Company Name: Group 1 Automotive
Company Ticker: GPI US
Date: 2016-10-20
Event Description: Q3 2016 Earnings Call

Market Cap: 1,261.17
Current PX: 59.06
YTD Change($): -16.64
YTD Change(%): -21.982

Bloomberg Estimates - EPS
Current Quarter: 1.730
Current Year: 7.541
Bloomberg Estimates - Sales
Current Quarter: 2727.500
Current Year: 11002.600

Q3 2016 Earnings Call

Company Participants

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

Other Participants

- John J. Murphy
- David Tamberrino
- Michael Montani
- David H. Lim
- William R. Armstrong
- James J. Albertine
- Rick Nelson

MANAGEMENT DISCUSSION SECTION

Operator

Welcome to Group 1 Automotive's 2016 Third Quarter Financial Results Conference Call. Please be advised that this call is being recorded.

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

Peter C. DeLongchamps

Thank you, Jamie and good morning everyone and welcome to today's call. The earnings release we issued this morning and the related slide presentation that include reconciliations related to the adjusted earnings we will 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 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 markets. Those and other risks are described in the company's filings with the Securities and Exchange Commission over the last 12 months. Copies of these filings are available from both the SEC and the company.

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

Participating with me today are 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 period, unless otherwise stated.

I'd now like to hand the call over to Earl.

Earl J. Hesterberg

Thank you, Pete, and good morning, everyone. I'm pleased to report that Group 1 earned $42 million of adjusted net income for the third quarter. This equates to record third quarter adjusted EPS of $1.96 per diluted share, an increase of 2.6% over last year despite some economic and political headwinds in many of our key markets.

For the quarter, total revenue increased approximately $23 million, or 1%, to a third quarter record of over $2.8 billion. On a constant currency basis, revenue grew over 3% for the quarter.

Turning to our business segments, during the quarter, we retailed over 45,000 new vehicles. Total consolidated new vehicle revenues increased 1.6% on a constant currency basis as the average new vehicle selling price increase of 5% was partially offset by 3% fewer unit sales. As has been the case throughout 2016, the volume weakness was seen throughout the oil dependent markets in the United States and in Brazil. UK market growth has also slowed due to economic uncertainty regarding Brexit.

Additionally, the British pound has weakened 15% versus the dollar in the past 12 months, creating a currency translation challenge.

Consolidated new vehicle gross profit was up nearly 4% on a constant currency basis, as gross profit per unit increased over 7%. U.S. new vehicle margins were up for the second consecutive quarter with an increase of nearly 10%, which I will cover further in a moment.

Our new unit sales geographic mix was 76% U.S., 19% UK and 5% Brazil. Our new vehicle brand mix was led by Toyota Lexus sales, which accounted for 25% of our new vehicle unit sales.

BMW/MINI, Ford, VW/Audi/Porsche and Honda/Acura each represented at least 10% of our new vehicle unit sales. And General Motors and Nissan accounted for roughly 7% of unit sales.

We continued to make progress during the quarter on reducing our above-average U.S. new vehicle inventory levels. Our U.S. new vehicle inventory stood at 26,900 units on September 30, a 2,700 unit or 10% decrease from June 30 on a same-store basis. This equates to a supply of 74 days, down from 83 days at the end of June.

During the quarter, we retailed over 33,000 used retail units. Total consolidated used vehicle retail revenues grew roughly 5% on a constant currency basis as we retailed 1.6% more units and the average used vehicle selling price increased 3%. Used vehicle retail gross profit increased roughly 1% on a constant currency basis as the retail unit increase was partially offset by a slight gross profit per unit decline. U.S. used vehicle inventory stood at 13,500 units, which equates to a 33-day supply.

Relative to stop-sale inventory, we currently have approximately 400 new and 500 used vehicles in stock under an OEM stop-sale order. This represents less than 2% of our U.S. new vehicle inventory and less than 4% of our used vehicle inventory. Total consolidated parts and service revenue increased 7% on a constant currency basis, while consolidated parts and service gross profit rose 6%.

U.S. same-store revenues increased 3.4% as collision and warning comps were difficult coming off of a 13% and 8% same-store growth from the prior year respectively. U.S. parts and service margins declined 60 basis points to 54.8% as there were several high-margin labor-intensive warranty campaigns in the prior year.

We maintain our guidance of mid-single-digit same-store revenue growth throughout the remainder of the year and for 2017. Finance and insurance gross profit increased 2% on a consolidated constant currency basis. This growth was driven by an increase in F&I per retail unit of 4% as retail unit sales were down 1%.

U.S. F&I penetration delivered yet another quarterly year-over-year increase of $73 per unit to $1,588. Regarding our geographic segment results, our U.S. same-store operations saw a total revenue decline of 2%, driven by an 8% decline in new vehicle unit sales. Sales were once again heavily impacted in the Texas and Oklahoma markets due to the weakness in the oil industry with decreases of 10% in Texas and 18% in Oklahoma.

As previously mentioned, we were able to offset most of the volume decline with improved new vehicle gross profit per unit, resulting in a new vehicle gross profit decline of only 1%. So despite an 8% decline in new vehicle unit sales, we were able to hold total same-store gross profit roughly flat due to a focus on improving new vehicle margins, a further expansion of our parts and service operations and strong F&I per unit results.

Our UK operations had a solid quarter with total same-store revenue growth on a constant currency basis of 6%, driven by a 6% increase in new vehicle revenue, a 5% increase in used retail revenue, an 8% increase in parts and service revenues and an 18% increase in F&I revenue. We did experience more volatility than normal during the quarter following the Brexit vote in late June.

July and August results were weaker than expected with September coming back closer to normal as customers had time to absorb exit implications. The vote also had a significant impact on the exchange rate with the pound weakening about 15% from the third quarter 2015. This had a meaningful impact on our results as same-store revenues on a U.S. dollar basis decreased over 10%. Our reported earnings per share were also negatively impacted by about $0.04. While it's too early to get a definitive 2017 industry forecast for the UK, we're tentatively expecting an industry sales decline next year.

In Brazil, Q3 industry sales were down an additional 17% and are down 23% year-to-date. Partially offsetting the weak new vehicle environment are process improvements the team has implemented in our used car operations, where we saw same-store used retail margins improve 360 basis points to 7.6% and total used gross profit dollars increased nearly 70% on a constant currency basis.

Underlying business improvements such as these have allowed the team to mostly offset a deep downturn in new vehicle sales and have us well positioned to take full advantage of the future recovery in the local market.

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

John C. Rickel

Thank you, Earl, and good morning, everyone. For the third quarter of 2016, we reported adjusted net income of $42 million. On a fully diluted per share basis, adjusted earnings increased 2.6% to $1.96. These quarterly results for 2016 exclude $6.6 million of net after-tax adjustments primarily explained by $6.7 million of net non-cash franchise right impairments, the largest of which was caused by an OEM brand in an open point to another dealer group.

Starting with the summary of our quarterly consolidated results. For the quarter, we generated an all-time third quarter record of over $2.8 billion in total revenues. This was an improvement of $23 million or approximately 1% over the same period a year ago.

On a constant currency basis, which ignores the change in foreign exchange rates, total revenues increased 3.3% for the quarter. Our gross profit increased $8.3 million or 2.1% from the third quarter a year ago to $406.7 million.

As a percent of gross profit, adjusted SG&A increased 110 basis points to 73.6%, partially reflecting the mix effect of our increased UK business which inherently has a higher cost structure.

Floorplan interest expense increased by $1.4 million or 15% from prior year to $11.1 million. This increase is primarily attributed to higher labor interest rate versus the third quarter last year. Other interest expense increased $3.2 million or 22.8% to $17.1 million, primarily reflecting the issuance of $300 million of our 5.25% bonds in December 2015. Our adjusted consolidated effective tax rate for the quarter was 36.5%.

Turning now to our geographic segment, starting with the U.S. market on a same-store basis. For the quarter, total U.S. same-store revenues decreased 2% to $2.2 billion, driven by decreases of 4.4% in new and 1.8% in F&I.

These increases were partially offset by a 3.4% increase in parts and service and a 1% increase in total used. The 3.4% increase in same-store parts and service revenue consisted of increases of 5.1% in warranty, 3.5% in customer pay, 3.2% in collision and 2% in wholesale parts.

As Earl mentioned, prior year comps were especially difficult in our collision and warranty segments. We reiterate our guidance of mid-single-digit same-store revenue growth through 2017. Our 1.8% F&I revenue decrease was driven by a 5% decrease in total retail units, partially offset by a PRU increase of $51 or 3.3% to $1578 per unit. Total same-store gross profit decreased 0.2%, driven by decreases of 3.9% in total used vehicles and 1.2% in new vehicles, partially offset by a 2.4% increase in parts and service.

As Earl previously mentioned, we displayed improved pricing discipline as our new vehicle gross profit per unit increased $121 per unit to $1,769, which mostly offset the 7.9% decline in new vehicle retail unit volume.

Our adjusted SG&A as a percent of gross profit increased 40 basis points to 71.1% and adjusted operating margin remained flat at 3.9% related to our UK segment, on a same-store basis with percentage change metrics on a constant currency basis.

For the quarter, total revenue decreased $34 million to $293.5 million, but increased 5.5% on a constant currency basis. Gross profit in the UK segment was up 7.2% from prior-year. New vehicle gross profit grew 1.3%, driven by a unit sales increase of 1.5%.

Total retail used vehicle gross profit increased 6.8% [ph] due to (14:03) 2.4% increase in unit sales combined with a 4.3% increase in gross profit per unit. Parts and service gross profit improved 7.4% and our F&I income increased 17.6%, which is attributable to both a 15% increase in gross profit PRU and a 2.3% increase in total retail units. For the quarter, our adjusted S&G as a percent of gross profit decreased 10 basis points to 77.5% and adjusted operating margin was flat at 2.2%.

Related to our Brazil segment on a same-store basis. As Earl mentioned, the total industry new unit volume decreased 17% from the third quarter of 2015. Our local team did a great job increasing both parts and service and F&I revenues as well as the improvements in the used business which Earl covered previously, which mostly offset the steep new vehicle sales decline and allowed us to about break-even for the quarter.

Turning to our consolidated liquidity and capital structure, as of September 30, we had $22.9 million of cash on hand and another $82.2 million that was invested in our floorplan offset accounts, bringing immediately available funds to a total of $105.1 million.

During the quarter, we repurchased 244,000 shares of our common stock at an average price of $50.61. Year-to-date, we've repurchased approximately 2.3 million shares at an average price of roughly $55.90 per share for a total of $127.6 million.

These repurchases equate to an approximate 10% reduction from our year-end diluted common share count of 22.6 million shares. As of October 20, we have approximately 20.6 million diluted common shares outstanding and $22.4 million remaining on our board-authorized share repurchase program.

During third quarter, we used $4.9 million to pay dividends of $0.23 per share, an increase of 9.5% per share over the third quarter a year ago and an annualized yield of approximately 1.5%.

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 corporate development efforts, the company is pleased to announce the addition of two UK Ford stores that were purchased this week, increasing our UK dealership count to 31. This now brings our Ford UK portfolio to six stores and our total company Ford portfolio to 18 stores. These two dealerships are contiguous to our existing Ford operations in the UK and are expected to generate approximately $65 million in annual revenues.

The company also divested of two dealerships which include a Hyundai store in California and a Porsche store in Massachusetts. In October, the company also divested of a Honda store in California. In total, these dealerships generated approximately $120 million in trailing 12-month revenues. The disposals are consistent with Group 1's portfolio management strategy.

During the quarter, the company was also awarded a Porsche open point in El Paso, Texas. The store is targeted to open in late 2017.

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

Q&A

Operator

Ladies and gentlemen, we'll now begin the question-and-answer session. [Operator Instructions] And our first question today comes from John Murphy from Bank of America Merrill Lynch. Please go ahead with your question.

<Q - John J. Murphy>: Good morning, guys.

<A - John C. Rickel>: Morning, John.

<Q - John J. Murphy>: Just had a couple questions here. I mean, first on the new vehicle gross profit per unit in the U.S., I mean that's really good news. I'm just curious how you think you're achieving that. And if you potentially were to drop that, could you drive significantly higher volumes?

I'm just trying to gauge really the competitive environment out there and how you're trading off volume versus this gross profit per unit and also if you can maybe comment on sort of the inventory levels right now sort of in conjunction with that.

<A - Earl J. Hesterberg>: Certainly, John. This is Earl. It is a bit of a trade-off, but there were certain brands that were continuing to give us sales targets that were significant year-over-year increases in markets that are way down, as you know. And so you just get to a point where you can't chase every target every month or every quarter. And you just have to trade off some volumes and avoid selling so many cars at losses. There's frequently a lot of vehicles sold at losses to hit these targets and we've just been working hard to have more discipline on that.

Now that said, each store has its own challenge. So I would say in some cases, we may have gone too far with a half dozen stores or so and we've got to get that balance right because when you lose too much volume, then there's impact on used vehicle trade-ins and F&I opportunities and so forth.

But generally, it's a discipline to balance volume and margin. And I think many dealers in the U.S. have gotten in very bad habits with a lot of this volume pressure at getting away cars and that's bad for the long-term health of the business.

Relative to inventory, we made a dramatic improvement. I wouldn't say we're any longer significantly overstocked, it's still a little bit higher than I would like, certainly in a couple of brands, but it's now totally manageable in my opinion.

<Q - John J. Murphy>: And Earl, just a follow-up on the GPU point, I mean, do you feel like the competitive environment out there in the markets that you're in has gotten a little bit more balanced from a dealer perspective or do you believe there are dealers out there that are chasing volume still too aggressively that needs to hopefully at some point cool off?

<A - Earl J. Hesterberg>: I think it's starting to turn, but yeah, there are still many dealers, including us in some places chasing volume. And the problem we have is many of our locations are in these markets where the industry is down double digits. And when you have targets that are up almost double digits, I mean it's just, it's a disconnect.

And that's the problem when OEMs provide target is they can't necessarily fine-tune them and prescribe for some of the pockets, like the oil industry where the industry isn't behaving like it is in other parts of the U.S. So you really get some disconnects on some of these targets versus reality.

<Q - John J. Murphy>: Okay. And then just a second question, as we think about diversification, considering some of the markets you're in, being the UK and Texas, Oklahoma, diversification, in the short run, seems like it's hampering you a little bit. In the long term obviously, this diversification is a good idea. Is there any region that you would sort of focus on as expanding into to diversify away from what are these weaker markets right now or is there the real potential because some of these markets are weaker to make good accretive long-term acquisitions as these markets are depressed?

<A - Earl J. Hesterberg>: So generally speaking, John, the best places for us to invest are where we have some concentration already. We could benefit from significantly more scale in Brazil while the market is very much down.

And the same in the UK, we've just added some scale earlier this year, but that takes some time to digest, but we'd be willing to add more scale in the UK or Brazil. Within the U.S., clearly it would be nice to have more scale outside of the oil patch, you know, on the East Coast, Southeast and other growing markets in the U.S.

So I would say we would have a high interest outside the oil patch in the U.S. to get a little more diversification within the U.S., but we would get the best leverage from operating in those three markets where we're concentrated today.

<Q - John J. Murphy>: Okay. And then just lastly, as we think about leasing, I mean there was a significant push in the first half of the year. Just curious what you saw in the third quarter from the automakers you represent and if we're still looking at lease rates that are north of 30% across the industry and really how you think that'll shake out as far as an opportunity and an issue for you both in the near-term and ultimately as those vehicles come back to the market?

<A - Earl J. Hesterberg>: Sure, John. My impression is that OEMs are starting to back off or slow down a little bit on leasing. Leasing is not as big for us because of our geographic concentration in South Central U.S., we're about 17% leasing whereas the industry is, as you say, closer to 30%. So it's not the same concentration for us because leasing is quite heavy in the Northeastern U.S. and California.

But with used car values likely having peaked sometime in the past, my impression is the OEMs are starting to become a little more prudent about how aggressive they get in pushing higher levels of leasing.

<Q - John J. Murphy>: Great. Thank you very much.

Operator

Our next question comes from David Tamberrino from Goldman Sachs. Please go ahead with your question.

<Q - David Tamberrino>: Great. Good morning. Just a couple from us here as we think about the quarter. I think one of the biggest surprises was the SG&A leverage here mainly for the U.K. and Brazil. We've been seeing, at least in the U.K, some year-over-year improvement, looked like you took a step back during the third quarter.

Is that partially from the integration of the acquisition from earlier this year or is that as a result of the lower volumes within the market? And then if you could add on to that, in Brazil, it looks like we went back up over 100% for SG&A flow-through there as a percentage of gross profit. Maybe just speak to what you're seeing on the ground there and what changes your implementing in the near term to get that back below 100%?

<A - Earl J. Hesterberg>: Yeah certainly, Dave, this is Earl. Yeah, in the U.K. which now is about 18% of our business whereas this time last year, it was about 11%, we made a large acquisition in February. And although it included four very high-performing Audi stores, the rest of those dealerships were generally broken and are still broken today, although I think a bit less broken than they were seven months or eight months ago.

So that is a big factor. And it's going to take up some time to integrate those stores and get those stores contributing. So that is a big issue; we're much bigger in the UK. The UK is structurally always five percentage points or six percentage points higher in SG&A as a percent of gross profit even on a good day and some of our recent acquisition stores are going to take a while to fix and integrate.

<A - John C. Rickel>: Yes, Dave. This is John Rickel. Just to dimension that, if you look at the consolidated UK results, we were at 83.4% SG&A as a percent of growth on a same-store, it was 77.5%. So that kind of gives you the gap – the work that we've got to do to Earl's point and we're working through those things, but it does take longer in the UK to get some of those costs out. You've got redundancy processes to go through, et cetera. So there is more to be done there, but it just takes a little bit longer.

And on Brazil, you're right. We clearly have gone back to just a little bit of a loss down there, driven by two things; one, the volumes obviously continue to be very challenging. The industry was down another 17% in the quarter and at some point, you can only take so much cost out. That's to Earl's other point about at some point, we're going to have to have some additional scale down there. But I think there are some at least initial signs of hope down there. The central bank cut rates overnight 25 basis points; that's the first time in a couple years.

You've seen rates start to come down. You've got new political situation down there. So we think that there may be some opportunities next year. But near-term it's do everything we can to take costs out, improve the processes and get ready for things to hopefully start to turn around.

<Q - David Tamberrino>: That's very helpful. And for my second one, can you maybe talk about the pace of sales in October that you've seen so far and then more specifically how is it tracking in the oil regions; Texas, Oklahoma and then maybe in the UK as I think we saw a little bit of improvement throughout the quarter from July to August, [ph] September, October (27:36) getting better in the UK or is it getting worse in Texas?

<A - Earl J. Hesterberg>: It's hard to really say that. I don't really expect any improvement in Texas and in the impact on auto sales in Texas has played out quite slowly and steadily over this year, kind of settling down, decreasing a percentage point or two every month or so. I don't see certainly any uptick yet. By the same token, I don't see any step function change down.

Oklahoma was probably the market that surprised us the most with the 18% decrease, but I think we always recognize that the Oklahoma economy is not nearly as diverse as Houston or many parts of Texas. So it's very heavily energy-dependant. But I think there is a general feeling we're getting closer to the bottom in Texas, but I don't think there is any declaration that we've hit the bottom yet. In the UK, it's still just mostly suffering from uncertainty. I don't think the market's particularly weak. But uncertainty is never good for consumer confidence which is the main driver of auto sales. But I have – certainly haven't any input that says the UK market is appreciably weaker than it was in September and it was fairly reasonable in September with retail sales down only 1%.

<Q - David Tamberrino>: Understood, thank you very much for the time this morning.

Operator

And our next question comes from Mike Montani from Evercore ISI. Please go ahead with your question.

<Q - Michael Montani>: Yeah, hey guys. Good morning. Just wanted to ask first if I could, in the UK, can you just remind us a little bit of your mix there, in particular in the premium side relative to the rest of the business. And then you mentioned an outlook for a decline in sales. Just help us to understand your thinking around that as we head into next year?

<A - Earl J. Hesterberg>: Yes. In the UK, we have 9 Audi dealerships and 11 BMW dealerships; [ph] sorry (29:55), that's our heavy mix, we mentioned earlier that we've just expanded the six Ford dealerships and we have a few other smaller franchises. So we're very heavy in Audi and BMW.

I believe the thought on the UK market not being in a growth mode at the moment relates simply to consumer confidence and this uncertainty. Of course you have a 15% exchange rate difference with the dollar, by a lesser amount with other currencies. But clearly the pound has weakened, so you're going to have imported goods increasing in price; that will also include imported cars. And I believe it's fair to say the real estate market is noticeably softer in the UK in recent months. And we normally find a correlation of weakness in real estate markets with consumer confidence as well.

<Q - Michael Montani>: Okay. Understood. And then if I could just ask for your thinking as it relates to some of your OEM partners. So curious to hear from the standpoint of BMW or Audi in the UK, are you anticipating price increases from those OEMs next year, have you heard anything specific there yet? And then I just had a U.S. follow-up.

<A - Earl J. Hesterberg>: I've not heard anything specific on BMW and Audi pricing. But I was responsible for automotive brands in Europe, two different brands, two different times. And when the exchange rate changes that much, I can assure you there will be some pricing actions taken to offset part of it. Now when and how much, that's up to each OEM, but that's too much currency movement to offset.

<Q - Michael Montani>: Makes sense. And then if I could just on the U.S. side, you'd mentioned there was a disconnect in some markets where incentives and stair steps were just unrealistic given the volumes that you're seeing in those markets. We had heard that there were some changes made, in particular from Ford. But I guess the question I'd ask is, has there been any more widespread changes and how are the discussions going at this stage with the OEM's about balancing production versus the need to incent to move the metal?

<A - Earl J. Hesterberg>: Actually that is a good point you made and your input is accurate. Ford eliminated their stair step some time ago which was an extremely positive move and our Ford business improved almost immediately. I'm sure there have been some other adjustments, but of course these things take time and frequently they are commitments made for a quarter. And so some of these reactions are slower than others. But I'm quite sure that most of these OEMs will have to adjust to the market because I don't think we're the – I don't think only the oil patch is suffering in some of the sales softness.

<Q - Michael Montani>: And did you guys give the same-store inventory units last year just to get a handle on the changes in the improvements made there?

<A - John C. Rickel>: Yeah, we're down about 2,700 units on a year-over-year same-store basis.

<Q - Michael Montani>: Okay, great. Thank you.

Operator

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

<Q - David H. Lim>: Hi, good morning, everyone. I just wanted to follow up on that last one. John, you said 2,700 units same-store sales basis, is that U.S. and what is that on a day supply basis?

<A - John C. Rickel>: Yeah, that's U.S. and that's about nine-day supply, David.

<Q - David H. Lim>: Nine day supply down year-over-year.

<A - John C. Rickel>: Down, yeah.

<Q - David H. Lim>: Got you. The other question I had is, are you guys pushing back on – continue to push back on dealer – on factory orders and are you seeing that kind of same behavior with other dealers in your competitive markets or other dealers continue to accept inventory from the OEMs?

<A - Earl J. Hesterberg>: David, this is Earl. I don't think any of us are having to push back as much as we did 90 days ago because many of the OEMs have now reacted and reduced production. It is true that we're still very sensitive to our inventory levels and they're still not quite where we'd like them to be. I think we like them to still be another six days or eight days lower. But they are coming in the line and I think you've probably read about many of the production cuts that the OEMs are making. So, I think the entire industry understood the problem and we're working together to get it back in alignment.

<Q - David H. Lim>: Got you. And then are you – do you have a view on – Earl, do you have any view on 2017 industry volumes? I mean what we've been hearing [ph] through our (34:59) channels is a lot of OEMs are actually assuming – outside of the ones that already have announced – are assuming a down industry environment for 2017. Can you maybe sort of dimensionalize that and what you're thinking?

<A - Earl J. Hesterberg>: Well, I think there's two camps. I think there's a camp that says flat and a camp that says a slight decrease. And I think there's some – there's some factor that will, will gain some clarity after we get a presidential election outcome and then we'll see what the mood of the public is because so much of consumer confidence is psychological and most experts would contend that the current electoral process is creating some distraction.

<Q - David H. Lim>: Relative to what you're seeing when you're in past cycles, are you seeing your Texas consumer – when it comes to parts and service – are they clamming up a little bit or not paying for the higher margin repairs? And then I have one follow-up after that.

<A - Earl J. Hesterberg>: Yes, that's a good point and it's valid. We are seeing the Texas customer pay business in Oklahoma being a little stickier. So we're increasing our marketing efforts accordingly. There's still a lot of good potential with the unit operation profile. But as you would expect, when our new vehicle sales soften up due to consumer confidence and financial pressure on the consumer, customer pay service tends to follow along with that.

<Q - David H. Lim>: Got you. And then finally, can you sort of, John or Pete or Earl, can you talk about transaction price relative to MSRP in general terms? Have you seen that percent widen over the quarter and year over year. I know that the OEMs like to talk about ATP, incentives as a percentage of ATP, but we also like to take a look at overall transaction price versus MSRP. Any color there would be very helpful. Thank you.

<A - Earl J. Hesterberg>: David, this is Earl. I don't really have any data. You're better with the data and I know you follow it personally quite closely. But it's true that incentive activity has been more intense in this past quarter. Some of that is clearly because inventory levels were high and you were in a time period where model years were changing. And certain brands and certain models were a bit high as the model year changed.

So normally, I would find that there's pressure on transaction prices when those incentives get as high as they did in the last couple months. I don't know that that's true at this moment because as you can see, the inventories are starting to adjust in a positive way.

<A - John C. Rickel>: David, this is John. What I can tell you is that our average transaction prices in total in the U.S. continue to increase. We were up about $1300 on a year-over-year basis. Some of that is obviously mix, as we've seen a richer mix of trucks. We've seen about five points of swing from car to truck. But to your detailed point on transactions, I don't have any better data than what Earl just mentioned to you.

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

Operator

And our next question comes from Bill Armstrong from C.L. King and Associates. Please go ahead with your question.

<Q - William R. Armstrong>: Good morning, everyone. Back to the energy market, so we're seeing the rig count actually creeping up over the last several months. Looks like the deceleration in your sales in the Oklahoma and Texas markets are still pretty weak.

At some point, if we see stabilization in the rig count and in oil prices, where do you expect to see or I should say when do you expect to see your sales sort of beginning to at least stabilize and sort of stem the bleeding?

<A - Earl J. Hesterberg>: Well, I wouldn't profess to be an expert in that. I think we've all been surprised a bit at some of the time lag in the impact of these job losses and the associated impact on vehicle sales.

But I would hope some time next year, we'll start to get some stability. We've lost 80,000 energy jobs in Houston alone, although we've actually offset them all, if you can believe that, but generally speaking, with lower income jobs at the moment.

But for example, General Electric announced lay-offs in their energy industry operations here six months ago, but the jobs actually just disappeared last week. So there is some time delay even when they announced these layoffs and when they actually take effect. And the same with – when they continue drilling again and the rig count goes up before they actually hired back more people, there's likely to be some time delay.

But as I mentioned earlier, we do believe we're getting much closer to a bottom. So we would hope that sometime next year, hopefully in the first half, we'll find that bottom and [ph] we can (40:41) start to work our way back up. In Houston where we're quite strong, our sales were only down 6%. So there's still some places where we can outperform the market which, on a relative basis, for the long term is quite important.

<Q - William R. Armstrong>: Got it. Understood. And then Brazil, you've had new unit comps down 30%, which was worse than the industry which was down 17%. In more recent quarters, due to your brand mix, you guys have you actually outperformed the industry and then – and this quarter, you underperformed the industry. Maybe you could give us some color on why that the relative performance has shifted and what would we should look for going forward?

<A - Earl J. Hesterberg>: That's a good question. But it's quite a granular answer, but the answer is that we're the biggest Honda retailer in Brazil. And they just introduced the new Civic. And the price on the new Civic, which is almost a luxury car in Brazil, is dramatically higher than it was before.

And we had a large amount of Honda volume that was in a fleet category which would be similar to Motability in the UK if you know what that is, it's government subsidized fleet sales for handicapped people and so forth. And the pricing on these new Honda models no longer qualifies for that scheme, so we lost a lot of fleet business.

But generally speaking, absent that, I'd say we're still pretty much in line with the market, which is still weak as you can see.

<Q - William R. Armstrong>: Got it. So should we – so it sounds like maybe that Honda Civic issue may kind of be a drag on comps until we anniversary that. Is that – would that be fair to assume?

<A - Earl J. Hesterberg>: It would be a drag on volume comps. Actually the margins on the new Civic compared to those fleet ones we're doing is much, much better. But we're just doing less of them because they're retail now, not fleet.

<Q - William R. Armstrong>: Understood. Okay, thank you.

Operator

And our next question comes from James Albertine from Consumer Edge Research. Please go ahead with your question.

<Q - James J. Albertine>: Thanks and good morning everyone. Quick question for you to sort of a different version of an earlier question that was asked on new vehicles, wanted to get some insights on the incremental supply and availability of used vehicles and then what you're seeing in terms of margin trends within that segment and maybe how we should think about it for the balance of this year?

<A - Earl J. Hesterberg>: Yes. This is Earl. That's a good question. There is dramatically increased supply on used vehicles. And that does put some pressure on the margins, I think. But the good news is the used vehicle market appears to be quite strong even in a market like Oklahoma where new vehicle sales were down 18%, used were only down 2% or 3%. And in some months, the market's still somewhat flat on used. So – but yes there is more supply, which will give us more volume opportunity, but it will probably have a little bit of margin trade-off.

<Q - James J. Albertine>: And if that's – that's very helpful. Thank you for that. And then if I may, sort of a question I think given that you're in Texas and Oklahoma and probably more scale than your public peers, sort of gives you this interesting insight we think, maybe a window into what a recession would look like. And our question is, is your business acting like you would expect? It sounds like on the used side, your top line was down 18% for new if I heard you right and for used down 2% to 3%; that's a good thing.

Specifically though, want to ask on F&I. I think a lot of people are asking, well, what would happen to F&I, they're performing quite well on a PVR basis relative to history. But if the broader U.S. or the UK or elsewhere gets more challenged, what happens to that F&I environment. So our question is Texas and Oklahoma weak top line, call it, recessionary type markets, what's happening to F&I within those markets?

<A - Peter C. DeLongchamps>: So, Jamie, this is Pete. Our F&I performance in both Texas and Oklahoma still remains good. I think the biggest headwinds that we could face in F&I is rising interest rates. But so far, as you can see, we've produced and with the volume that we do in Texas and Oklahoma, F&I has held up.

<A - Earl J. Hesterberg>: Yeah, my impression is that we haven't seen a penetration issue. It's just a lack of opportunities when sales volume decreases. Is that correct, Pete?

<A - Peter C. DeLongchamps>: Yes.

<A - John C. Rickel>: The PRU – said differently, the PRU is held up, Jamie. It's just the volume impact that rolls through.

<Q - James J. Albertine>: And you're seeing incremental opportunities I would think on the used side as may be customers are looking more late-model given that supply increase?

<A - John C. Rickel>: Directionally, yes, but there is some trade-off with the CPO's which come with the off-lease vehicles.

<Q - James J. Albertine>: Got it. Thanks so much.

Operator

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

<Q - Rick Nelson>: Thanks.

<A - Earl J. Hesterberg>: Hi Rick.

<Q - Rick Nelson>: Just to follow up on Jamie's question about Texas, Oklahoma with that top-line downturn, can you speak to the dealership profitability in those markets – what sort of declines we saw?

<A - Earl J. Hesterberg>: Yes, I would say, Rick, that the profitability of those dealerships very much mirrors that new vehicle percentage decline. I would say it probably correlates somewhat reasonably. So if you're 10% in new vehicle sales, profit's probably somewhere in that vicinity as well.

<Q - Rick Nelson>: So you are able to manage the expenses in those markets given the variable cost model?

<A - Earl J. Hesterberg>: Yes, to a certain degree. I don't think you can really leverage SG&A when you're down 10% or 18% because a certain percentage of your personnel costs are fixed. But yeah, we adjust the best we can on both personnel costs, advertising and you've seen the work we've done on inventory. So yeah, we're pretty good at flexing the cost structure, but it's not like you can really leverage when your sales are down that much.

<A - John C. Rickel>: Rick, this is John Rickel. The other thing to bear in mind is the volumes were down that much. But as we indicated, we saw the same improvement in margins in those markets as we did overall. So the gross profit dollars were not pressured nearly as much as the volume headline would make you think. So that's why you're able to hold the profit decline to about that level.

<Q - Rick Nelson>: Got you. Good to know. Thanks. Also want to ask about the acquisition environment, what you're seeing in terms of pricing with the weakening environment. Are you seeing more [ph] geared (47:57), I guess, from terms of solid expectations?

<A - Earl J. Hesterberg>: Yes, Rick, there's probably been an explosion of deals in recent months in both the U.S. and the UK for obvious reasons. I don't have any indication that prices are more reasonable, but I think they will become more reasonable, just because of supply and demand. There are many people that understand that the market growth isn't in the same profile potential as it was a few years back.

<Q - Rick Nelson>: Okay. Looks like your pace of divestitures actually is outpacing acquisitions at least this quarter.

<A - Earl J. Hesterberg>: That was just coincidental, Rick. I mean, we're just always cleaning up, sometimes you come up on a CapEx point where you have to invest in a facility. And generally, if the dealership is in a good return now, more CapEx isn't the answer to your problems. So those are mostly cleanup actions as I wouldn't read anything into that, we're still interested in expanding our company in all three of the markets that we can find opportunities that [ph] hit (49:18) our return on investment hurdle.

<Q - Rick Nelson>: Okay. And just a follow-up to that, if you could tell us where net debt-to-EBITDA stands today and what sort of level you would be comfortable with if the acquisition environment, if the multiples were [indiscernible] (49:38).

<A - John C. Rickel>: Yeah, this is John. I mean, what we look at is rent-adjusted total leverage, and we're just around kind of the high 3.8s to close to 3.9. We're really, from a protect the balance sheet standpoint, don't want to go much above four times. So there is a little bit of dry powder. If it was really the right deal, you might stretch for a short period, but in general, we really kind of want to protect that four times cap.

<Q - Rick Nelson>: Good, good to know. Thanks a lot and good luck.

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

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

Operator

And our next question is a follow-up from Mike Montani from Evercore ISI. Please go ahead with your follow-up.

<Q - Michael Montani>: Hey, guys, thanks for taking the follow-up. So wanted to ask just in terms of credit availability, if you've seen any impact, you mentioned leasing a moment ago, but have you seen any impacts broadly both in the energy market and then in the U.S. on a larger scale?

<A - Peter C. DeLongchamps>: Hey, Mike. It's Pete DeLongchamps. We probably have as much communication and interaction with our lenders as we've ever had and I'll tell you from our perspective, we have not seen a pullback in credit, whether it's the U.S. or in Texas.

<Q - Michael Montani>: All right, okay. And then I guess a follow-up maybe on used vehicle pricing. I don't know John, if you can parse it out at all, but used vehicle ATPs were still up for you all. Is there any way to tease out kind of what like-for-like pricing did versus mix impact?

<A - John C. Rickel>: Not really used – I mean our sense is that overall, used vehicle prices have been pretty solid, but I can't really give you an analytical cut of how much of that is mix versus like-for-like.

<Q - Michael Montani>: Would you generally tend to follow like an [ph] ADA (51:28) index that's showing down low-single-digits or do you think the Manheim kind of up 1 to 2 is more accurate at this point?

<A - Earl J. Hesterberg>: For our mix, I would tell you I think Mannheim is probably a little more accurate.

<Q - Michael Montani>: Okay. Thank you.

Operator

And ladies and gentlemen, at this time we've reached the end of today's question-and-answer session. I'd like to turn the conference call back over to management for any closing remarks.

Earl J. Hesterberg

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

Operator

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