WHERE THE RUBBER MEETS THE ROAD

2019 Annual Market Profile of the Automotive Dealership Landscape

“People don’t want to buy a quarter-inch drill, they want a quarter-inch hole.”

—Theodore Levitt
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LETTER FROM THE PRESIDIO TEAM

We are pleased to present The Presidio Group’s 2019 Annual Market Profile of the automotive dealership landscape. *Where the Rubber Meets the Road* is written with the stated objective of providing automotive dealership operators and owners with actionable and value-added information to assist in business and strategic decisions. The following is the summary of the topics discussed in this publication:

From a broader economic perspective, these are historic times

- The current bull market is now in its 10th year with the S&P 500 increasing almost 230% since the beginning of 2009
- Interest rates remain near record lows after a 35-year downward trend from their peak in 1981
- The U.S. auto industry is in the 10th year of its current sales cycle – 2019 new vehicle sales forecasted to be in the high 16 millions

The automotive retail business continues to generate substantial cash flow

- The diverse business model of automotive retail is attractive to investors for its ability to adapt to the changing business climate and generate stable cash flows
- In a low interest rate environment, automotive retail provides investors with an opportunity to generate attractive yield on investments

The value of dealerships may have peaked

- Dealership profitability has been under pressure over the last few years as the industry has been impacted by lower new vehicle margins and rising interest rates
- Expected increases in the number of dealerships being brought to market may tip the scales from a long-standing seller’s market to a more buyer-friendly market

The auto industry is undergoing the most dramatic change in over 100 years

- Electrification of vehicles is underway with global electric vehicle (EV) sales projected to reach 11 million units by 2025
- Developments in CASE technology – Connected, Autonomous, Shared Mobility, Electrification – continue to converge toward Transportation-as-a-Service (TaaS), a new business model with the potential to disrupt the traditional vehicle ownership model

Experts at The Presidio Group’s Second Annual Auto Conference expect vehicle ownership to change drastically in the coming years

- Consumers will rely less on personally owned vehicles as adoption of ride-sharing and car subscription models increase – potentially resulting in a decline in U.S. new vehicle sales of up to 40%
- Gen Z and Millennials will be the first to adopt alternative ownership models with a focus on cost per mile – the tipping point for adoption will be reached when operating costs are approximately 50-55 cents per mile
- An autonomous fleet of ridesharing vehicles will provide access to cheap transportation, with some forecasters projecting a 30% increase in miles traveled in the U.S.

Presidio has expanded our team to meet the growing needs of our clients; we are working with dealer groups of all sizes, including some of the largest in the U.S., to respond to the disruptive forces with two distinct strategies

- A long-term strategy involving a more fleet-focused distribution model to capitalize on the opportunities that will be available in a TaaS environment
- A shorter-term strategy of portfolio management which may include monetizing dealership assets, real estate ownership optimization, and estate planning

Future changes in consumer mobility will provide lucrative investment opportunities for dealers and investors

- Presidio has partnered with an established investment firm with deep automotive related expertise to form *Next Auto Capital* – an investment fund that will focus on solid, positive cash flow companies that are positioned for growth as consumer mobility moves towards TaaS

With impending changes to the industry, we believe that now, more than ever, it is imperative for dealers to develop a long-term strategic plan to ensure their future success. One thing is for certain, the coming decades will not be “business as usual.”

As always, we stand ready to assist you in developing the appropriate strategy for your business. So, reach out and let us know how we can help.

—The Presidio Team
DRIVING WITH BRODIE COBB

Brodie Cobb founded The Presidio Group in 1998 and was one of the first investment bankers to focus on transactions in the automotive sector. To date, The Presidio Group has closed 89 auto transactions valued over $5.1 billion and remains a leader in the automotive sector.

Q: What is the current state of the auto retail industry?

First of all, the business environment continues to be very supportive. The economy continues to fair well, the labor market remains strong, consumer lending is readily available and interest rates, although higher over the past year, remain at historically low levels. We are now 10 years from the Great Recession, and U.S. new vehicle sales are forecasted to be between 16.5 and 17.0 million. It doesn’t get much better than this!

Over the past few years the industry has faced some challenges in the form of new vehicle margin pressure and higher interest rates. As we have become accustomed to, the franchised dealer model is incredibly versatile, and dealers tactically responded to these challenges by focusing on the more controllable aspects of their businesses – used vehicles, F&I and parts and service. And, in many cases they were able to offset the lower profitability of the new vehicle department. It appears that we may be seeing some better news so far this year with industry-wide margins stabilizing and interest rates, at least for now, reversing course.

From an overall perspective, the industry remains highly fragmented with the top 10 dealers selling only 8.3% of the new vehicles in the U.S. last year. Continuing at the pace of consolidation the industry has experienced over the past few years, which is a little over 1%, just isn’t going to significantly change the landscape. We believe it is becoming increasingly important for dealers to gain scale and improve their market position in order to compete in the future economy. Fortunately, we expect the next few years will present a unique opportunity for many dealers to expand their businesses as more deals continue to come to market, including larger, more geographically diverse opportunities. It is going to be an exciting time for dealers who are positioned for growth.

Q: So the business environment is strong and dealer profitability is improving, what is there to be concerned about?

Well, I wish I could tell you that things were going to stay like this forever, but the truth is they’re not. First of all, we can’t ignore that we operate in an incredibly cyclical industry that is highly dependent on consumer lending and interest rates. We are 10 years into the most recent sales cycle, and while we don’t know when sales will slow, it seems inevitable at some point.

Second, we are at the forefront of what will be the most significant disruption in consumer mobility in the last 100+ years. Like Theodore Levitt pointed out, transportation consumers don’t necessarily want an ICE vehicle, they want the best means of transportation. And we believe that consumer mobility will transition to Transportation-as-a-Service (TaaS) with the infrastructure ultimately supported by autonomous vehicles. It’s important to note that disruption in other industries is historically preceded by a sharp decline in values well in advance of the actual disruption being evident in the existing business model’s operating metrics. In plain English, this means that dealerships will lose significant value well before the operating metrics, such as cash flow, begin to decline. This is because investors base their valuations on forward-looking performance regardless of current run rates. The concern for existing dealers is trying to get that timing right. And timing the market is not easy.

Q: What would you say to dealers as they prepare for the years and decades ahead?

The first thing I would say is this time it is actually going to be different. The pace of technological advancements will cause disruption in every facet of the automotive industry, including the retail channel and dealerships operations. With this level of disruption, there will be winners and losers. Some manufacturers will come through the electric vehicle (EV) and autonomous vehicle revolution stronger than ever, while others probably won’t make it. New entrants have already gained a foothold in electric vehicle manufacturing, and unknown future competitors will also enter the market. While many are questioning Tesla’s long-term viability, we need to remember that the likes of Rivian and Bollinger Motors are waiting in the wings…not to mention the major EV manufacturers in China with an eye on global sales. In short, dealers should be evaluating their manufactures’ existing technologies, partnerships and financial condition to assess their competitive position in a future dominated by EVs.

Now more than ever is the right time for dealers to establish a long-term strategic plan for their future. We do not believe that ignoring these seismic forthcoming changes and staying with “business as usual” is a prudent strategic plan. We are already working with many clients on developing the right plans for their business, and we have added capacity and expertise to the Presidio team to meet the growing needs of our clients during what will undoubtedly be the most interesting and opportunistic decade or two in the history of the automotive industry.
In the analysis presented below, we identify the key drivers of dealership value and provide an assessment of their impact on the current market. George Karolis, Presidio’s President (left), commented, “Automotive retail is a very dynamic industry, especially from an M&A perspective with many factors influencing the price buyers are willing to pay for dealerships. For decades the industry has largely been operating with a tight supply of dealerships for sale. Perhaps the most profound change we are seeing today is the increase in the number of dealerships being brought to market. Simple microeconomics would dictate that increased supply, accompanied with a relatively fixed demand, will cause a decrease in values...we’ll have to see how the market reacts to this new dynamic.”

**Deal Pricing Dynamics**

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<th>Dealership Profitability</th>
<th>Peak</th>
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- Remains near historically high levels after peaking in 2017 for most dealers across the country
- The decline over the past few years is attributed mostly to new vehicle margin pressure and higher interest rates

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<th>Weak</th>
<th>Investor Sentiment</th>
<th>Strong</th>
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- Cash-generating investments are in high demand during periods of low interest rates
- A versatile, diversified business model makes dealerships attractive investments

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<th>High</th>
<th>Interest Rates</th>
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- Historically low interest rates provide “cheap” financing to support acquisitions
- Return on Invested Capital hurdles are lower, which increases the price investors are willing to pay for dealerships

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<th>Low</th>
<th>Real Estate Values</th>
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- Underlying asset values are reaching highest levels in history
- Health of the dealer body will impact long-term values

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<th>Buyer’s Market</th>
<th>M&amp;A Market (Deal Flow)</th>
<th>Seller’s Market</th>
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- Disruption and uncertainty about the long-term future of automotive retail, coupled with macroeconomic/geopolitical risks are leading to increased sell-side deal flow
- With more opportunities to choose from, buyers are becoming more selective; top tier franchises and strong markets are still in high demand

"Perhaps the most profound change we are seeing today is the increase in the number of dealerships being brought to market."
For many of us the concept of autonomous vehicles - a fleet of driverless cars rolling across our roadways - is difficult to plan for because it seems so far off and so futuristic. While we do believe our future transportation will include some form of autonomous vehicles, it remains highly uncertain as to the basic questions of who, how and when? At Presidio, we have been assisting our clients with strategic plans to address the more immediate change facing our industry, the electrification of our vehicles, while keeping a cautious eye on the long-term future of consumer mobility.

In a recent interview, Jay Leno (an avid car collector) said, “I predict a child born today probably has as much chance of driving in a gas car as people today have driving a car with a stick shift. They’ll still be around, there’s just not many of them.” At first glance, that appears to be a very aggressive statement. But if you look at the patterns that are emerging around the globe, perhaps Mr. Leno is right in his prediction. The fastest EV adoption rates are being seen in countries like Norway where public policy, consumer preference and charging infrastructure are aligning to drive drastic change in a short period of time. Fueled by an array of government incentives, Norway is pushing towards their objective of 100% of new car sales being zero emissions vehicles by 2025. Closer to home, California is implementing broad-based policies with the goal of reducing greenhouse gases and improving air quality over the next decade, which are impacting manufacturers, dealers and consumers.

But, what will it take for EVs to go “mainstream” in the United States? For the most part, Americans make decisions with their pocketbooks, and we believe it will ultimately be economics that will drive mass EV adoption in the U.S. Throughout the history of our industry, manufacturers and dealers have trained the consumer to focus solely on the upfront cost of the vehicle. However, with the advent of EVs, consumers have appropriately begun to shift their focus to total cost of ownership. Assessing the three major components of total cost of ownership between internal combustion engine (ICE) vehicles and EVs will provide us with an understanding of the pace of change we might expect in the future:

- **Upfront cost of the vehicle:** The current price difference between ICE vehicles and EVs is largely driven by the cost of the battery. According to a recent research report from a major investment bank, the cost of batteries has declined at a rate of 15-20% annually over the past few years as economies of scale have been achieved in the manufacturing process. Public policies in the U.S. (including federal and state tax credits) have further reduced the ‘price gap’ and encouraged consumers to purchase EVs. An increase or extension of the current tax credits would provide additional incentives for consumers and would increase the pace of EV adoption. Other public policies that are less straightforward include the cost of gas credits that manufacturers with a low percentage of overall EV sales are required to purchase to comply with federal and state emissions standards. These credits have the effect of increasing the cost of ICE vehicle production. With emissions standards expected to tighten further, this added cost of ICE production will make EV pricing relatively more attractive in the future.
- **Cost of maintenance:** EV drivetrains represent the first example in a very long time where technological advancements are driving simplicity, rather than complexity, in our vehicles. For example, the Tesla drivetrain is reported to have only 17 moving parts, compared to the average of 200 moving parts in an ICE drivetrain. From a mechanical perspective, EV maintenance is already proving to be far cheaper than maintaining an ICE vehicle. Once again, it is the cost of the battery and the need for replacement that weighs heavily on the total cost ownership of EVs. As future advancements in technology extend the useful life of batteries and costs decline, battery replacement will continue to decline as a component of an EV’s maintenance costs.
- **Estimated depreciation:** Depreciation is impacted by the upfront cost of the vehicle and its useful life. Many factors are already pointing to a future where the ‘price gap’ between ICE vehicles and EVs will be nominal for comparable vehicles. And, with new EV technology still relatively “young,” industry experts and consumers may be conservative in their current estimates of an EV’s useful life. As mentioned earlier, EVs have a simpler drivetrain than ICE vehicles with fewer “points of potential failure.” Over time, the simpler EV design should prove to be superior to that of ICE vehicles, increasing the vehicles useful life and reducing the amount of annual depreciation. Moreover, many of the system upgrades in EVs are software based and are provided over-the-air, which removes the potential for systems obsolescence and extends the useful life of the overall vehicle.

What does the EV revolution mean for dealers? There is little doubt that the transition of the U.S. vehicle fleet from ICE vehicles to EVs will have major ramifications on auto dealership operations. A few concepts for dealers to consider are:

- Franchised dealer sales as a percentage of U.S. new vehicle sales may fall as EV manufacturers with direct-to-consumer sales increase market share.
- With longer-lasting EVs, there may be less turnover in vehicle ownership and, thus, fewer opportunities to generate revenue from vehicle sales (including F&I).
Certain current manufacturers may gain or lose market share based on their ability to design, develop and manufacture vehicles that will be competitive in the EV marketplace; only dealers who are aligned with the right manufacturers will be rewarded.

New vehicle margins may remain under pressure due to the competitive market for EVs and government regulations that are effectively mandating EV manufacturing irrespective of consumer demand and manufacturing costs.

Residual values of used ICE vehicles may fall as consumer demand moves towards EVs, impacting customers’ ability to use the equity in their trades to purchase new vehicles.

The lower cost of maintaining the mechanical components of an EV compared to an ICE vehicle may result in fewer repair orders and lower revenue per repair order; today, roughly 50% of dealership gross profit is from service and parts, which will decline tremendously with a growing EV units in operation environment.

In business, it is rare for a transition on such a massive scale to not be accompanied with a change in industry leaders. For dealers, the stakes are high as their future is dependent on specific manufacturers to successfully navigate from predominantly ICE vehicle production to full scale EV production. In addition, the transition to EVs also presents a real threat to franchise-based manufacturers as they may lose market share to EV manufacturers who are focused on establishing a foothold in the U.S. with direct-to-consumer sales. It is inevitable that market share will “change hands” during this transition with the real potential of impacting future sales and profitability of certain franchises.

THE PRESIDIO GROUP’S SECOND ANNUAL AUTO CONFERENCE: DISRUPTIVE FORCES IN CONSUMER TRANSPORTATION

On May 8, 2019, Presidio held its second annual auto conference in Dallas. Once again, our objective was to connect the largest and most influential dealers in the nation with speakers who are experts in their fields, orchestrating an open dialogue about the disruptive forces facing our industry and the potential impact they will have on auto dealers and the value of their businesses. None of us found it ironic that severe weather in the Dallas area did its best to disrupt the ‘disruption’ conference! Our speakers did an excellent job of laying out their short-term and long-term views of the industry and the challenges that dealers will face as new technologies continue to drive changes in consumer mobility.

Our speakers included automotive industry veterans, Wall Street analysts and executives from some of the largest automotive manufacturers, rental car companies and automotive technology providers in the world. With discussion topics like those below, we are already looking forward to our third annual conference in 2020.

- Incumbent automotive manufacturers are transitioning their capacity toward EV manufacturing – expect the majority of U.S. sales to be comprised of EVs by 2030 – and anticipate that the transition to an EV fleet will negatively impact dealer profitability.
- OEMs expect dealership consolidation to accelerate with single operators owning multiple same brand franchises in highly populated markets.
- A confluence of technologies are converging that will disrupt the traditional car ownership model – a series of business case studies from other industries demonstrates that the value of an incumbent’s business begins to fall well in advance of the actual disruption taking place.
- Level 4 autonomous vehicles – a “fully autonomous” vehicle designed to perform all safety-critical driving functions and monitor roadway conditions for an entire trip will be available within the next 5 years.
- The cost of comprehensive AV systems (cameras, LIDAR, RADAR, HD maps, etc.) is expected to drop below $10,000 by 2025.
- Consumers will rely less on personally owned vehicles as adoption of ride-sharing and car subscription models increases – potentially resulting in a decline in U.S. new vehicle sales of up to 40%.
- Gen Z and Millennials will be the first to adopt alternative ownership models with a focus on cost per mile – the tipping point for adoption will be reached at approximately 50-55 cents per mile.
- An autonomous fleet of ridesharing vehicles will provide access to cheap transportation with some forecasters projecting a 30% increase in miles traveled in the U.S. – assumes increase in usage for delivery of products and access to consumers without drivers licenses such as the young, elderly and disabled.
KEEPING AN EYE ON INTEREST RATES

With the Federal Reserve’s most recent action in July 2019 to reduce the target interest rate by 25 basis points to 2.25-2.50%, changes in interest rates may seem like yesterday’s news. But, when you consider that auto retail is one of the most interest rate sensitive business sectors in the U.S., we’d be remiss to not mention the benefits we are all experiencing from this period of historically low rates. We are the first to agree that auto dealers are remarkable business people. Yet, we also realize that they, like almost all U.S. sectors and businesses, have benefitted from a 35-year wind at their backs. Low interest rates have kept vehicle loan payments affordable for many Americans, keeping vehicle sales near all-time highs. As dealers, we have benefited from inexpensive floor plan, mortgages and acquisition financing, allowing us to improve the profitability of our stores and finance growth.

"...auto retail is one of the most interest rate sensitive business sectors in the U.S."

Perhaps just as important, in low interest rate environments, investors will typically lower their overall return thresholds as they finance acquisitions with low cost debt. Holding return on equity hurdles constant, the lower cost of debt generally increases the value investors are willing to pay for underlying businesses. Presidio has analyzed the numerical effect of interest rates on dealership valuations with our analysis showing a 6% increase in dealership value for every 1% reduction in interest rates. Just as low interest rates drive the value of dealerships upward...we should expect the exact opposite to be true in a rising interest rate environment. Bluntly, it is hard to see how today’s auto retail model works within the high interest rate environment we experienced in the 1970s and 1980s.

EXPANDING THE PRESIDIIO GROUP

Since our inception, The Presidio Group has been mostly a west coast operation. That all changed in early 2019 when George Karolis joined our team as President and established a presence in the Atlanta market. George is an automotive industry veteran, executing hundreds of dealership and real estate transactions over his 20+ year career in automotive retail. With the addition of Keith Style (former CFO of Asbury Automotive Group, Inc.) as Principal and Lauren Pfohl as Analyst, our east coast team is fully up and running. Brodie Cobb commented, “Bringing George in to head up our M&A practice and adding our east coast team could not have come at a better time. Our augmented geographic reach has already proven beneficial in supporting our clients throughout the U.S. as they execute on their strategic plans.”

Presidio also formed a partnership with a leading investment firm in the auto retail sector to capitalize on forthcoming changes in consumer mobility. Next Auto Capital (NAC) is an investment fund that was established through a partnership with Fraser McCombs Capital with an investment focus on profitable, automotive-related companies that are well-positioned for today’s current marketplace as well as the growth from consumer mobility changes in the future.
ABOUT THE PRESIDIO GROUP

The Presidio Group LLC is an independent merchant banking firm focused on investment banking and principal investing. The firm was founded in 1998 with the simple mission to relentlessly put the interests of its clients first. By 2016, all three of Presidio’s business segments had grown successfully, yet had developed unique needs that were better met externally. Accordingly, Presidio reorganized, spinning out its private equity division and merging its investment advisory subsidiary with Tiedemann Advisors. The firm retained ownership of its merchant bank which continues to focus on the auto retail sector.

Today Presidio focuses on the following:

Investment Banking
- Corporate advisory with emphasis on M&A and private capital raising
- Focus on the auto dealer sector
- Deep relationships with broader corporate and financial community

Principal Investing
- Investing in companies that service consumer mobility both today and tomorrow
- Partnering with leading private dealers and leading automotive-related families and businesses in consumer mobility investing

PRESIDIO TEAM MEMBERS

The Presidio Group brings its unmatched experience in auto dealership M&A, sophisticated financial knowledge, and relationship-driven approach to every client we serve. Our team members have a combined nearly 100 years of experience in the automotive industry. During their careers, the current Presidio Team has closed approximately 275 auto-related transactions totaling approximately $7.3 billion. Because we are an investment bank, not a dealership brokerage firm, our clients receive thoughtful and insightful analysis followed by advice tailored to help them attain their individual and corporate strategic goals. Our services include: market assessment, financial analysis and valuation, offering materials, transaction structure and negotiation and even advising on both external and internal transaction-related communications.

Brodie Cobb
Founder and CEO
bcobb@thepresidiogroup.com
(415) 449-2525

George Karolis
President
gkarolis@thepresidiogroup.com
(678) 831-5520

Doug Stewart
Principal
dstewart@thepresidiogroup.com
(415) 449-2522

Keith Style
Principal
kstyle@thepresidiogroup.com
(678) 831-5523

Lauren Pfohl
Analyst
lpfohl@thepresidiogroup.com
(678) 831-5518
CONTACT US

We hope you have enjoyed our 2019 Annual 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, and we will give you our viewpoints on *Where the Rubber Meets the Road*!

(415) 449-2500
auto@thepresidiogroup.com