

Company Name: Group 1 Automotive
Company Ticker: GPI US
Date: 2018-04-26
Event Description: Q1 2018 Earnings Call

Market Cap: 1,350.07
Current PX: 64.61
YTD Change(\$): -6.36
YTD Change(%): -8.962

Bloomberg Estimates - EPS
Current Quarter: 2.139
Current Year: 8.391
Bloomberg Estimates - Sales
Current Quarter: 2832.429
Current Year: 11427.778

Q1 2018 Earnings Call

Company Participants

- Peter C. DeLongchamps
- Earl J. Hesterberg
- Daryl A. Kenningham
- John C. Rickel

Other Participants

- Aileen Smith
- Rick Nelson
- Derek J. Glynn
- David H. Lim

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Group 1 Automotive's 2018 First Quarter Financial Results Conference Call. Please be advised that this call is being recorded.

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

Peter C. DeLongchamps

Thank you, Brian. 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 results we will refer to on this call for comparison purposes have been posted to Group 1's 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 Automotive are forward-looking statements that are made pursuant to the Safe Harbor provisions of the 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, Earl Hesterberg, our President and Chief Executive Officer; John Rickel, our Senior Vice President and Chief Financial Officer; Daryl Kenningham, our President of U.S. Operations; and Lance Parker, our

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Vice President and Corporate Controller. Please note that all comparisons in the prepared remarks are the same prior-year 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. The year began with generally weak business conditions in all three of our markets in January and February. This is somewhat typical in the UK and Brazil, but the impact of Brexit on the UK market is a more recent negative factor impacting vehicle sales, and the U.S. market was less than vibrant early in 2018.

However, our business improved dramatically in March with much stronger market conditions in the U.S. and Brazil and benefiting from a strong used vehicle sales performance by our UK team, as well as growing contributions by some of our recent acquisitions.

Prior to commenting specifically on our first quarter results, I would like to briefly address some strategic actions that we announced in our March 19 press release. These initiatives, while adding cost in the short term, are vital to strengthening the long-term growth prospects of our used vehicle and aftersales business segments. These businesses are much more stable and controllable than the new vehicle portion of our business, which is very cyclical and appears to have recently peaked in both the U.S. and UK.

To strengthen our used vehicle business, we announced Val-U-Line, a proprietary brand for older model, higher mileage vehicles that historically we have frequently sent directly to the wholesale market after being received as a trade-in. We believe this market segment presents a major opportunity for Group 1. This vehicle population historically accounted for roughly 4% of our total retail unit sales. We plan to grow this penetration to at least 10% of our used business by the end of the year, and we are already well on the way to accomplishing this.

It is also important to note that we will be utilizing our existing brick-and-mortar footprint to generate this incremental volume, which will better leverage our existing assets. Daryl will update you in just a minute on the early progress in this area.

Related to aftersales, which generated 45% of our total gross profit in the first quarter, we announced several initiatives aimed at training and retaining key dealership personnel as well as expanding our capacity. Our employees will benefit from enhanced pay plans, defined career paths, more flexible work schedules and a state-of-the-art Service Advisor University training facility, which is now complete and operational.

The modified work schedules will also allow us to expand customer service hours over time and thereby expand our capacity by approximately 20% without any need for additional brick-and-mortar investment. Although it is early, we have been encouraged by the initial results. We have installed our new work schedule in 65 of our U.S. dealerships and we are already seeing an improvement in retention in hiring with a 17% increase in our Service Advisor head count from the same period last year.

We are very excited about the opportunities these initiatives will provide us. While they did add about \$3 million of costs in the quarter, the incremental gross profit they will generate over time should provide a very strong return on our investment.

Turning to our first quarter results, I'm pleased to report that Group 1 earned \$35.8 million of net income for the quarter. This equates to record first quarter earnings per share of \$1.70 per diluted share, an increase of 11% over last year, driven by revenue and gross profit growth across all regions.

Total revenue increased 11% on a constant currency basis to a first quarter record of \$2.9 billion.

Turning to our business segments, during the quarter we retailed over 41,000 new vehicles. Total consolidated new vehicle revenues increased 10% on a constant currency basis as the average new vehicle selling price increase of 2%

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combined with 8% more unit sales. Consolidated new vehicle gross profit was up 6% on a constant currency basis, as gross profit per unit decreased slightly.

Our new unit sales geographic mix was 70% U.S., 25% UK, and 5% Brazil. Our new vehicle brand mix was led by Toyota Lexus which accounted for 24% of our new units; VW and Audi represented 14%; BMW and Mini represented 13%; Ford, 11%; and Honda and Acura represented 10% of our new unit sales.

During the quarter, we retailed over 36,000 used retail units. Total consolidated used vehicle revenues grew 12% on a constant currency basis as we sold 12% more units and the average used vehicle selling price remained flat. Used vehicle gross profit decreased 2% on a constant currency basis as the unit increase was more than offset by a gross profit per unit decline of 12%, which we will cover further in a moment.

Total consolidated parts and service revenue increased 8% on a constant currency basis, driven by increases in wholesale parts of 13%, customer pay of 9%, and warranty of 6%, with collision revenues down slightly.

Finance and insurance gross profit increased 14% on a consolidated constant currency basis. This growth was driven by an increase in retail units of 11% and F&I per retail unit of 3%.

Regarding our geographic segment results, I'd like to turn the call over to Daryl Kenningham, President of U.S. Operations, to discuss our U.S. first quarter results before I cover the UK and Brazil. Daryl?

Daryl A. Kenningham

Thank you, Earl. Our U.S. same-store revenues grew 4% for the quarter while same-store gross profit increased 3%. Same-store revenue growth was driven by new vehicle unit sales that were up 2% which was consistent with the industry. Our used vehicle retail unit sales were up 8%, parts and service revenue was up 3%, and F&I up 10%.

New vehicle sales in Texas and Oklahoma continued their positive trend and were up a combined 4% in the quarter on a same-store basis. The Houston metro area, our largest in the U.S., increased 5% on a same-store level as local economic data remains promising amid the uptick in drilling activity and continued recovery and reconstruction efforts post hurricane.

We continue to hold U.S. new vehicle inventory at a reasonable level. Our inventories stood at 27,200 units at quarter end, a decrease of 3,300 units on a same-store basis compared to March 2017. Our inventory supply of 72 days was down from 86 days at the end of the first quarter 2017. U.S. same-store used vehicle retail sales grew 8%, as focus on growing our used car business is beginning to pay off. Our Val-U-Line products were 9% of total retail units, already more than double our previous mix only three months after launch.

As announced in our March press release, we saw pressure in used vehicle gross profit per unit during the quarter, which declined \$296 from the prior year to \$1,226. This decline was significantly more pronounced in our luxury brands and primarily in our CPO business, as we work with our OEM partners to absorb and increase supply of off-lease and loaner vehicles. A portion of the decline relates to the continuing shift in consumer demand from cars to trucks. Our increased mix of Val-u-Line vehicles was not a significant factor in our reduced used vehicle margins.

Our total U.S. F&I per retail unit delivered set another quarterly year-over-year increase of \$81 per unit to another all-time quarterly record of \$1,718. This increase was largely driven by increased product penetration, namely, extended warranties and maintenance contracts, which benefit our business by bringing customers back into our service shops.

U.S. same-store parts and service revenues increased 3.4%, driven by increases in wholesale parts of 10.4% and customer pay of 3.1%. These increases were partially offset by a 1% decline in our collision business. Warranty revenues were mostly flat due to the presence of several major OEM recall campaigns, including General Motors ignition switches and Takata airbags in the year-ago comparative period.

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Same-store after-sales gross profit increased 2%, as the 3% increase was partially offset by a 70-basis point decline in gross margin to 53.1%. This decline was largely due to the mix of our 10% increase in wholesale part sales. We maintain our guidance of mid-single-digit same-store after-sales revenue growth throughout 2018.

In closing, I'd like to thank the 9,748 Group 1 team members in our U.S. stores for the tremendous work they do every day.

To discuss our UK and Brazil business, I'll now turn the call back over to Earl.

Earl J. Hesterberg

Thanks, Daryl. Our UK operations performed well given a very difficult year-over-year comparison due to the substantial pull ahead that occurred in the first quarter of 2017 due to a vehicle tax change. Our same-store new vehicle unit sales decreased 10% in an overall market that declined over 12%. An extremely strong same-store used car performance with unit volume up 5% and revenues up 13% enabled us to keep total same-store revenue flat on a constant currency basis. This was a very impressive performance by our UK team in a weak market. Furthermore, an efficient integration of our two most recent dealer group acquisitions supported a consolidated quarterly gross profit increase of 26% on a constant currency basis.

Although the first quarter of the year is always the weakest selling period in Brazil, we achieved significant growth in a market beginning to recover from a deep recession as quarterly same-store gross profit increased 7% on a constant currency basis. This growth was driven by an 11% increase in new vehicles, a 10% increase in aftersales, and a 9% increase in F&I. Our same-store new vehicle unit sales increase of 23% outperformed the overall industry increase of 15%.

We continue to be very proud of the work our local team has done, and are well positioned to take full advantage of the recovering market.

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

John?

John C. Rickel

Thank you, Earl, and good morning, everyone. For the first quarter of 2018, our net income increased \$3 million or 9.2% over our comparable adjusted 2017 results of \$35.8 million. On a fully diluted per share basis, earnings increased 11.1% to \$1.70, yet another record first quarter result. While there were no non-GAAP adjustments for the first quarter of 2018, the 2017 results excluded \$1.1 million of non-recurring net income recognized from an OEM legal settlement. Also, on January 1, 2018, the company adopted ASC 606 for revenue recognition which impacted F&I and aftersales revenue and gross profit. The net impact of this adoption in the first quarter was a reduction in net income of approximately \$450,000 and an EPS of about \$0.02.

Starting with the summary of our quarterly consolidated results. For the quarter, we generated \$2.9 billion in total revenues, which was a 13.5% increase over the prior year. Our gross profit increased \$36.2 million or 9.4% from the first quarter a year ago to \$419.8 million. As percent of gross profit, SG&A increased 130 basis points to 77.3%. The increase is more than explained by the \$3 million one-time bonus and \$3 million of quarterly strategic initiative costs that were mentioned in the March press release.

Floorplan interest expense increased by \$2.1 million or 18% from prior year to \$14.1 million. Two-thirds of this increase is attributed to a higher LIBOR interest rate versus the first quarter of last year. Other interest expense increased \$1.8 million or 10.7% to \$18.8 million, primarily due to increased mortgage and other borrowing. Our consolidated effective tax rate for the quarter was 22.4%, which should be lower than our full-year rate due to the first quarter being more heavily weighted towards the UK. We forecast our full-year 2018 tax rate to be between 23% and

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24%.

Turning to our consolidated liquidity and capital structure, as of March 31, we had \$33.1 million of cash on hand and another \$98.4 million that was invested in our floorplan offset accounts, bringing immediately available funds to a total of \$131.4 million. During the quarter, we repurchased 135,605 shares at an average price of \$67.83 for a total of \$9.2 million. As of today, we have approximately \$20.3 million diluted common shares outstanding and \$40.4 million remaining on our board authorized share repurchase program.

Also during the first quarter, we used \$5.5 million to pay dividends of \$0.26 per share, an increase of 8% per share over the first quarter a year ago and an annualized yield of over 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.

I'll now turn the call back over to Earl.

Earl J. Hesterberg

Thanks, John. Related to our corporate development efforts, the company was pleased to have previously announced the March edition of five Mercedes-Benz franchises in the UK that will generate approximately \$260 million in annual revenues. These are our first Mercedes-Benz franchises in the UK and expand our total Mercedes-Benz exposure to 13 dealerships across the U.S., UK, and Brazil.

We also previously announced the April purchase of a Toyota franchise in Brazil that will generate approximately \$45 million in annual revenues and will also provide us with the opportunity to further expand our Toyota presence, with additional open points to be announced at a future date. These six dealerships bring our total 2018 year-to-date acquisition activity to 12 franchises, generating \$405 million of annual revenues.

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

Q&A

Operator Thanks. We will now begin the question-and-answer session. [Operator Instructions] Our first question today comes from John Murphy with Bank of America. Please go ahead.

<Q - Aileen Smith>: Good morning, guys. This is Aileen Smith on for John. First question...

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

<Q - Aileen Smith>: Good morning. First question on what has been the hot button lately, used GPUs. A few weeks ago, you cited market tightness and other initiatives that drove used GPUs down about \$200 year-over-year in January and February. Did this ease in any way in March or following the quarter, or should we still expect some pressure through at least some part of this year?

<A - Earl J. Hesterberg>: We saw it improve in March. And it's too early to call April obviously, but we did see quite an improvement in March, and we're pleased with the March result.

<A - John C. Rickel>: Yeah. This is John.

<Q - Aileen Smith>: Great.

<A - John C. Rickel>: I would add to that that the \$200 that we communicated for kind of January, February that was total used gross profit per unit. And if you noticed, we ended up only down about \$122. So definitely, we saw some bit of improvement in March.

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<Q - **Aileen Smith**>: Okay. And on the SG&A performance in the quarter, I appreciate the commentary in the press release and what you'd noted before with the onetime employee bonuses and the costs associated with those strategic initiatives. Is it fair to assume that excluding these costs, you would have leveraged SG&A in the quarter on stronger same store sales growth?

<A - **John C. Rickel**>: Yes. Absolutely. If you take those two items out, we would have actually had about a 60% flow through. So we're actually pretty happy with the overall base cost control.

<Q - **Aileen Smith**>: Okay. Understood. And last question, would you characterize the more aggressive acquisition activity in the quarter as being indicative of a more robust pipeline or rather just your willingness to pull the trigger on deals? I know the two go kind of hand in hand, but I'm wondering how we bracket, how much of its driven by your capital allocation strategy versus what could be valuations in the private markets maybe looking a little bit more attractive than they did a year or so ago?

<A - **Earl J. Hesterberg**>: This is Earl. I would say the activity we've had this year is more circumstantial than related to any kind of market environment. For example, the UK Mercedes franchises and entering the Mercedes network in the UK, we've been working on that for two years to three years. It just happened to come good in the first quarter of this year.

And the other acquisitions were also opportunistic. We've been looking at those markets for some period of time, and it just so happened we found some pieces that fit our return hurdles and our strategic desires.

At the moment, in terms of capital allocation and for the past couple months, I would say the math is most compelling in terms of capital allocation for us to repurchase shares. It doesn't mean that we [ph] will (00:21:51) stop acquisitions. We'll continue to look for things that are in geographies that are important to us and that we believe have long-term value to our shareholders.

<Q - **Aileen Smith**>: Great, that's very helpful. Thanks for taking the questions.

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

Operator

Next question today is from Rick Nelson with Stephens. Please go ahead.

<Q - **Rick Nelson**>: Thanks, and good morning. So, to service and parts capacity additions that you talked about, was pretty well interesting. How do you see that ramping and what's the ultimate opportunity here in terms of capacity?

<A - **Daryl A. Kenningham**>: We'll, we are – Rick, good morning, Daryl. We're – 65 is sourced through our new work schedule out of 117. We won't roll the new work schedule to all of the stores just because some of them are too small. But we expect to have that fully rolled out by certainly the third quarter. And with that comes the capacity that we indicated. Much of that capacity ends up in Saturday business. And so, I would expect by late this year, we'll be able to realize that capacity.

<Q - **Rick Nelson**>: Got you. And at what point do you see these new initiatives? Obviously, you're spending money upfront. At what point do the new strategies become accretive to your EPS?

<A - **John C. Rickel**>: Yeah, Rick. This is John. I think certainly, first quarter and into the second quarter, you're still in the [ph] comp space (00:23:41). As Daryl indicated, we're still rolling these things out. It takes a little while to get the people in and get them trained. But I think, certainly as you get into the second half, we should be able to start to offset the cost and then probably late this year and into early next year, they probably start to become accretive.

<A - **Daryl A. Kenningham**>: Rick, one thing to add. Earl mentioned a couple of things in his comments that we are seeing better retention with our service advisors as a result, we believe, of our new work schedules and our increased training efforts. And we're seeing – we saw some decent same-store sales growth in used car businesses this quarter. So

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we believe we're starting to see indications [ph] as well (00:24:25) – we're pleased with.

<Q - Rick Nelson>: Okay. And, finally, if I could ask; one of your peers had talked about some costs related to hail damage that they'll incur in 2Q. You've got a lot of stores that are also in those markets. Any commentary along those lines would be helpful.

<A - Earl J. Hesterberg>: Yeah. Hi, Rick. It's Earl. Yeah. We had some serious hail damage in North Texas and also in Shreveport, Louisiana. And it looks like the cost to our company of that damage will be about \$3 million.

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

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

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

Operator

Next question comes from Derek Glynn with Consumer Edge Research. Please go ahead.

<Q - Derek J. Glynn>: Yeah. Thanks for taking my question. This is Derek on for Jamie. F&I PVR continues to be a source of strength. Could you just speak more to what's driving this? And also from a modeling perspective, if there is a range we should be expecting for the rest of the year? I believe in prior calls you mentioned a mid-\$1,600 range from PVR. Just wondering if that's changed at all. Thanks.

<A - Peter C. DeLongchamps>: Yes, Derek. This is Peter DeLongchamps. And I'd like to thank all F&I teams in all three countries are doing a terrific job this past quarter. And at the end of the day, we keep working on the underperforming stores and its paid dividends, and we're doing a much better job of selling products. And I think the mid-\$1,600 PVR is probably a good modeling number moving forward. We got rising interest rates and with our stated plan to increase the used car business, I think that's a good number for you to continue modeling towards.

<A - John C. Rickel>: To clarify – this is John Rickel – that is a U.S. number. Obviously, we have improving results in the UK and Brazil, but they are not those – the number Pete gave you is for U.S. only.

<Q - Derek J. Glynn>: Okay. Thank you. That's helpful. And then just secondly, can you speak more to what you're seeing in Texas, Oklahoma in terms of same-store trends, given the rally you've had in energy prices? What are you seeing in local economies there? Thanks.

<A - Earl J. Hesterberg>: This is Earl. Yeah. We finally are starting to see a brighter picture in the energy-related markets. Of course, the core of that is Houston, where so many of these energy companies are headquartered. I would – the sentiment in consumer confidence are definitely improving and our sales performance in our oil-related markets definitely improved in Q1, I think about 5% in Houston and a little bit more than that in a couple of the other oil-related markets.

I wouldn't say there's been a heavy amount of hiring that's occurred yet, but we believe that's just in the early stages that they'll start to be adding back some of these higher paid energy jobs.

So, things are really much brighter in the oil patch now, and probably the brightest they've been in three years.

<A - Daryl A. Kenningham>: Probably in Texas. Oklahoma is still a little bit under pressure.

<A - Earl J. Hesterberg>: Yeah, more so in Texas than Oklahoma. That's a good point to make.

<Q - Derek J. Glynn>: Got it. All right. Thank you.

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[Operator Instructions] Our next question comes from David Lim with Wells Fargo Securities. Please go ahead.

<Q - David H. Lim>: Hi. Good morning. Just something a little bit more strategic. With your – the amount of dealerships that you have in the Texas zone, does it make sense to consolidate like refurbishment activities under one roof, like a centralized refurbishing center? And then, you guys ever consider like a non-negotiable used vehicle pricing model, something similar to like a CarMax? And then I have one follow-up.

<A - Earl J. Hesterberg>: Yeah. Hey, David. It's Earl. Yeah, we've considered both of those. We've toyed around with it a little bit. I wouldn't say we're ready to do the regional or market recon yet. It's very time-critical to get these cars front-line ready and photos taken and all of that within 24 hours if you can. So that is a potential area for improvement at some point, but we haven't pulled the trigger on that yet but it's certainly valid food for thought. And what was the second...

<A - Daryl A. Kenningham>: One price on used.

<A - Earl J. Hesterberg>: One price on used. Yeah, I think for 20 years now, I've watched one price working. And clearly, the only place it seems to work well, CarMax has done a good job with it. But we just haven't seen very many success stories with that because the market is so dynamic. And one of the ways we manage our inventory quite well – and don't even know that we've even had more than 35 days or 36 days of supply of used cars is, we price these cars maybe not daily but every couple of days because of the market's dynamic and we need to keep the inventory clean. So, one price is still something that we think is difficult to implement effectively for us. But clearly others in the market do it; we'll keep an eye on it, and you never say never.

<Q - David H. Lim>: Understood. And then – I guess is a two-part follow-up. One on your U.S. sales outlook. It seems like SAAR was definitely stronger in Q1, and I guess it was some level of fleet that was involved. And then secondly, to follow up on my very first question, would you guys also think about developing your own like auction model, again given your density in the Texas area? Thank you.

<A - Daryl A. Kenningham>: David, did you – this is Daryl, did you say auction model?

<Q - David H. Lim>: Yes, yes.

<A - Daryl A. Kenningham>: We have an internal auction that we do weekly, and I assume from your question you mean, would we consider doing something external?

<Q - David H. Lim>: Yes, correct.

<A - Daryl A. Kenningham>: We look at all of those things on a regular basis, and as Earl just mentioned, never say never, but I wouldn't say that's something we'd be looking at in the next year or so. But we're trying to leverage the internal auction as much as we can ourselves. And then on the SAAR, I think we're – even with the relatively strong March, I think we're probably safe sticking with our original SAAR forecast for now.

<A - John C. Rickel>: Yeah. David, we are on [ph] 16.8 (00:31:09). We'll watch as the year progress. Obviously the first quarter ran a bit better than that, and we certainly saw a very strong March, but it's a bit choppy. The first two months were pretty weak. The unknown is, how much this tax piece is going to play into the rest of the year.

<A - Daryl A. Kenningham>: And also, David, the inventories, as we mentioned, are down considerably from a year ago. And so the OEMs have adjusted production well in general. And so there's not as much inventory pressure as there was a year ago to chase volume.

<Q - David H. Lim>: Understood. Thank you so much.

Operator

This will conclude our question-and-answer session for today. I'd like to turn the conference back over to Earl Hesterberg for any closing remarks.

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Earl J. Hesterberg

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

Operator

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

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