to rent GM vehicles to drive for Lyft with no commitment to purchase the vehicles. Drivers monitor time spent driving for personal use versus driving for Lyft and are charged accordingly. GM is hoping to increase market presence in major cities via Lyft due to the popularity of ride-sharing apps in urban areas. This investment may also be a way for GM to boost sales of non-trucks/SUVs in cities. This program benefits Lyft by expanding the number of Lyft drivers to include those who may only be able to afford to rent a vehicle.

As the two companies announced, they are also partnering to work on autonomous vehicle programs. In May, GM acquired Cruise Automation to further its autonomous vehicle program. Cruise Automation has created a technology kit that allows certain Audi models to become autonomous vehicles for highway driving. GM hopes to have autonomous, electric Chevrolet Bolt vehicles driving for Lyft within a year and may be utilizing the newly acquired technology to do so. However, manufacturers typically take many years to implement changes into vehicle models. Further, many vehicles already come with autonomous features, such as self-parallel parking or lane drift warning systems. Additionally, huge technology firms such as Alphabet (Google) and Uber are fierce competitors in this space. Uber, for example, has invested in its own autonomous vehicle research center. We see widespread autonomous driving likely to be many years away.

The response from other manufacturers is already underway. Toyota recently announced a partnership with Uber, the largest ride-sharing company, to provide a similar vehicle-leasing program to Uber drivers. Volkswagen invested $300 million in Gett, a popular ride-sharing app in Europe. These investments also have risks. Lyft and Uber both exited the Austin, Texas market due to strict local regulations. Ride-sharing apps have been subject to much regulatory scrutiny and backlash, particularly from traditional taxi and livery services. Additionally, this investment is primarily about GM acquiring a distribution channel, which does not immediately affect or improve GM’s manufacturing competencies. However, the partnership may allow GM to push its product through Lyft.

We see these investments potentially affecting the dealer model in several ways. With increased leasing programs, drivers may access a vehicle they could not afford to purchase. Depending upon the kinds of programs that GM may pursue with Lyft, there is also opportunity for increased fleet sales through dealerships despite lower margins. Dealerships may have an opportunity for increased service revenue. Lyft vehicles may travel more miles and require more service because the vehicles are used as for-hire vehicles. The automaker could require or incentivize Lyft drivers using GM vehicles to service the vehicles at a GM dealership.

In the near-term, we do not see any likely significant changes to dealership business and valuations from these manufacturer activities. Lyft and Uber have approximately 500,000 total combined drivers, whose vehicles account for a very small portion of the over 255 million U.S. passenger vehicles. Uber projects ride bookings growth of 2.4x in 2016, but the effect on overall vehicle registrations and ultimately vehicle sales would remain small. The long-term implications for dealership valuations are not immediately clear, but we believe disruption of the distribution channel would likely take a long time to materialize.
PRESIDIO’S AUTO TEAM

The Presidio Group brings its unmatched experience in auto dealership M&A, sophisticated financial knowledge, and relationship-driven approach to every client we serve. During our careers, we have closed more than $3.4 billion in auto dealership transactions and are well-versed in the often emotional process involved in selling and buying a dealership. Ultimately, with The Presidio Group by your side, you can focus on the business, while we work to optimize the transaction structure and terms on behalf of our clients.

Because we are an investment bank, not a dealership brokerage firm, our clients receive thoughtful and insightful advice tailored to help them attain their individual strategic goals. Our services include: market assessment, financial analysis and valuation, offering materials, deal structure and negotiation, and even advising on OEM and employee communications.

Brodie L. Cobb, Founder and CEO

Brodie leads Presidio’s auto practice. This is an area that Brodie has been passionate about since before he founded the firm in 1997. Back then, Presidio was one of the first investment banks to focus on transactions in the automotive retail sector. Today with more than 50 individual transactions totaling over $3.4 billion, it is also one of the most experienced and respected firms in this arena. Prior to Presidio, Brodie was an investment executive focused on the automotive sector at NationsBanc Montgomery Securities where he helped to take public three of the largest entities in this sector – United Automotive Group (now Penske Automotive Group), Sonic Automotive, and Group 1 Automotive. He began his career at Security Pacific Bank’s LBO Funding Group. Brodie earned his M.B.A. from the University of Texas and B.A. degree from Tulane University. He competed for a spot on the 1988 U.S. Olympic Team in sailing and races bicycles.

James “JT” Taylor, Managing Director

JT joined The Presidio Group as the primary relationship manager for our clients. During his more than 30-year career in the automotive industry, he has worked on both the retail and manufacturer sides, developing deep relationships throughout the U.S. and Canada. Prior to Presidio, JT led product planning for Toyota in North America and was also part of the Lexus launch team. JT was an operating partner in a number of successful dealerships and worked with Joe Gibbs Racing, Southeast Toyota distributors, and the Wollfington Companies in a variety of automotive opportunities. JT earned his B.A. in economics from the University of Cincinnati. JT and his wife enjoy their six adult children and serving at their church. He follows motorsports with a passion and will go to a race of anything with four wheels and a motor.

Doug Stewart, Senior Consultant

Doug joined Presidio in 2014 as a senior consultant on the auto team. Prior to Presidio, he was the West Region Chief Financial Officer for Group 1 Automotive for 11 years responsible for 12 import, luxury, and domestic auto dealerships all located in California. Prior to Group 1, Doug was the CFO for 13 years for a private dealer group with six Japanese franchises in Southern California. In his 25-year tenure as an automotive group CFO, he was involved in 26 acquisition, disposal, and termination transactions valued at $240 million. Doug is a CPA and worked for one of the “Big Eight” accounting firms for nine years. Doug earned his B.S. in accounting from the University of Southern California. Doug is involved in amateur sports car road racing and races a Spec Racer Ford. He also enjoys golfing and cycling and is an avid hockey fan.

Lawrence Pier, Associate

Lawrence joined The Presidio Group in 2015 as an associate with the auto team. Prior to Presidio, Lawrence was an investment banker at Stifel Nicolaus for two years where he served on dozens of transactions for over $1 billion in value. Before his finance career, he worked as an entrepreneur and as a consultant. Lawrence previously founded a limousine service, which he sold in a strategic disposition. He also designed a performance scorecard solution for ADP Dealer Services (now CDK Global) to provide real-time Dealer Management System feedback. Lawrence earned his M.B.A. from the University of California, Berkeley and his B.B.A. from the University of Michigan. Lawrence has refurbished a 1980 Ferrari 308 GTSi and enjoys keeping up with vintage autos. He is also an avid baseball fan.

Lucy Sinacola, Analyst

Lucy joined The Presidio Group auto team in 2016 as an analyst. Previously, Lucy held internships at Stifel Nicolaus in investment banking, Spinnaker Capital in private equity operations, and Hercules Technology Growth Capital in accounting. She graduated with a B.S. in business administration from Northeastern University. Lucy enjoys running, rock climbing, hiking, and following hockey.
CONTACT US

We hope you have enjoyed our 2016 Automotive Market Profile. As the leading investment bank in the auto dealer sector, we would be pleased to discuss any of the subjects in our report or other questions you may have. Just call us for a FREE CONSULTATION, and we will give you our view points on *Where the Rubber Meets the Road*!

(415) 449-2500
auto@thepresidiogroup.com

---

**BRODIE COBB**
Founder and CEO
bcoobb@thepresidiogroup.com
(415) 449-2525

**JAMES “JT” TAYLOR**
Managing Director
jltaylor@thepresidiogroup.com
(415) 449-2520

**DOUG STEWART**
Senior Consultant
dstewart@thepresidiogroup.com
(415) 449-2522

**LAWRENCE PIER**
Associate
lpier@thepresidiogroup.com
(415) 449-2542

**LUCY SINACOLA**
Analyst
lsinacola@thepresidiogroup.com
(415) 449-2533