Q2 2018 Earnings Call

Company Participants

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

Other Participants

- Aileen Smith
- Michael Patrick Ward
- Rick Nelson
- James J. Albertine

MANAGEMENT DISCUSSION SECTION

Operator

Good morning, ladies and gentlemen. Welcome to Group 1 Automotive 2018 Second 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, Nicole, 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 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 provision 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 on today's call, 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

Vice President and Corporate Controller. Please note that all comparisons in the prepared remarks are of the same prior-year period unless otherwise stated.

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

Earl Julius Hesterberg

Thank you, Pete, and good morning, everyone. I'm pleased to report that Group 1 earned $50.8 million of adjusted net income for the quarter. This equates to record quarterly adjusted earnings per share of $2.45 per diluted share, an increase of 31% over prior year, driven by significant revenue and gross profit growth in addition to strong expense control. Total revenue increased 9% on a constant currency basis to the second quarter record of $2.9 billion.

The quarter benefited from a relatively strong U.S. vehicle market in June and some favorable year-over-year new vehicle sales comparisons in the UK where the overall new vehicle sales environment remained weak due to uncertainty surrounding Brexit. Our company also benefited from our corporate-wide focus on our used vehicle business, as well as initiatives to grow our UK aftersales operation. Additionally, a major cost reduction initiative in both the U.S. and UK early this year paid dividends in our second quarter results.

Turning to our business segments, during the quarter, we retailed over 43,000 new vehicles. Total consolidated new vehicle revenues increased 7% on a constant currency basis, driven by a 6% increase in unit sales. Consolidated new vehicle gross profit was up 2% on a constant currency basis. This gross profit per unit decreased 4% due to both the mix effect of our UK acquisitions and pressure on luxury brand margins in the UK.

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 sales, which accounted for 24% of our new units; VW/Audi represented 14%; BMW and MINI represented 12%; and Ford represented 11% of our new unit sales.

During the quarter, we retailed over 38,000 used retail units, driven by an extremely strong performance in the U.S., as well as good growth in the UK. Total consolidated used vehicle revenues grew 15% on a constant currency basis as we sold 12% more units and the average used vehicle selling price increased 3%. Used vehicle gross profit increased 14% on a constant currency basis as the unit increase combined with the total used vehicle gross profit per unit increased 2%. The used volume and per unit margin increase were the result of our corporate-wide focus in this area of our business and especially our new Val-u-Line initiative in the U.S.

Total consolidated parts and service revenue increased 7% on a constant currency basis, driven by increases in customer pay of 10%, wholesale parts of 8%, collision of 5%, and warranty of 2%. Our U.K. aftersales business grew a remarkable 9.4% on a local currency basis.

Finance and insurance gross profit increased 8% on a consolidated constant currency basis. This growth was driven by an increase in retail units of 12%, partially offset by an F&I per unit decline of 4%. The F&I per unit decline reflects the mix effect of our UK dealership acquisitions and the impact of Val-u-Line used car volume in the U.S. that Daryl will cover next.

Now, turning to 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. quarterly results before I cover the UK and Brazil. Daryl?

Daryl A. Kenningham

Thank you, Earl. We were pleased with our used car performance and cost control in the U.S. in the second quarter. Same-store used vehicle retail unit sales were up 11% and total used vehicle gross profit increased 6%. Total same-store gross profit increased 1% and combined with improved adjusted SG&A leverage of 110 basis points, same-store adjusted operating income increased 5%. Our adjusted operating margin improved 20 basis points to 4.2%.

Val-u-Line retail unit sales increased to 10% of our quarterly used units during the quarter and was a contributing factor in our same-store used vehicle gross profit growth. In addition, we lowered our reliance on the used vehicle wholesale markets as our wholesale unit sales volume declined 26%. Our new internal auction process, more aggressive internal inventory transfer policies, improved reconditioning practices and more disciplined inventory management drove this trend. In addition to the 11% same-store sales increase, we increased our total used vehicle gross profit by $60 per unit, a nice improvement over the first quarter trend.

Val-u-Line transactions generated an incremental $1.1 million in F&I gross profit. The average Val-u-Line sale generated $390 of F&I income, which, while fully incremental, lowered our U.S. F&I PRU by $25, largely explaining the year-over-year decline in our F&I PRU. Our quarterly aftersales results were slightly lower than anticipated at a 2% increase in same-store gross profit. The results were negatively impacted by a 6% decline in warranty gross profit, which could be primarily explained by the lapping of the Takata airbag recall campaigns. Both collision and wholesale parts gross profit increased 4%, while customer pay increased 3% on a same-store basis.

We continue to roll out our four-day workweek initiative and are very pleased with our aftersales growth in the 31 stores where it's been fully implemented. To support this initiative, we'd increased our training capacity, a Group 1 Service Advisor University by 50% and also launched a Service Manager University.

Lastly, I would like to recognize the efforts of our team controlling costs. As I mentioned, adjusted SG&A as a percentage of gross profit improved by 110 basis points from the prior year to 70.3%. Our relentless focus on costs must continue as the new vehicle environment is very competitive in volume and margin. In addition, the largest – the large recall on warranty volumes appear to be plateauing or declining.

Before turning the call back over to Earl, I'd like to thank the 9,600 teammates in our U.S. stores for their great work. Earl?

Earl Julius Hesterberg

Thanks, Daryl. Our UK operations continue to perform very well in a challenging overall market environment dominated by discussions regarding Brexit. Since the beginning of 2016, we have increased our UK dealership count from 17 stores to 47 stores and are on pace to generate $2.7 billion in annual revenues. We're now a top 10 dealer group in the UK.

Continued operating improvements across all of our stores and extremely strong performance by our Audi and Ford businesses resulted in another quarter of very meaningful same-store profit growth. Total same-store gross profit growth of 6% on a constant currency basis was driven by increases in F&I of 15%, total used vehicles of 11% and aftersales of 10%. These increases were partially offset by a 9% decline in new vehicle gross profit due to the margin decline I mentioned earlier.

Leveraging our scale, assimilating our recent acquisitions, and the major cost reduction initiative also resulted in lower SG&A as we reduced adjusted SG&A as a percent of gross profit by 140 basis points from the prior year. We expect continued progress in this area as we further rationalize our cost base and standardize business practices to take full advantage of the scale we've built in the UK.

Now, turning to Brazil, which despite significant business disruption from a 10-day truck driver strike, generated a 5% same-store revenue and 2% same-store gross profit growth on a local currency basis. Aftersales was most impacted by the strike as the shops were unable to recover lost service business due to finite stall capacity. As a result, aftersales gross profit declined 1% on a same-store local currency basis.

We would expect this to be a one-time issue and should return to generating significant same-store gross profit growth in the third quarter. Despite the disruption, the team was able to both increase gross profit and leverage SG&A by 280 basis points resulting in strong bottom line growth. 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 second quarter financial results in more detail.

John?

John C. Rickel

Thank you, Earl. Good morning, everyone. For the second quarter of 2018, our adjusted net income increased $11 million or 27.6% over our comparable 2017 results to $50.8 million. These 2018 adjusted quarterly results exclude $5.7 million of net after-tax income consisting of $15.2 million of net income associated with dealership and real estate dispositions, partially offset by $9.5 million of charges related to multiple hailstorms, asset impairments related to a held for sale dealership operation, and acquisition-related legal items.

On a fully diluted per share basis, adjusted earnings increased 31% to $2.45, an all-time quarterly record. For the quarter, we generated $2.9 billion in total revenues, which was a 10.2% increase over the prior year. Our gross profit increased $33.3 million or 8.2% from second quarter year ago to $438.2 million. As a percent of gross profit, adjusted SG&A decreased 50 basis points to 73%. On a same-store basis, adjusted SG&A declined 110 basis points to 72.3%, reflecting strong improvements in each of our three markets.

Floorplan interest expense increased by $1.3 million or 10.1% from prior year to $14.6 million, reflecting higher LIBOR interest rates versus the second quarter of last year. Other interest expense increased $2.1 million or 12.1% to $19.4 million due to increased mortgage and other borrowings.

Our consolidated effective tax rate for the second quarter was 24.5% and year-to-date it is 23.9%. We forecast our full-year 2018 tax rate to be between 23.5% and 24%.

Turning to our consolidated liquidity and capital structure. As of June 30, we had $41.6 million of cash on hand and another $144.1 million that was invested in our floorplan offset accounts bringing immediately available funds to a total of $185.6 million. During the second quarter, we repurchased 610,752 shares at an average price of $68.90 for a total of $42.1 million. In July, we repurchased an additional 367,773 shares at an average price of $67.98 for a total of $25 million.

Year-to-date through today, we have repurchased 1,114,130 shares at an average price of $68.46 for a total of $76.3 million. These repurchases totaled 5.5% of our beginning of the year share flow. As of today, we have approximately $19.4 million diluted common shares outstanding and $73.4 million remaining on our board authorized share repurchase program.

Also during the second quarter, we used $5.3 million to pay dividends of $0.26 per share, an increase of 8% per share over the second 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.

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

Earl Julius Hesterberg

Thank you, John. Related to our corporate development efforts, the company was pleased to have previously announced the second quarter 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. This acquisition brought our total 2018 year-to-date acquisition activity to 12 franchises generating $405 million of annual revenues.

Also in Brazil, the company is pleased to announce the July relocation of the São Paulo Honda franchise. The new facility, which is owned by the company, will allow for a significant uplift in new, used and aftersales business. We're excited about the further expansion of our Brazilian operations as we continue to grow scale in the market.

During the quarter, we also disposed off a Mercedes-Benz franchise in California that generated $95 million in trailing 12 months revenue and terminated the BMW franchise in the UK that generated $20 million in trailing 12-month revenue. Both of these dispositions are consistent with our strategy of disposing of underperforming assets and redeploying capital in ways that are beneficial to our shareholder. We'll continue to assess our capital allocation priorities by comparing the acquisition market to our common stock valuation.

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

Q&A

Operator

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

<Q - Aileen Smith>: Good morning guys. This is Aileen Smith on for John. Thanks for taking the question. You drove some pretty notable SG&A leverage in the quarter despite what was still somewhat muted same-store sales growth, particularly in your new and your parts and service business. Should we be assuming that this type of performance on SG&A is sustainable, and is there a rule of thumb we should be thinking about in terms of same-store sales where you're typically able to leverage SG&A off the back of them?

<A - John C. Rickel>: Yeah, this is this is John Rickel. We do think that the improvements that the team have made are sustainable. And normally, we would expect somewhere on a 40% to 50% flow-through of any gross profit growth that we would deliver.

<Q - Aileen Smith>: Okay. That's very helpful. And one of your peers has obviously been fairly aggressive on asset dispositions over the past year or so and another one indicated yesterday that they're taking a hard look at some of their assets and may look to rationalize underperformers, and I appreciate the commentary you just made earlier on some of the dispositions you made in the quarter, but how aggressive could you get on this front and how material could it possibly be you to the SG&A leverage into the bottom line for you guys?

<A - Earl Julius Hesterberg>: This is Earl. Yeah, we have more disposition work to do. I wouldn't see it as a major lever for SG&A, and I would see it more as a consistent effort. These things take time, but we have some more disposition work to do. And given our current capital allocation approach and strategy, I think you'll see more dispositions than acquisition quite frankly.

<Q - Aileen Smith>: More acquisitions than dispositions?

<A - Earl Julius Hesterberg>: No, [ph] prefer (19:29) some more disposition than acquisitions.

<Q - Aileen Smith>: Great, that's very helpful. And last question, obviously, one of your peers pre-announced a few weeks ago and cited pressure on new vehicle growth is related to automakers in particular. As you have a fair amount of exposure to both BMW and Honda, can you provide some commentary maybe on what you're seeing, if it's similar pressure from these OEMs? And if so, how you've been able to offset that with your growth is coming down in the quarter, but not as substantially as one might assume?

<A - Earl Julius Hesterberg>: Yeah, this is Earl. Yeah, I believe that the two automakers were BMW and Honda. And, yes, we did experience the same situation on BMW. We had a significant margin pressure and a bit less on Honda. We also had margin pressure quite a bit on BMW in the UK. But we – we're able to offset that with some better margin performance in the U.S. in both domestic brands and Toyota. I don't know if Daryl has anything to add to that.

<A - Daryl A. Kenningham>: No. That's exactly right.

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

Operator

Our next question comes from Michael Ward of Williams Trading. Please go ahead.

<Q - Michael Patrick Ward>: Thanks very much. Good morning, everyone.

<A - Earl Julius Hesterberg>: Good morning.

<Q - Michael Patrick Ward>: Two things. First of all, I think back in March when you announced the used vehicle strategy and your service strategy, you mentioned some of the costs would continue into the second quarter. Did you still have some costs and are those largely behind you?

<A - Daryl A. Kenningham>: We did have some costs. Some of those are related to staffing, which we look at as a positive thing because it's – the change in the worse schedule has enabled us to staff which was one of our limiters and been able to grow our aftersales growth. But we did have some in the second quarter, but we expect that that will moderate as it [ph] goes forward (21:23).

<Q - Michael Patrick Ward>: Okay. And it looks like the used car focus has certainly paid off pretty quickly in the service side. Are you seeing similar-type benefits?

<A - Daryl A. Kenningham>: We're seeing similar benefits in service. This is Daryl by the way. We're seeing similar benefits in service. We are adjusting our rollout a little bit to ensure that we have our technicians and our advisors in sync on the new schedule. So, we're seeing improvements in retention and customer satisfaction and, in some cases, customer pay improvement.

<Q - Michael Patrick Ward>: Second thing, can you provide any color on what's happening in the markets in Texas in particular, but also Oklahoma? From what I can tell, those two regions combined were up 1% or so. And do you hope – just can you provide any color where the market is, what's happening and was there anything in particular that went on?

<A - Earl Julius Hesterberg>: Yeah. Mike, this is Earl Hesterberg. Yes, quite surprisingly, I think that some people – our quarter had no meaningful benefit from that low batch. So, generally speaking, sales have not recovered there yet. For example, our sales in Houston, which is by far our biggest market, were down 1.5% for the quarter. I think along in the Gulf Coast, they were down 7%. The only exception to that is West Texas, Lubbock, Amarillo, that area. They're somewhat close to the Permian Basin where there's a lot more drilling activity. So, I think there's been a lot more jobs and a lot more people out there. But when you look at the core oil patch like Houston, Beaumont, San Antonio, we're still backwards year-over-year on new vehicle sales there, and that's again some fairly weak comps.

Although, I will tell you the consumer sentiment, consumer confidence is increasing an awful lot. The jobs that tend to be in Houston and in the heart of the oil patch are frequently headquarters and support jobs, and that hiring has not yet really been significant. We think it will follow and at some point we'll get back to some strength that will lap some fairly weak comps, but we really did not have any material new vehicle sales benefit from the oil patch. Oklahoma was also down several percentage points in sales for the quarter.

<Q - Michael Patrick Ward>: Okay. So both – that region could be a tailwind as we go second half and into 2019 [indiscernible] (23:57)?

<A - Earl Julius Hesterberg>: Yes indeed. We would expect that to eventually become a tailwind. This was not in the second quarter. I think it's important to clarify that for people.

<Q - Michael Patrick Ward>: Beautiful. Thank you.

Operator

Our next question comes from Rick Nelson of Stephens. Please go ahead.

<Q - Rick Nelson>: Hey, thanks. Good morning, and congratulations. Like to ask you about the UK. Same-store results were quite strong over there both new and used. Is the outlook, Earl, is as you see it going forward?

<A - Earl Julius Hesterberg>: Rick, this is Earl. Yeah. I think some of the sales numbers may have presumed to peak a little bit at the moment in the UK because it's still a weak new vehicle market and it's all related to this uncertainty around Brexit. At some point, late this year and early next year, Brexit has to be clarified. It is a confusing subject to everyone, even people who follow it. But at some point, the UK is going to leave the EU and life will get back to normal and we think the car market will respond positively when that happens. It's somewhat amazing that we're able to do as well as we can. The second quarter comps for everybody, for the industry and dealer groups probably look a little better than they really are because of that tax change on April 1 last year, pulled a lot of business into March. So, the comps in April and May were a bit easier this year. But we benefited a lot from being able to integrate some recent acquisitions and really leverage some performance improvements plus our mature Audi and Ford businesses, those are just very strong brands in the UK and they continue to perform extremely well even in the weak new vehicle sales environment.

<Q - Rick Nelson>: [indiscernible] (26:05) in the UK, a very strong growth over there. Are you not seeing the warranty challenges that you see here in the U.S.?

<A - Earl Julius Hesterberg>: Not yet. Not yet, Rick. We're not seeing as much of that yet. They didn't necessarily have the same recalls and there are still some more diesel activity in the UK. I guess we'll eventually lap that too. But again, the UK had a strong – had a very strong period of sales growth for five years or so. So, there's a favorable units in operation profile even after a week of weak sales for more than a year.

<Q - Rick Nelson>: And finally, if I could ask about the new strategies that you've rolled into the service departments, in those 31 stores, iIf you could talk about the lift that you're seeing. I know you're adding capacity with those initiatives.

<A - Daryl A. Kenningham>: Sorry, Rick, this is Daryl. We've seen our growth in customer pay in those 31 stores is higher than our customer pay growth in the stores we've not fully rolled out. And so we're pleased with that, and see that as validation for rolling the remainder of our stores out through the rest of the year.

<Q - Rick Nelson>: Got you. Thanks a lot, and good luck.

<A - Daryl A. Kenningham>: Thank you.

Operator

[Operator Instructions] Our next question comes from James Albertine of Consumer Edge. Please go ahead.

<Q - James J. Albertine>: Great. Thank you, and good morning, everybody.

<A - Earl Julius Hesterberg>: Good morning, Jamie.

<Q - James J. Albertine>: Wanted to – first of all, [ph] nice perfume of the pig (28:00), I hadn't heard that one before. I really like that. That's right up there with that dog won't hunt. Great Texan slang. Listen, first of all, congratulations on a big beat. Want to talk a little bit about your strategy though, divesting being at the forefront of that relative to acquisitions. We all know how fragmented the market is right? We talked about consolidation for the dealer sector for some time. Can you maybe shed some light on what's changed? I mean, is there a perception that there's just lower quality out there or lack of strong managers to run these stores and is that really the driving force behind sort of this pivot to divesting and optimizing what you have versus trying to kind of grow over time and consolidate the market?

<A - Earl Julius Hesterberg>: Yeah. Sure, Jamie, this is Earl. What's changed is the map, all right, the multiple arbitrage between what our company and the companies in our sector quite frankly are trading at in terms of valuation and the cost of quality acquisitions probably more so in the U.S. than the UK. But that map has to work and it just doesn't seem to work very well for the types of acquisitions that we are interested in these days relative to brands and geographies and so forth. I would tell you that we'll still do acquisitions when we can find one that works, and we're paying something less than what we're trading at and is the right brand and have some consistency with our strategic approach going forward. But right now, the map says the best thing we can do is buy more of our own acquisitions and repurchase shares, and that map has become more clear over the last six to nine months.

<Q - James J. Albertine>: Okay. That's fair, and thank you for the detail. And then, if I may, a question on used. You had some very strong unit growth there, gave some margin up on a GPU basis. It looks like as well during the quarter. I wasn't sure if that was part of Mike's question earlier on the cost. [ph] It's somewhat like (30:16) a captured in COGS or not, but also just wanted to get a sense for where is used GPU going from here and how do we think about modeling that? If we can expect further volume growth in the back half as kind of late model supply comes back to market, stuff like that? Thanks.

<A - Daryl A. Kenningham>: Jamie, this is Daryl Kenningham. We expect to see growth in the second half of the year. I can't tell you it will be 11% same-store, but we feel like we'll see some growth. And we're working hard on the margin and we'll try to retain as much as we can. I think John might have something to add to that.

<A - John C. Rickel>: Yeah. Jamie, this is John Rickel. The one thing I would point out is, we have a deliberate strategy, which the team executed on quite well, of moving wholesale to retail. So, what I would encourage you to do is look at total used margin not retail margin because we moved 2,000 units from basically what is really low margin wholesale up into retail. And on a total basis, that allowed us to grow our total used margin by $60. So, we were actually up the way we think about it in the quarter, and I think those levels are sustainable. And the team is continuing to look for ways to improve, but I think for modeling, if you've got to run the levels that we ran this quarter is probably good for the rest of the year.

<Q - James J. Albertine>: Well, then, John, a point of clarification, if I may, and I apologize if you guys talked about this and I missed it. If we think about mix within your used volume, is there anything about a loaner vehicle that you decide to retail or an awfully slate model vehicle that you decide to retail that would be negative from a mix perspective on margin or am I over thinking it?

<A - Earl Julius Hesterberg>: This is Earl. No, you're absolutely correct. There's increasing...

<Q - James J. Albertine>: Okay.

<A - Earl Julius Hesterberg>: ...pressure from certain brands on our team to push more and more of these service loan vehicles at something less than an optimal time in mileage and so forth. So, that does put some downward pressure on our margin, let's say, compared to a couple years ago for those same brands. So, that somewhere in the mix, that is a factor.

<Q - James J. Albertine>: Well, thank you again, and best of luck.

<A - Earl Julius Hesterberg>: Thank you.

Operator

This concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

Earl Julius Hesterberg

Okay. Thanks to everyone for joining us today. We look forward to updating you on our third quarter earnings call in October.

Operator

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