Company Name: Group 1 Automotive
Company Ticker: GPI US
Date: 2014-10-23
Event Description: Q3 2014 Earnings Call

Market Cap: 2,009.35
Current PX: 82.82
YTD Change($): +11.80
YTD Change(%): +16.615

Bloomberg Estimates - EPS
Current Quarter: 1.337
Current Year: 5.467
Bloomberg Estimates - Sales
Current Quarter: 2497.875
Current Year: 9873.091

# Q3 2014 Earnings Call

## Company Participants

- Peter C. DeLongchamps
- Earl J. Hesterberg
- John C. Rickel

## Other Participants

- N. Richard Nelson
- Scott L. Stember
- David H. Lim
- Elizabeth Lane Suzuki
- Jamie J. Albertine
- Brett D. Hoselton
- William R. Armstrong
- Paresh B. Jain

## MANAGEMENT DISCUSSION SECTION

### Operator

Good morning, ladies and gentlemen, and welcome to Group 1 Automotive's 2014 Third Quarter Conference Call. Please be advised that this call is being recorded.

I would now like to turn the conference over to Mr. Pete DeLongchamps, Group 1's Vice President of Financial Services and Manufacturer Relations. Please go ahead, Mr. DeLongchamps.

### Peter C. DeLongchamps

Good morning and thank you, Amy. Welcome to today's call. The earnings release we issued this morning and a related slide presentation that includes reconciliations related to the adjusted results we'll refer to on this call for comparison purposes have been posted to the Group 1 website. Before we begin, I'd 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 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 risks and uncertainties, which may cause the company's actual results in future periods to differ materially from forecasted results.

Those risks include, but are not limited to, risks associated with pricing, volume and the conditions of the market. Those and other risks are described in the company's filings with the SEC over the past 12 months. Copies of these filings are also available from Securities and Exchange Commission and the company.

In addition, certain non-GAAP financial measures, as defined under SEC rules, may be discussed on this call. As required by applicable SEC rules, the company provides reconciliations of any such non-GAAP financial measures to the most directly comparable GAAP measures on its website.

Participating with me on today's call, Earl Hesterberg, our President and Chief Executive Officer; John Rickel, our Senior Vice President and Chief Financial Officer; and Lance Parker, our Vice President and Corporate Controller. 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, Pete, and good morning, everyone. On an adjusted basis, Group 1 earned $39.8 million in the third quarter which equates to $1.57 per diluted share. On a GAAP basis net income and EPS were $26.2 million and $1.03 respectively.

Our 2014 third quarter earnings results excluded $13.6 million of net after-tax adjustments with the single largest item being a one-time loss of $17.9 million related to the repurchase of all of our remaining convertible senior notes. Eliminating these notes simplifies our balance sheet and will be accretive to the results going forward. John will cover the adjustments in more detail momentarily.

For the quarter, total revenue increased $286.3 million or 12.2% to a record $2.6 billion. This increase was driven by improvements in all areas of the business with new vehicle revenue up 9.7%, used retail revenue up 16.2%, parts and service revenue up 14.3%, and finance and insurance revenue up 17.7%.

Results varied across our geographic exposures. U.S. operations had strong growth with total revenue increasing 15.1%, driven by the improving U.S. sales environment and recent acquisitions. Some of this growth will be tempered in Q4 as we made some dispositions late in the quarter, representing $275 million of annualized revenue.

The UK had another solid quarter with total revenue growth of 7.4%, reflecting significant growth across used vehicle, parts and service, and finance and insurance segments, partially offset by softer sales in new vehicle retail. The weakness in new vehicles reflects a decision we made to stop some high-volume, low-margin fleet sales primarily within our Ford business several quarters ago.

For Brazil, the market remained very weak, down 12% in Q3. But our revenue was down only 8% from the prior year period, about equal to our second quarter results. Within that total, strong growth of 12.2% in used retail, 9.8% in parts and service and 18.6% in F&I were partial offsets to weaker new vehicle revenues. Most importantly our Brazilian business returned to profit in Q3.

While the U.S. market remains very competitive, we saw same-store new vehicle margins improve slightly, up $21 per unit to $1,675. Same-store finance and insurance income per retail unit continued to expand and margins on our same-store parts and service business improved 80 basis points to 53.6%. Same-store used retail margins declined slightly to $1,547 or $82 per unit.

Used sales were impacted to some degree by the strength of new vehicle sales in August and early September. On a consolidated basis for the quarter, we retailed 44,494 new vehicles and 28,776 used retail units, with new unit sales up 5.2% and used retail unit sales increasing 10.4%.

Group 1's new vehicle sales mix was 82.3% U.S., 9.2% Brazil and 8.5% UK. Our new vehicle brand mix was led by Toyota Lexus sales which accounted for 28.3% of our new vehicle unit sales. While BMW Mini, Honda Acura and Ford all represented over 10% of our new vehicle unit sales and Nissan was at 8.9%.

At the end of the third quarter, U.S. new vehicle inventory stood at 27,515 units, which equates to a 75-day supply, compared to a 79-day supply for the third quarter of 2013. U.S. used vehicle inventory stood at 12,112 units which equates to a 30-day supply compared to a 35-day supply for the third quarter of 2013.

Same-store consolidated revenue grew 5.5% driven by increases of 8.4% in used vehicle retail sales, 7.4% in parts and service, and 10% in finance and insurance. Our same-store consolidated finance and insurance income per retail unit increased $114 to $1,336 with robust improvements in each of the three country groups, including a $76 per unit increase in the U.S. to an all-time quarterly record of $1,475 per unit.

Relative to our cost performance, on a consolidated basis selling, general and administrative expenses as a percent of gross profit improved an adjusted 120 basis points to 73.9% with the improvement explained by focused cost reduction efforts across all of our operations. Total adjusted SG&A as a percent of gross profit improved 110 basis points in the U.S. and 230 basis points in the UK. In Brazil, we have made significant progress on reducing cost through a major restructuring which reduced total head count by 150 positions or approximately 10%.

On a sequential basis, SG&A as a percentage of gross profit improved 820 basis points to 86.9%. Largely, as a result of these cost improvements, we were profitable this quarter in Brazil. This result is a great testimony to the quality of our Brazilian management team.

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

## John C. Rickel

Thank you, Earl. Good morning, everyone. Our adjusted net income for the third quarter of 2014 rose $6.9 million or 21% over our comparable 2013 results to $39.8 million. On a fully diluted per share basis, adjusted earnings increased 30.8% to $1.57.

These results for 2014 exclude $13.6 million of net after-tax adjustments, including $17.9 million of charges related to the repurchase of all of our 2.25% as well as the remainder of our 3% convertible notes and $6.6 million of asset impairments, primarily associated with the pending disposition of vacated U.S. dealership real estate and three remote franchises in Brazil.

These charges were partially offset by a net after-tax $8.6 million gain on the sale of U.S. dealerships and associated real estate and a $3.4 million income tax benefit related to deductible goodwill in Brazil. The comparable results for the third quarter of 2013 excluded $101,000 of net after-tax adjustments.

Starting with a summary of our consolidated results. For the quarter, we generated $2.6 million in total revenue, which was an all-time quarterly record. This was an improvement of $286.3 million, or 12.2%, over the same period a year ago and reflects healthy increases in each of our business segments.

Our gross profit increased $45.2 million, or 13.7%, from the third quarter a year ago to $374.7 million. For the quarter, adjusted SG&A as a percent of gross profit improved 120 basis points to 73.9%, and adjusted operating margin was 3.3%.

Floorplan interest expense decreased $250,000, or 2.2%, from prior year to $10.5 million, primarily due to lower floorplan borrowings in Brazil. Other interest expense increased $3.3 million, or 32.8%, to $13.2 million. This increase is primarily attributable to an increase in weighted average debt outstanding related to our issuance of $550 million of 5% bonds, which we used to retire our 2.25% and our 3% convertible notes over the prior two quarters.

Our adjusted consolidated effective tax rate for the quarter was 37.1%, reflecting the favorable mix impact of increased profitability in the UK. We expect our tax rate to be approximately 38% over the remainder of 2014.

Now turning to third quarter same-store results, in the third quarter, we reported revenues of $2.4 billion, which was $125 million or a 5.5% increase from the comparable 2013 period. Within this total, new vehicle revenue was up 3.4%, and used vehicle revenues improved 8.4%. Both finance and insurance and parts and service delivered another strong quarter, growing revenues 10% and 7.4%, respectively.

New vehicle revenue increased to $1.4 billion, as a slight decrease in unit sales was more than offset by an increase in our average new vehicle sales price of $1,354 to $34,128 per unit. By country, same-store new vehicle unit sales increased 4.4% in the U.S., decreased 12.4% in the UK, and decreased 21.9% in Brazil. Our used retail revenues improved $43.2 million to $558.8 million on a 2.5% increase on unit sales and an increase in our average used vehicle retail sales price of $1,155 to $21,475.

F&I revenue per retail unit rose 9.3% to $1,336, driven by increases in income per contract and penetration rates for most of our major product offerings. The 7.4% revenue growth in parts and service is explained by increases of 20.7% in warranty, 14% in wholesale parts, 3.6% in collision and approximately 1% in customer pay.

There were a number of high-volume recalls in the third quarter from General Motors, BMW, Toyota and Ford, which contributed to the warranty increase. Also as manufacturer paid maintenance continues to expand in the U.S., there's an ongoing shift of business from customer pay to warranty.

As a reminder, all parts and service revenues are not impacted by increases in internal business. The revenue associated with internal work is eliminated upon consolidation, which varies across the sector as some of our competitors account for internal work differently.

In aggregate, our same-store gross profit grew $21 million or 6.5% to $343.7 million. Our same-store new vehicle gross profit dollars increased 2.8%, as slightly lower volumes were more than offset by a $60 increase in gross profit per unit to $1,801. Our used vehicle retail gross profit decreased 0.7%, as a 2.5% increase in unit sales was more than offset by a gross profit per unit decrease of $50 to $1,550.

Our F&I gross profit grew $8.1 million or 10% reflecting the improved dollars per retail unit previously mentioned. Finally, parts and service gross profit grew $11.1 million or 8.5%, primarily reflecting the strong revenue growth mentioned previously, as well as a 50 basis point improvement in margins to 52.8%.

For the third quarter, we grew our total gross profit by $21 million, while adjusted SG&A expenses rose $11.9 million. This equates to a gross profit flow-through of 43%, which is well within our target of 40% to 50%. As a result, our adjusted SG&A as a percent of gross profit decreased 100 basis points to 73%.

Turning now to our geographic segments starting with the U.S. market on an actual basis, total U.S. revenues grew 15.1% to $2.2 billion driven by increases of 17.9% in F&I revenue, 17.4% in total used vehicle revenue, 14.1% in new vehicle revenue and 14.1% in parts and service revenue.

The increase in our parts and service revenues reflects growth in all areas of the business and our F&I revenue growth reflects an 11.8% increase in retail vehicle sales volume, coupled with improved profitability for retail unit which grew $75 or 5.5% to $1,450. Total gross profit improved 14.9%, driven by increases of 15.5% in parts and service and 14.6% in new vehicles as well as the F&I increase that I just mentioned.

From the third quarter, we grew our gross profit by $41.7 million, while adjusted SG&A expenses rose $27.4 million. As a result, our adjusted SG&A as a percent of gross profit improved 110 basis points to 72.9%. Adjusted operating margin for the U.S. business segment increased 20 basis points to 23.6%.

Related to our UK segment, our UK operating team delivered another outstanding quarter with total gross profits for the UK segment up 17% from prior year. There's been no acquisition or disposition activity in the past 12 months, this metric is on a same-store basis as well.

New vehicle gross profit grew 18.6% as an increase in gross profit per unit of $643 to $2,466 more than offset a 12.4% decline in unit sales. This increase in gross profit per unit and decrease in unit sales is directly attributable to a decision we made several quarters ago to discontinue some high volume, low-profit new vehicle sales at our Ford dealerships.

Used vehicle retail gross profit improved 8.2% on 5.5% more retail units, an increase of $39 in gross profit per unit to $1,572. Parts and service gross profit improved 19.9% representing double digit increases in each segment. Our F&I growth of 13.2% is attributable to a 20.1% increase in gross profit per retail unit, the $747 which was partially offset by a 5.8% decrease in total retail units.

During the third quarter we leveraged our costs in SG&A as a percent of gross profit improved 230 basis points to 74.7%. Operating margin for the UK business segment increased 50 basis points to 2.7%.

Related to our Brazil segment, on a macro basis, as discussed on the second quarter call, the economy slowed from the prior year and the uncertain political environment due to pending election has hindered economic expansion. As such, we retailed 4,072 new units compared to 5,139 in the third quarter of 2013, a decrease of 20.8%.

We did, however, show positive growth in each of the other business segments as we increased total used gross profit by 26%, parts and service gross profit by 9.1%, and F&I gross profit by 18.6%. Increase in F&I was despite a decrease in total retail units of 18.5% as we increased F&I gross profit for retail unit by $180 or 45.3% to $577.

The head count reductions discussed by Earl rose 825 basis points sequential improvement in adjusted SG&A as a percent of gross profit from 95.1% in the prior quarter to 86.9% this quarter. The cost reduction coupled with the improvements in our used, parts and service, and F&I business segments allowed us to generate a profit in Brazil for the quarter.

Turning to our consolidated liquidity and capital structure, as of September 30, 2014, we had $50.7 million of cash on hand and another $62.5 million that was invested in our floorplan offset account, bringing immediately available funds to $113.2 million.

In addition, we had $252.3 million available on our acquisition line that can also be used for general corporate purposes. As such, our total liquidity at September 30th, 2014 is $365.5 million. As of September 30, we completed the repurchase of all the remaining 3% convertible notes as well as completing the previously announced redemption of all $182.8 million face value of our 2.25% convertible notes.

These repurchases were funded using proceeds from the $200 million add-on to a 5% coupon bond issuance as well as excess funds from the original $350 million issuance that occurred in the second quarter. Beginning next quarter, the ongoing impact of the repurchase of both 3% and the 2.25% convertible notes is estimated to reduce our diluted share count than additional 800,000 shares from third quarter levels.

In total, the combination of these actions with the previously reported redemption of 80% of our 2% notes in the second quarter has reduced our fully diluted share count by approximately 2.7 million shares and improved EPS by approximately $0.12 per quarter assuming the stock price of $75. Please refer to our investor presentation on the website for the pro forma income statement effect from both of these transactions.

With regards to our real estate investment portfolio, we own $653.3 million of land and buildings at September 30 which represents 41% of our dealership locations. The financing holdings will utilize our mortgage facility and executed borrowings under other real estate specific debt agreements.

As of September 30, we had $58.8 million outstanding under our mortgage facility and $296.6 million of other real estate debt excluding capital leases. During the third quarter we repurchased approximately 230,000 shares of our outstanding stock at an average price of $73.9 for a total of $16.8 million.

As of September 30, we had $37.7 million of share repurchase authorization remaining. Also in the third quarter, we used $4 million to pay dividends of $0.17 per share. 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 back over to Earl.

## Earl J. Hesterberg

Thanks, John. Related to our 2014 corporate development efforts, we previously announced the acquisition of a Chevrolet and Mazda franchise in Houston, Texas; Mercedes-Benz and Sprinter franchise in the metropolitan area of St. Antonio, Texas and a Mercedes-Benz franchise in Brazil.

Year-to-date we have acquired 12 franchises worldwide that we estimate to generate approximately 680 million dollars in annual revenues. We previously announced divestitures of a Honda franchise in New Jersey and a BMW mini franchise and a Mercedes-Benz and Sprinter franchise in New York.

On September 30, 2014, the company disposed of a Volkswagen dealership in Florida which generated approximately $15 million in trailing 12 months revenues. Year-to-date Group 1 has invested seven franchises that generated roughly $390 million in trailing 12-month revenues.

The end of September, we also signed a letter of intent to dispose of our three Renault stores in Brazil. Because that transaction is not yet closed, it is not included in these revenues. We continue to adjust our dealership portfolio to ensure we are generating appropriate returns for our shareholders.

That concludes our prepared remarks. I'll now turn the call over to the operator for your questions. Operator?

# Q&A

## Operator

Thank you. [Operator Instructions] Our first question comes from Rick Nelson at Stephens.

**<Q - N. Richard Nelson>**: Good morning.

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

**<Q - N. Richard Nelson>**: Can you speak to the increase in the gross profit per unit in the UK? It was pretty substantial.

**<A - Earl J. Hesterberg>**: Across the board or in total? I mean, across the board or new vehicles, I' sorry.

**<Q - N. Richard Nelson>**: Yes. New car per unit up 35%

**<A - Earl J. Hesterberg>**: Yes. It was a plate change month and we had exceptionally strong months in our luxury brands, which are two-thirds of our dealerships. That was out in BMW.

**<A - John C. Rickel>**: Rick, this is John Rickel. And the other key driver there was as we mentioned in the scripts, we made a decision to get out of some really low margin, high volume fleet business we had been doing. That really helped improve the gross profit for retail unit. We improved $643 per unit. Largely driven by that decision to get out of that low margin, high volume fleet business.

**<A - Earl J. Hesterberg>**: In this quarter last year, there was one deal for very, very low profit of 600 units and that deal did not occur.

**<Q - N. Richard Nelson>**: And the acquisition, it really seems to be heating up, $370 million in revenue acquired this quarter. If you could comment on the acquisition multiples and the pipeline that you see out there, Earl?

**<A - Earl J. Hesterberg>**: Certainly, Rick. This is Earl. Yes. We had some opportunities earlier in the year and they were large opportunities. And I believe those will work well for our shareholders. I don't see those same opportunities for our company at the moment. It does appear that prices have gotten very, very high. And while there still seems to be a lot of businesses on the market, I don't see that type of pace in the U.S. in the near-term.

**<Q - N. Richard Nelson>**: Okay. Thanks for that. Also, I'd like to ask you about, within the U.S., the regional areas of strength and weakness. I know the northeast has been a challenge. Is that still the case and the central regional is kind of performing well?

**<A - Earl J. Hesterberg>**: Certainly. Of course, Texas remains very strong and so does Boston and New Hampshire. New England was very strong for us this quarter. The weaker area for us has been New Jersey and New York. We exited New York. New Jersey is still a challenge for us.

Of course, we have dealerships in Atlantic City and you've probably read about the casinos and some of the issues in that part of the world. So, that's still a weak area. Also the Gulf Coast, in particular New Orleans. The New Orleans, in fact, the total Louisiana new car market is down significantly this year. So I'd say that the weak areas for us were New

Jersey and the Gulf Coast.

**<Q - N. Richard Nelson>**: Thanks a lot. And good luck.

**<A - Earl J. Hesterberg>**: Thanks, Rick.

## Operator

The next question comes from Scott Stember at Sidoti & Company.

**<Q - Scott L. Stember>**: Good morning, guys.

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

**<Q - N. Richard Nelson>**: Good morning, Scott.

**<Q - Scott L. Stember>**: On the new car side in the U.S., your gross margins were flat with a year ago. Could you just talk about mix between luxury – or strength of luxury versus midline imports, and how that played into what appears to be a pretty strong gross margin quarter for you guys?

**<A - Earl J. Hesterberg>**: I don't think the quarter was particularly strong. I think it was just basically steady. I know it bumped up a little bit, but I think that's normal noise. It's still a very competitive market. I don't think we had a big change of luxury or Japanese brand mix. So I think it's pretty much steady as it has been for us. We work hard to try to maximize the margins, but it's very difficult to do in a competitive market with a lot of strong OEMs and strong dealers fighting for share.

**<A - John C. Rickel>**: Yes, Scott, this is John Rickel. It really wasn't mix driven. Most of the improvement really came out of the domestic brands, is where we saw most of the margin improvement.

**<Q - Scott L. Stember>**: Okay. Got you. And on the parts and service, if we wanted to break it out by country, the percentages that you talked about on a same-store basis, the warranty and customer pay, is there any way to maybe parse that out a little more by country, U.S. versus UK versus Brazil?

**<A - John C. Rickel>**: Sure. This is John again. Give me just one second. The U.S. -

**<Q - Scott L. Stember>**: Hello?

## Operator

Hi. This is the operator -

**<A - John C. Rickel>**: Hi. Sorry. That was us. Yeah. The U.S. had similar sort of growth. We were up 6.1% on U.S. basis, and kind of followed the same pattern, Scott. Most of the growth was warranty. It was up 20.2%. Wholesale was up 8.6%. Collision was up 1.8%, and customer pay was up about 1%.

**<Q - Scott L. Stember>**: Okay. Got you.

**<A - John C. Rickel>**: And UK was up 21.8% on a same-store basis. They had kind of double digits across each of the segments. And then Brazil was up 8.4% with a lot of that explained by improvements in collision.

**<Q - Scott L. Stember>**: Okay. Just trying to get to the 1% increase in customer pay and the ongoing shift of some of these included maintenance programs from customer pay to warranty. Could you maybe just quantify, high level, how many hundreds of basis points that's accounting for so we can get to a true customer pay number?

**<A - John C. Rickel>**: I do not – Scott, this is John. That's really kind of difficult because some of this stuff is mixed in. I mean, when we've looked at this previously, it's a couple hundred basis points. But I mean that's really a rough guess.

**<Q - Scott L. Stember>**: Okay. Got you. That's all I have right now. Thank you so much.

**<A - Earl J. Hesterberg>**: Thanks, Scott.

## Operator

The next question comes from David Lim at Wells Fargo.

**<Q - David H. Lim>**: Hello, good morning.

**<A - John C. Rickel>**: Good morning, David.

**<Q - David H. Lim>**: So my first question is strong SG&A to gross profit leverage in the quarter. I was wondering if you could peel back the onion there and sort of give us additional color. Obviously, SG&A grew at a slower clip versus gross profit. Can you sort of bucket the major areas where you got some cost savings, and will that flow through going to next quarter as well as in 2015?

**<A - John C. Rickel>**: Yeah, David. This is John Rickel. I mean, kind of the big buckets – obviously Brazil, it was to a large degree head count driven. The team has done a great job of restructuring and sizing the business down there for the present sales environment. And we clearly think that that those levels of savings are sustainable and probably some ability to continue to grow those as we go forward. UK was kind of leverage across each of the areas. A lot of it is we continue to build scale and we're leveraging things like personnel and as long as the gross profit dollars continue to grow there, we should be able to leverage that as well. And in the U.S., advertising was certainly one of the buckets, and we continue to be very focused on being efficient with the advertising. So I think that's sustainable as well.

**<Q - David H. Lim>**: The other question that I have is on the same-store sales on the UK in particular. I know that you've mentioned about not participating the fleet. But if we exclude the Ford side of the business and we just focus on your BMW as well as Audi franchises, how did they perform on a same-store sales basis in the quarter? And are you seeing any kind of issues with the UK consumer in general?

**<A - Earl J. Hesterberg>**: Well, we haven't seen any issues with the consumer yet, David. But our Audi and BMW stores performed extremely well. I would say that Audi stores grew sales more than the BMW stores because our BMW stores are more mature. We've owned those businesses for a longer period of time, and we've performed at a higher level. Our Audi and Ford businesses are not as mature. So we probably performed a little bit better on the Audi side of the business in units. But they're very strong profit performances for the quarter.

**<A - John C. Rickel>**: And, David, I would add – this is John. When you look at it, we basically performed consistent with what the industry change were for the brands. If you exclude the decision we made on the Ford fleet business, basically, the team performed at what the market adjusted for our brands results were for the quarter. So we're very pleased with how the sales were over there.

**<Q - David H. Lim>**: Great. And then the other question I have is, I know that I might be getting a little bit ahead of myself, but any preliminary thoughts on 2015 U.S. industry sales?

**<A - Earl J. Hesterberg>**: David, this is Earl. I think there will be some small growth again. I'm looking at the other industry experts and some of the OEM meetings I've attended. Most people think this year is coming in at 16.4 million. Our original forecast this year was 16.3 million so we were pretty much on that. I know one of the bigger OEMs that we deal with is forecasting 16.7 million for next year. And I would think that range and anywhere up to 17 million should still be possible next year. So I would say a little bit of growth again next year. Things seem very stable.

**<Q - David H. Lim>**: And just finally my last question here is are you seeing any kind of irrational behavior in the leasing front where OEMs are playing more with the residual values as of late?

**<A - Earl J. Hesterberg>**: Not as of late, David. I think most of the OEMs in the recent period have gotten fairly aggressive in leasing. But I haven't seen anything atypical lately. But I may not be close enough to it to be a good source for that.

**<Q - David H. Lim>**: Thank you, gentlemen. I appreciate it.

**<A - John C. Rickel>**: Thanks, David.

## Operator

Our next question comes from John Murphy, Bank of America Merrill Lynch.

**<Q - Elizabeth Lane Suzuki>**: Good morning. This is Liz Suzuki on for John. Just looking at the used vehicle business in the U.S. your average transaction price went up by about 4% where your gross profit per unit decline to fair amount. Can you just comment on what's happening in the supply/demand dynamic that's causing that discrepancy?

**<A - Earl J. Hesterberg>**: Sure. This is Earl. Yes, there was some pressure in the used car business in the quarter. First of all, after August, generally, there's a seasonal pressure in terms of downward prices in the guide books. But also I think it's been well publicized that there is some increasing supply with off-lease vehicles and things like that.

And then in addition, there were some pretty aggressive new car marketing pushes, particularly through Labor Day in August. I think new car prices and transaction prices probably sat down on used car prices. So when the market shifts like that and there's pressure on demand, I think we all try to keep our inventory turning and keep it clean.

So we probably retail some vehicles at a lower margin rather than sending them to auction and take a small wholesale profit. So I think it's a combination of increasing supply and new car pressure pushing down on used car demand.

**<Q - Elizabeth Lane Suzuki>**: Okay. Thanks. And going back to same-store sales in the UK, it looks like parts and service is incredibly strong, which I would imagine wouldn't have been impacted by that shift away from fleet. So what was the driver of this strong parts and service performance there, and were there particular incentives or initiatives that the company was putting in place?

**<A - Earl J. Hesterberg>**: Well, I'd like to tell you it was our brilliance. But I think it's a combination of the longer we've operated these dealerships, the more we've been able to increase our capacity and operate them more efficiently. But also, we've now had several years of increasing industry sales in the UK. So you get that same unit and operation profile that we have in the U.S. where we're in the sweet spot now where the universe of one, two and three-year-old units in operation is really ballooned from a few years ago.

So we're in the sweet spot in the UK as well. And with the majority of our business being luxury brands, Audi and BMW, those owners have a very high rate of loyalty. So I think those are the main factors that really gave us an impressive quarter.

**<Q - Elizabeth Lane Suzuki>**: Okay. And just one more quick one, which is as we look at your plans for your store footprint and trying to model acquisitions versus dispositions, what's the estimated net impact of acquired stores versus dispositions for 2015 in terms of what would not be included in the same-store base?

**<A - Earl J. Hesterberg>**: Wow. That's impossible for me to predict just because the market is so dynamic. And most everything we do is somewhat opportunistic. When we find something that works for us strategically and a good return on investment, we will do our best to acquire it. And the major dispositions in terms of major assets that we have that hadn't been performing – underperforming dealerships that we want to dispose of, we've taken care of that at this point. So I couldn't really help you model anything because I don't know.

**<Q - Elizabeth Lane Suzuki>**: Okay. Thank you.

## Operator

Our next question comes from James Albertine at Stifel.

**<Q - Jamie J. Albertine>**: Great. Thanks and good morning, everyone. Rare to hear a question that stumps Earl so I appreciate your candor there. Very quickly, if I could, on the divestitures or dispositions as well. You made a comment earlier that suggested that pricing has actually gotten a little higher, as it relates to the acquisition environment – the M&A environment.

So is your decision to dispose off the Long Island dealerships, the Honda in New Jersey and so forth more a function of that or is there something about operating in contiguous markets that you're learning is better for leverage or better for your longer-term trajectory and just something operational that is driving those decisions?

**<A - Earl J. Hesterberg>**: Well, each market is so different. Again, it's awful hard for me to give you a rule of thumb. In the case of exiting the Long Island market, it was just a very high-cost place to do business. And we had some major capital expenditures required that was only going to make that worse. And we just didn't have a consistent track record of generating the profits that we needed for a good return for our shareholders.

So we had opportunities to invest in places like Texas where we are highly confident that we have scale leverage and know what we will get out of an investment. So, it was really kind of a shareholder-driven thought process. But each market is so different and the dynamics are so different, we're constantly evaluating that. And it's kind of hard for me to prognosticate much beyond that.

**<Q - Jamie J. Albertine>**: And some of those required capital expenditures I would assume are sort of overhang from the hurricane impact a year and a bit ago.

**<A - Earl J. Hesterberg>**: There was some of that. And some was the need to expand and increase efficiency. But much of it and most of it was OEM-driven.

**<Q - Jamie J. Albertine>**: Okay, great. And then also wanted to get your opinion as it relates to capital allocation. How do you balance the return on capital commitment for an M&A-driven deal versus maybe looking at the dislocation and sentiment and the share prices as of lately for your group in terms of more of a share repurchase focus?

**<A - John C. Rickel>**: Yes. Jamie, that's a great question. This is John. I mean, clearly, we think that if we can continue to find acquisitions that hit our return parameters of 15% to 20% pre-tax returns on discounted cash flow basis, we think those are great places to deploy capital. But we're also prepared to return capital to shareholders. The repurchase of the convertibles over the summer was in effect doing that. We took out 2.7 million shares as a part of that.

And then at the end of the quarter, right after the blackout fall lifted, we were able to get in and actually buy shares back at what we thought were attractive prices. So, we're going to continue to monitor it. And we've got a really good track record of being good stewards of the capital and buying stuff that's opportunistic. So, we watch what's going on and deploy the capital accordingly.

**<Q - Jamie J. Albertine>**: Thanks for that color. And if I could sneak-in a housekeeping question and then I'll turn it back to the queue. Any FX translation impact that we should think about as it relates to the UK and Brazil during the quarter? We had thought it would be more of a headwind just based on the trajectory that we'd seen versus the dollar and the pound. But any color there? Apologies if I missed, if it's in the release [indiscernible] (42:19).

**<A - John C. Rickel>**: No, Jamie. This is John. That's a good question. No, there really was not a lot. The pound on average for the third quarter hadn't really moved very much from where it was third quarter last year and similar with the Brazilian real. So, there is very minimal FX impact in the quarter.

**<Q - Jamie J. Albertine>**: Thanks again. And good luck in the fourth quarter.

**<A - John C. Rickel>**: Thank you.

## Operator

Next question comes from Brett Hoselton at KeyBanc.

**<Q - Brett D. Hoselton>**: Good morning, gentlemen.

**<A - John C. Rickel>**: Good morning, Brett.

**<Q - Brett D. Hoselton>**: Let's see here. First just to kind of sum up, it sounds like on the luxury brands, you're saying the performance from a total gross profit standpoint very good in the luxury brands in the UK. It sounds like in the U.S., kind of in-line with the import brands and so forth. Is that a fair characterization of what you're saying?

**<A - John C. Rickel>**: Yes, Brett. I think that's a fair summary.

**<Q - Brett D. Hoselton>**: Okay. And then in the U.S., used vehicle gross profit per units has been a hot topic since peer of yours pre-announced. So my question to you is how – it looked like you had a little bit of pressure on used vehicle gross profit per unit. Can you talk to that? Was there anything specific in the quarter or is it just kind of moved around a bit and is just down and that's okay?

**<A - Earl J. Hesterberg>**: There's a little bit of pressure in the quarter, Brett. And I'm not sure how much of it is increasing supply and how much of it was some downward pressure on transaction prices for new vehicle. You remember how big the August SAR was. There was a lot of activity by the OEM. So, there was a little bit of pressure. But we keep our inventory pretty clean, 34-day supply. So, we can adjust pretty quickly. But there were some pressure.

**<Q - Brett D. Hoselton>**: And then Brazil, obviously, a headwind year-over-year. But I'm really interested in kind of knowing what are you seeing on the ground sequentially, how did, relative to second quarter, how did third quarter perform and then as you've kind of gotten into the fourth quarter are you generally seeing it declining or continuing to decline, stabilizing or improving sequentially?

**<A - Earl J. Hesterberg>**: Well, sequentially the market was a bit better in the third quarter just because the World Cup disruption was not there. But it's certainly not a strong market. But at least we had a normal number of business days in each of the months in the quarter. We would not have been profitable, in my opinion, had we not taken drastic cost reduction actions. So I still think the Brazil market is indeed weak because the economy overall is weak.

Unfortunately, for the fourth quarter, it's impossible to predict because of this presidential election, which is preoccupying the entire country. And we'll just have to see what the overall attitude and psychological environment is once the winner of the run-off is selected. And every year in the second half of December, there isn't a lot of activity in Brazil. They start their summer holidays and Christmas holidays. And so we'll just have to see. But we knew that, which is another reason, we had urgency in cutting cost.

**<Q - Brett D. Hoselton>**: And then from an acquisition divesture standpoint, I think you've seen a little bit more divesture activity recently than you've seen in let's say previous years. And you've kind of [ph] culled (46:06) your mix and so forth – I understand that. But as we look forward into 2015, how should we think about your divesture activity? In other words, were you just going through a period where it's unusually high, but are there some additional divestures that are significant as you look forward?

**<A - Earl J. Hesterberg>**: I would characterize our divestures in the third quarter of businesses at large as very unusual. I think there's always the potential for small divestures as we fine-tune our portfolio. But I don't see any major divestures of several hundred million dollars in revenue like we had in the third quarter. I don't see that on the near-term horizon.

**<Q - Brett D. Hoselton>**: Okay, thank you very much, gentlemen.

**<A - John C. Rickel>**: Thanks, Brett.

## Operator

[Operator Instructions] And our next question comes from Bill Armstrong at C.L. King.

**<Q - William R. Armstrong>**: Good morning. Back to Brazil, you had a very, very substantial increase in used vehicle gross profit per unit. What's driving that, and how sustainable is that improvement?

**<A - John C. Rickel>**: Yes, Bill, this is John Rickel. I mean, part of that has been that we've been able to provide a little bit of additional capital so that they can actually keep some of their units around a little bit longer. That was one of the things that when we did the acquisition in 2013 that we were able to bring to the table. So I think by helping them with some of their bank lines and improving access to capital, they've just been able to keep a little bit more inventory. And we think that that's certainly a part of the business we can continue to help them with.

**<Q - William R. Armstrong>**: Does that provide you with a competitive advantage also?

**<A - John C. Rickel>**: Yes. We think so. When we look versus the other groups down there, what we're able to bring to the table with strength of the balance sheet and the relationships we have with banks, we definitely think it's a competitive advantage going forward.

**<Q - William R. Armstrong>**: Okay. Back in the U.S. on the acquisition front, I think in Earl's opening comments, he mentioned that asking prices are getting pretty high. Although, we keep hearing that more and more sellers are putting their dealers up for sale. So, how does that work out? Are you seeing more deals coming your way, but they're just asking too much money? Or how do you see this market kind of evolving right now?

**<A - Earl J. Hesterberg>**: You stated it as precisely as I would have. I have seen more deals on the market in the last couple of months. But the ones that I've seen, the price is just wouldn't work for a proper return on investment. That can change tomorrow. It's very dynamic also. But you summed it up pretty well.

**<Q - William R. Armstrong>**: I know an asking price is different than an actual transaction price. Given the fact that there seems to be a lot of sellers out there, are these sellers willing to at least negotiate so they can get a deal done, or are they just kind of fishing?

**<A - Earl J. Hesterberg>**: That's a good point, too. Almost every deal starts with an asking price that's too high. So I think, perhaps, the point you're making, there is potential for more acquisitions because there are so many deals out there, and prices do get negotiated. So the potential exists, yes.

**<Q - William R. Armstrong>**: Okay. All right. Great. Thank you.

## Operator

The next question comes from Ravi Shanker at Morgan Stanley.

**<Q - Paresh B. Jain>**: Good morning, everyone. This is Paresh Jain in for Ravi. A couple of questions, one on UK and then one on Brazil. In UK, you guys are seeing significant F&I per vehicle growth. And you also have one of your dealer peers making about $1,000 per vehicle there. Is that something you can get to over time, or is there something that works differently for you guys?

**<A - John C. Rickel>**: Yeah. This is John Rickel. I mean, certainly, we've taken notice of what our peer has done, and we have put more emphasis. Now, we've been very pleased with the increases. Whether or not we can get all the way to $1,000, I don't know. It's certainly a good goal for us. I would point out that they have significantly more scale in the market. And that helps some of the volume bonuses that they receive from at least one of the manufacturers that we're aware of. But with that, we have made good improvements, and we continue to look for additional opportunities to move the number up there.

**<Q - Paresh B. Jain>**: That's good color. On Brazil, you guys mentioned that there's still significant uncertainly and volatility there, but you guys recently added another dealership. What gives you confidence to increase your footprint there at this point of time, and can we expect more to come?

**<A - Earl J. Hesterberg>**: Well, we're in Brazil for the long term. And what I've learned over the years is you build these businesses for the long term. And the peaks and the valleys are unpleasant noise. But our job is to make that the strongest business we can. And we did that quite deliberately in the UK over six or seven years. And we now have a pretty strong business and we're going to do the same thing in Brazil.

So actually the bottom of the market is the time to strengthen your portfolio. And for us to be able to join the Mercedes dealer network is something that is a strategy policy for our company whether we're at a valley or a peak in a market like Brazil.

So, we're going to continue to try to make that organization stronger and more efficient. And then some day when the market comes back, hopeful we'll have disproportionate leverage to the upside. So, we're not afraid to be prudent in strengthening that business.

**<A - John C. Rickel>**: The other point that I would add to that that I think is really key as well is take a look at the result this quarter, what the team did. What gives us the confidence is we have a very professional and very strong management team down there. I think everybody has been impressed by the fact that we're able to turn from a loss last quarter to a profit this quarter. That's the sort of thing that also gives us confidence to continue to expand down there as we've got a very, very good management team.

**<Q - Paresh B. Jain>**: Understood. And finally a housekeeping one, if I may. And apologies if I missed this earlier. Have you guys stated what your used supply was at the end of 3Q versus 2Q and what the mix looked like?

**<A - Earl J. Hesterberg>**: U.S. used supply was at 30 days. And that would have been down probably a couple of days from where we were at second quarter.

**<Q - Paresh B. Jain>**: Got it. Thanks so much, guys.

**<A - John C. Rickel>**: Thank you.

## Operator

At this time, I show no further questions. Would you like to make any closing remarks?

## Earl J. Hesterberg

Thanks to everyone for joining us today. We look forward to updating you on our fourth quarter earnings call in February.

## Operator

The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.