Auto Dealerships Spring 2023

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INTRODUCTION

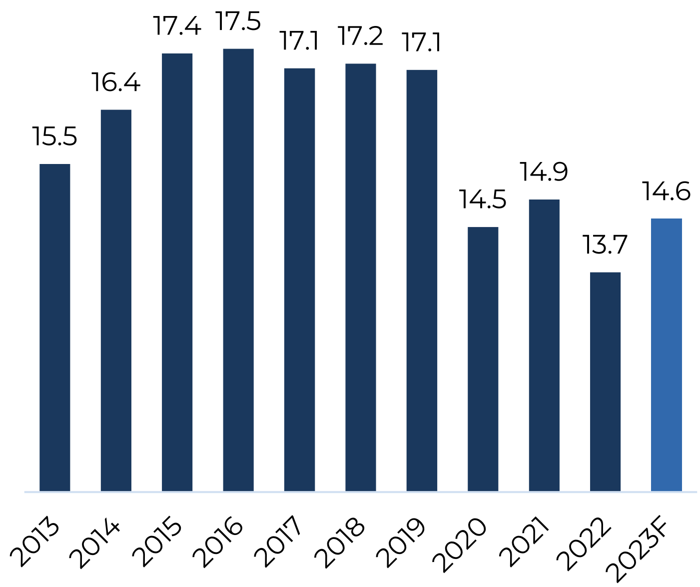
2022 was the peak year for dealership profits and this led to a historic level of dealership M&A transactions. However, overall dealership profit margins have begun deteriorating from the highs of 2022 due to declining unit economics in the face of increases in unit sale volumes.

Unit economics on the sale of new vehicles spiked in 2021 due to high demand, tight supply, and fewer incentives. By the end of 2022, deterioration in profit per new vehicle was evident and the trend has persisted in 2023. At the same time, new vehicle sales are forecasted to increase, but will it be enough to compensate for the lower unit economics?

Dealership M&A will likely continue at elevated levels in 2023, but macroeconomic factors including interest rate levels, credit availability, and inflation will create downward pressure on valuations. At dealerships, profit margins will be more relevant in valuations than in history. Dealerships that focus on enhancing margins through fixed operations, F&I sales, inventory management, and decreasing advertising costs will be best positioned to achieve the highest values for their brands and geography.

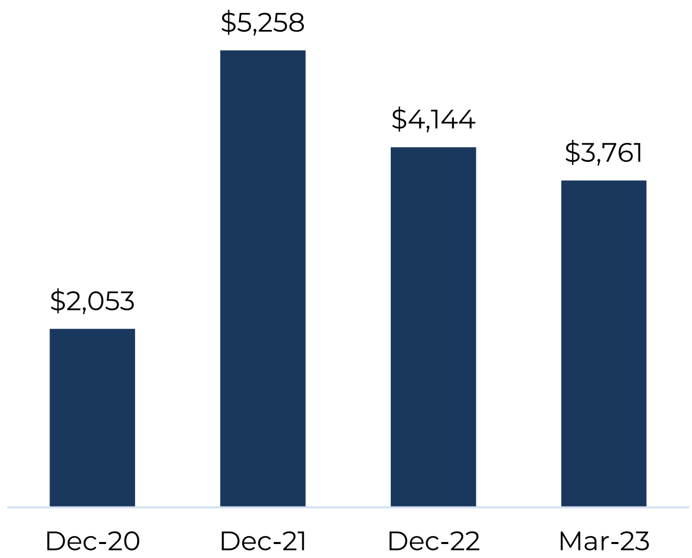
NEW VEHICLE SALES REMAIN LOW[1]

(units in millions)



TOTAL RETAILER PROFIT PER UNIT[1]

($ in actual)



[1]Source: NADA

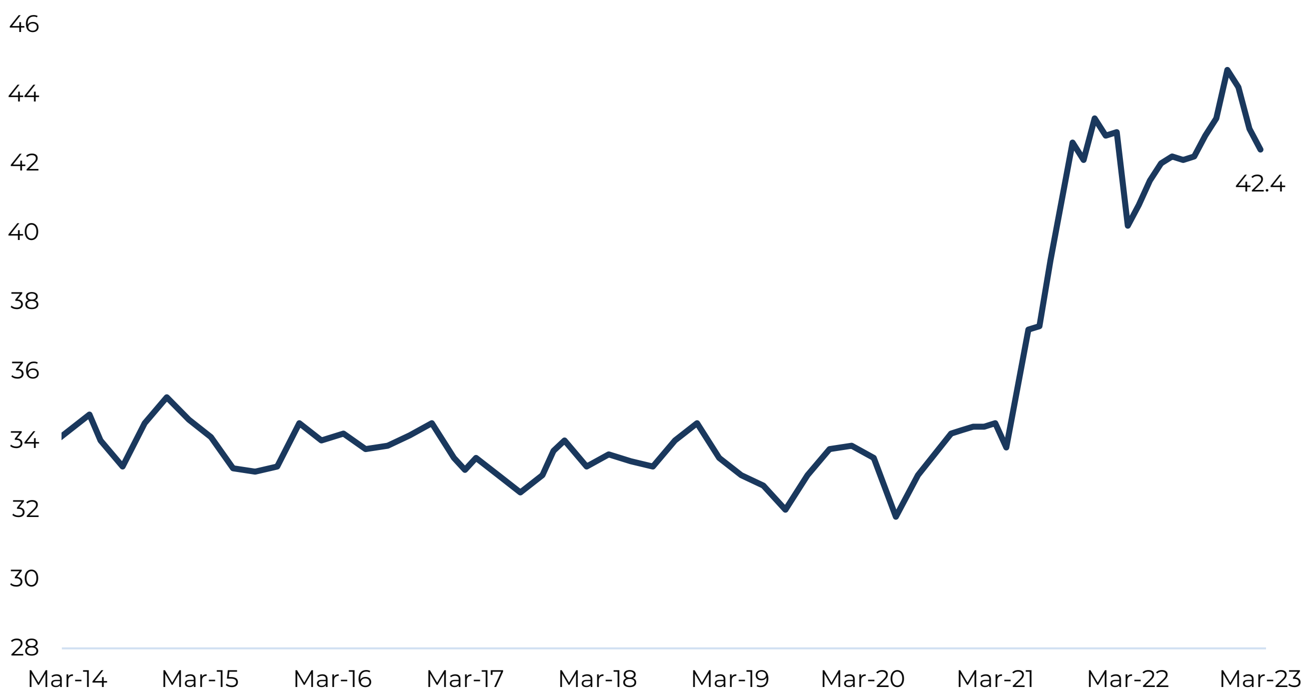
FIVE KEY TRENDS ARE IMPACTING DEALERSHIP ECONOMICS

1. Decreasing Affordability is Weighing on Unit Sales
2. Fixed Operations and Ancillary Sales Drive Profitability
3. Reinsurance: The Silent Profit Center
4. Marketing is Becoming More Expensive
5. Evolving Sales Models Provide Opportunity & Challenges

1 DECREASING AFFORDABILITY IS WEIGHING ON UNIT SALES

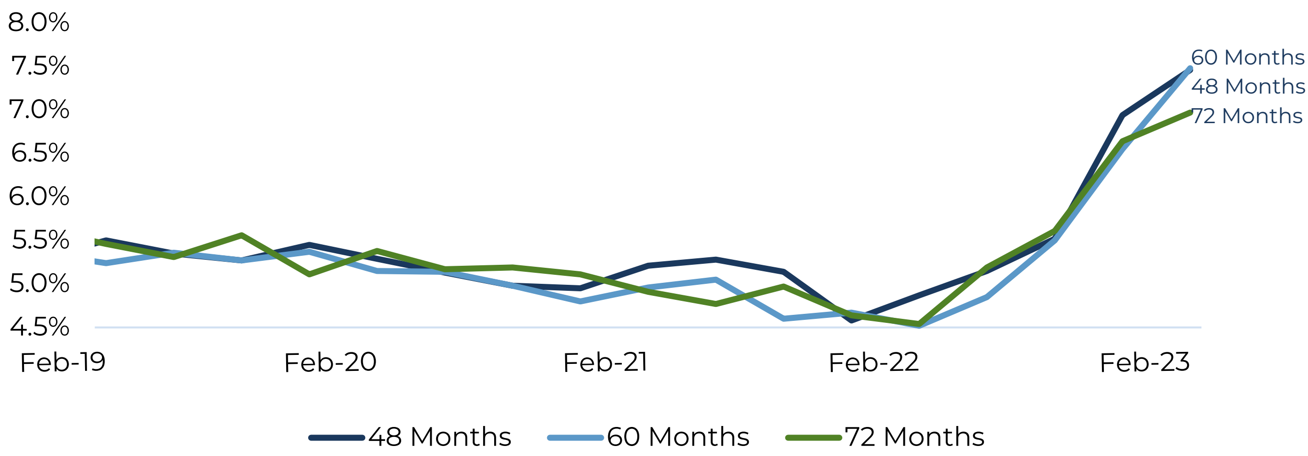
Vehicles are less affordable to the American car buyer than at any time in the last 11 years. Affordability has been impacted by the higher cost of vehicles due to scarcity and inflation, elevated interest rates on loans, and lower purchasing power of the average consumer. The Cox Affordability Index measures the number of weeks a consumer must work in order to purchase the average new vehicle. As of March, the average car buyer has to work 42 weeks to afford a new car, an increase of over 20% compared to the historical range of 32 – 36 weeks that was experienced from February 2012 to August 2021.

COX AFFORDABILITY INDEX

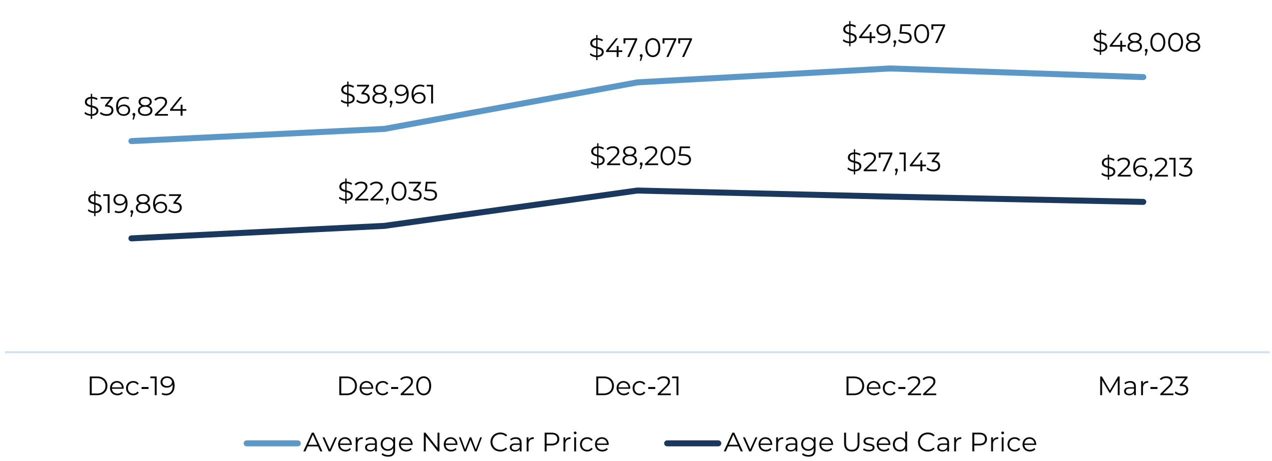


A significant driver of the decrease in affordability has been the increase in interest rates and the price of vehicles. The Federal Reserve raised the benchmark rate nine times since 2021, increasing the federal funds rate to 4.75% - 5.00%. As a result, auto loan interest rates have increased to 6.95% - 7.50% from 4.50% - 5.15% in late 2021. In March 2023, the average new car cost $48,008, a 30% increase over 2019 while average used cars increased 32% to $26,213. The increase has been due to the scarcity of vehicles and higher component costs. The growth in car prices has outpaced both inflation and wage growth, which each increased 19% from March 2019 to March 2023.

CONSUMER INTEREST RATES ON NEW AUTO LOANS[2]



AVERAGE CAR PRICE[3]

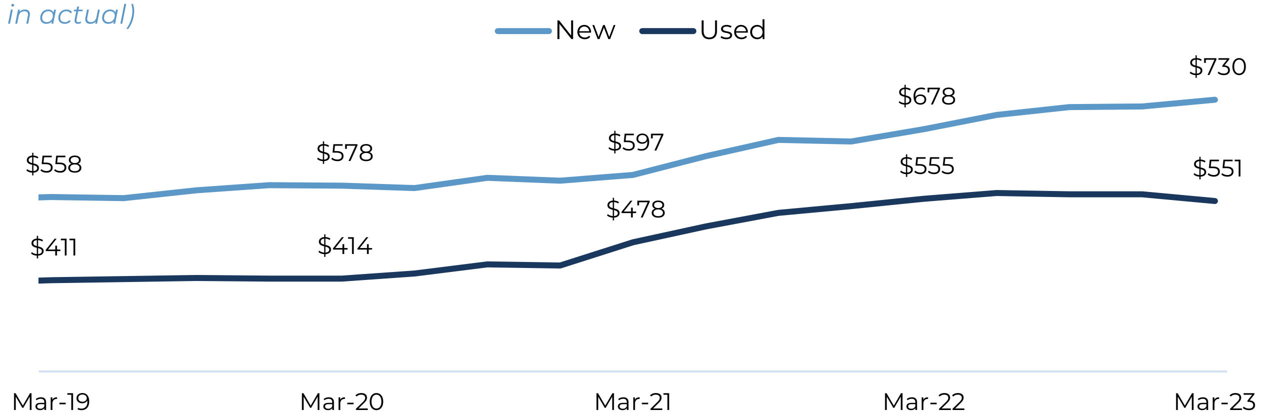


[2]Loans at commercial banks; Source: FRED
[3]Sources: KBB and Zebra

The increase in interest rates combined with higher new car prices has driven an 8% year-over-year increase in payments on new cars as of March 2023. Used cars experienced a small decline in price toward the end of 2022 and into early 2023 but, due to rising rates, experienced almost no change in payment amounts.

AVERAGE MONTHLY NEW AND USED CAR PAYMENT[4]

($ in actual)



As interest rates rise, affordability will continue to be strained, but improved supply-side dynamics could mitigate this burden on consumers.

[4]Sources: CBS, Edmunds, and Cox

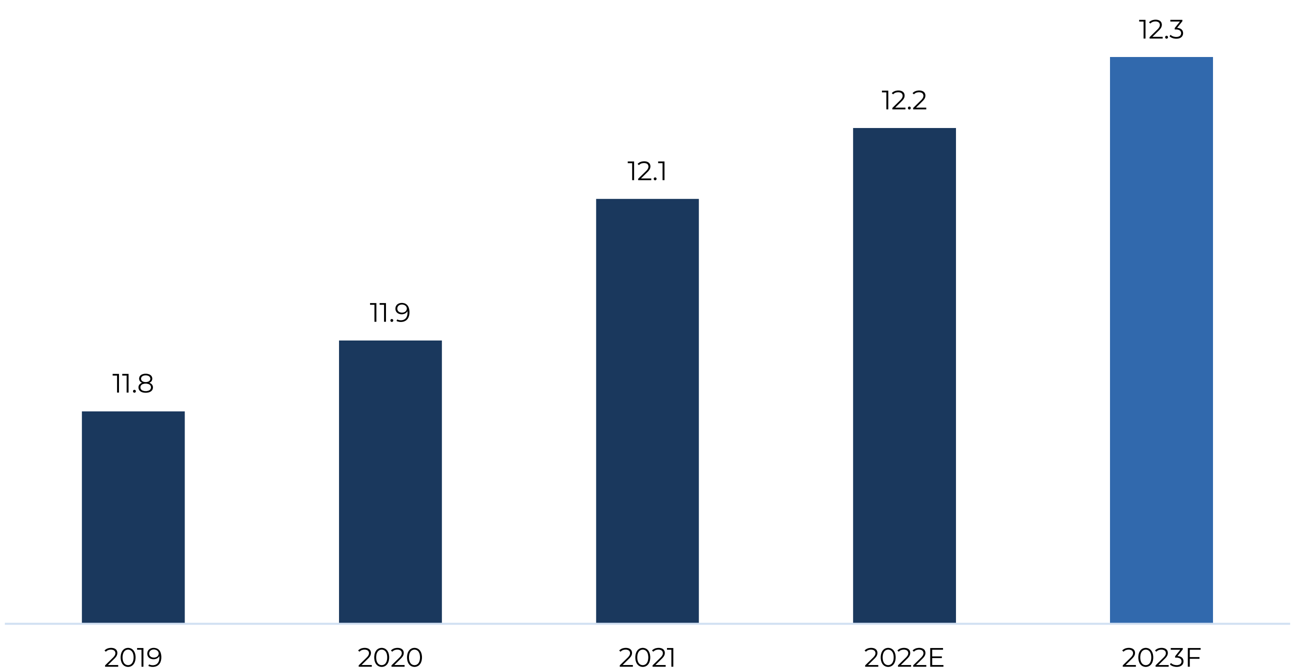
2 FIXED OPERATIONS AND ANCILLARY SALES DRIVE PROFITABILITY

Service lane and F&I revenue contribute 25% and 35% respectively to an average dealership's gross profit. These business lines will be even more important in 2023 and 2024 as increased inventory and low affordability will depress vehicle sales.

Owners are holding on to their vehicles longer creating a greater need for F&I products and service lane offerings. According to a survey conducted by Gfk, nearly a quarter of individuals shopping for a vehicle are likely to wait another 12 months due to affordability. The average age of passenger vehicles on the road is forecasted to reach 12.3 years in 2023. Simultaneously, vehicle miles driven has returned to pre-pandemic levels.

AVERAGE AGE OF VEHICLES ON THE ROAD[5]

(years)

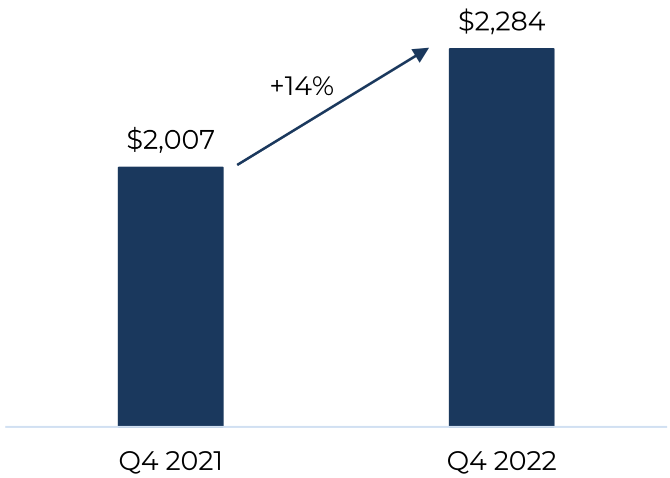


[5]Sources: Hedges Company

Dealerships earn roughly $6,000 of gross profit on the sale of a new vehicle itself (up 30% year-over-year as a result of high consumer demand). Additionally, dealerships can earn nearly $2,300 on selling a vehicle service contract (VSC) or other F&I products, significantly boosting profitability. Public dealerships have continued to focus on improving F&I product penetration to bolster profitability. In Q4 2022, the six public dealership groups earned an average of $2,284 of F&I profit per vehicle on a same-store basis, a 14% increase year-over-year.

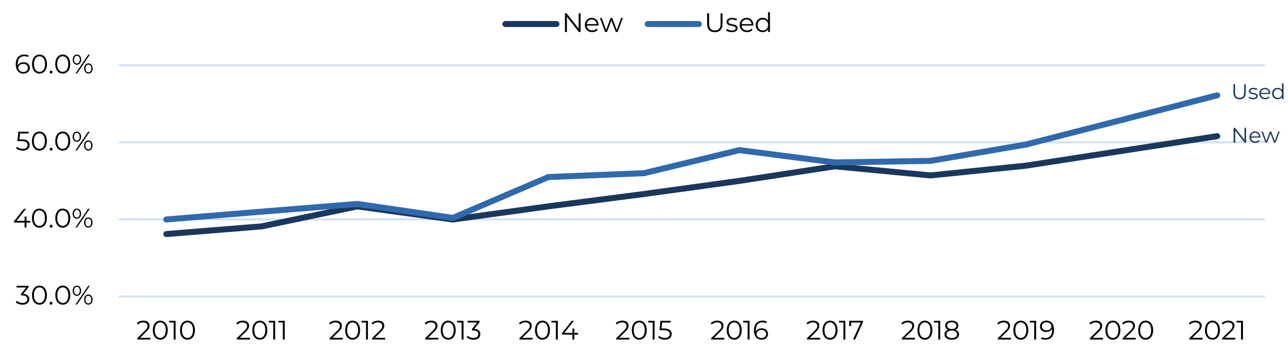
F&I GROSS PROFIT PER VEHICLE[6]

($ in actual; same store sales)



Dealerships have become more efficient at selling F&I products as well. Penetration rates for vehicle service contracts have significantly increased over the past several years. They reached all-time highs in in 2021[7] as low sales volumes from diminished demand during the peak of the pandemic pushed dealerships to optimize every sale and created an enhanced focus to promote F&I products. As inventory levels dropped and demand returned dealerships were able to generate enhanced F&I sales with pre-loaded packages and required bundles.

F&I Penetration Rates[7]



[6]Sources: Public Dealerships: AutoNation (NYSE: AN), Asbury Automotive Group (NYSE: ABG), Group 1 Automotive (NYSE: GPI), Lithia Motors (NYSE: LAD), Penske Automotive Group (NYSE: PAG), Sonic Automotive (NYSE: SAH)
[7]Per NADA; data unavailable for 2019 and 2020

COLONNADE'S F&I PROFITABILITY PER VEHICLE INDEX[8]

Through industry research and expertise, Colonnade has developed an index to track the average F&I profit per vehicle retailed across dealerships. The index is benchmarked on the December 2019 average F&I profit per vehicle as reported by dealerships to NADA. Post 2019, the index is based on the month-over-month change in average F&I profit per vehicle reported by dealerships to NADA and JM&A.

F&I profit per vehicle continued to increase until the second half of 2022. As of December 2022, profit per vehicle was down nearly 7% compared to one year prior. However, compared to two years prior, profit levels were up 45%. Market conditions, including elevated interest rates, inflated car prices, and inventory challenges, impacted F&I profit during late 2022 and are expected to continue to challenge F&I profits in 2023.

[8]Sources: NADA and JM&A

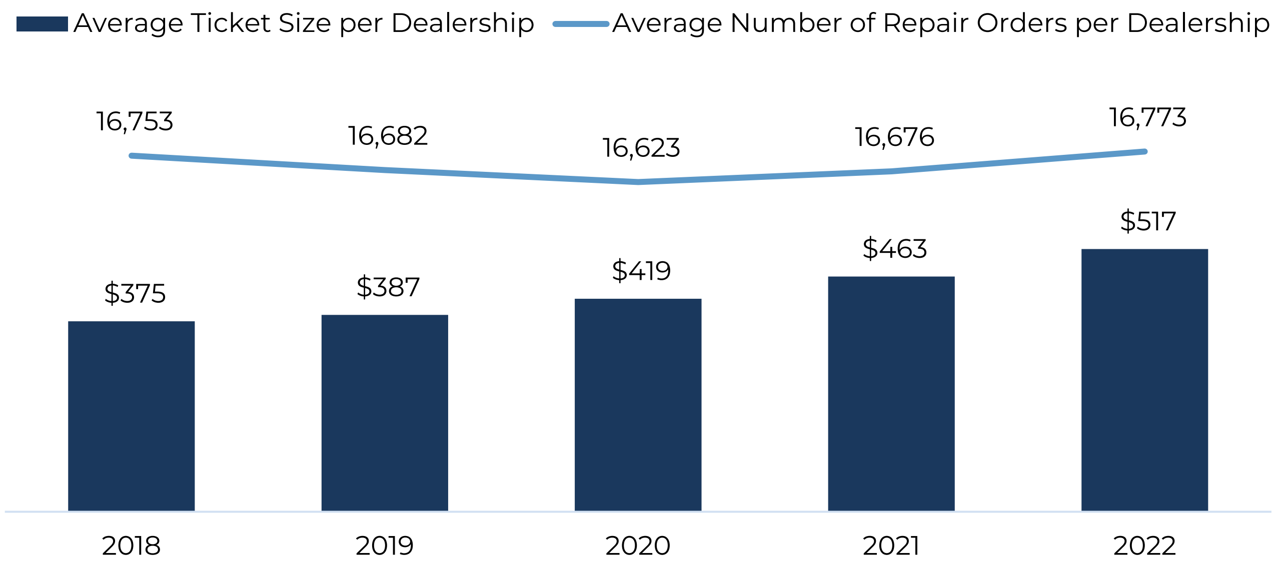
FIXED OPERATIONS

Decreasing affordability has led owners to maintain their current vehicles rather than purchase a replacement. This trend has caused an increase in fixed operations revenue as more consumers prioritized service on existing vehicles.

Fixed operations demonstrated strong revenue growth in 2022 as inflation and service needs resulted in increases in average ticket size while total service volumes recovered to 2019 levels. With retail sales expected to be flat or down, fixed operations as a profit center will become increasingly important.

TICKET SIZE AND ORDER VOLUMES AT ALL-TIME HIGHS[9]

($ and units in actual)



More dealerships are focused on generating revenue through the service lane. 52% have express service operations, compared to 40% in 2014.

We expect to see that the dealerships will spend more on marketing for the service lane.

[9]Source: NADA

3 REINSURANCE: THE SILENT PROFIT CENTER

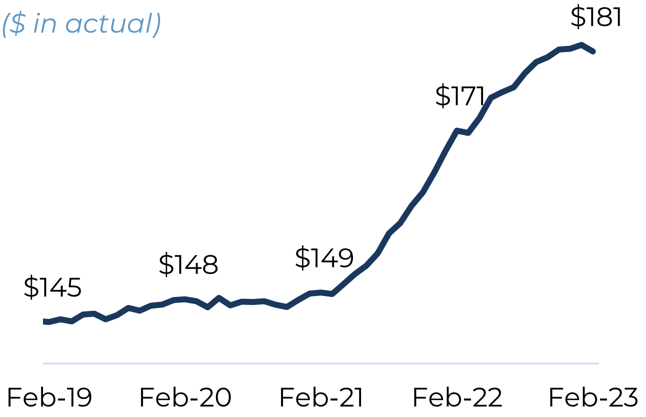
F&I sales and reinsurance can have a significant impact on dealership valuations, but the full profits may not be evident on the dealership's income statement. While F&I gross profit is included in dealership financials, reinsurance underwriting profit and investment income is often off-balance sheet. Dealership owners typically hold reinsurance positions outside of the dealership's legal entity. Buyers and sellers must carefully construct the transaction to recognize the value in reinsurance.

In a traditional buy/sell transaction, the seller retains the reinsurance program and receives multiple years of cash flow, while the buyer establishes new positions. However, significant earnings will not begin for several years. To determine the value of this cash stream, cash flow projections must be created and appropriately discounted for timing, uncertainty, and risk. Alternatively, the buyer could purchase the existing reinsurance entity along with the dealership assets, allowing the buyer to experience earnings in year one and reducing the uncertainty tied to establishing a new program. Regulatory approvals for this acquisition will take time.

In diligence, underwriting performance should be carefully evaluated. In 2023, many of the F&I contracts in reinsurance predate this inflationary period, causing higher loss ratios than prior years. The costs of claims have increased as dealership labor rates went up 13% and parts costs have increased 25% since 2019[10]. In addition, unrealized bond prices have created losses in portfolios. Buyers should consider normalizing investment income.

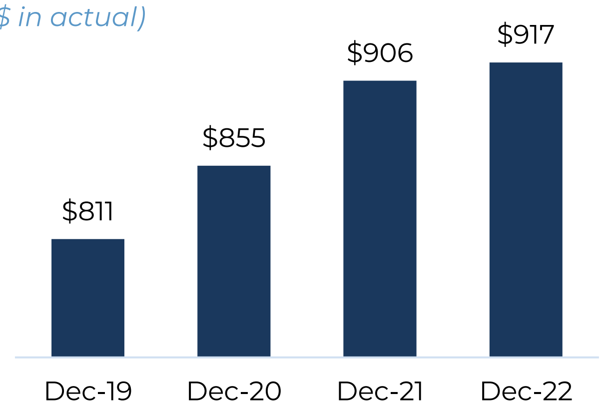
MOTOR VEHICLE PARTS AND EQUIPMENT COST CPI[10]

($ in actual)



AUTOMOTIVE SERVICE TECHS MEDIAN WEEKLY EARNINGS[10]

($ in actual)



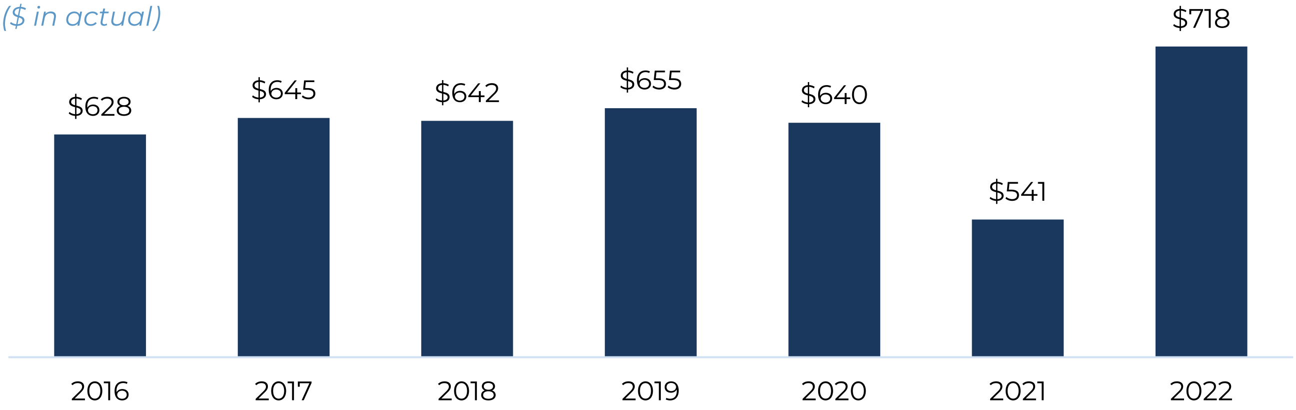
[10]Source: FRED

4 MARKETING IS BECOMING MORE EXPENSIVE

Cars are less affordable, and inventories are returning. Consequently, buyers are postponing purchase decisions and shopping around. To generate more traffic, dealerships must spend more effectively on marketing.

AVERAGE DEALERSHIP ADVERTISING COST PER NEW UNIT SOLD[11]

($ in actual)



Dealerships are spending more on advertising and each dollar is becoming less effective. Dealerships need to strategize around containing costs: savvy dealerships are using technology solutions to reduce the overall expenses for lead generation. FRIKINtech is at the forefront of reducing dealership marketing costs by using equity mining of existing dealership customers for vehicles and services. Another tactic is to increase customer retention through an improved experience. For example, AFG.tech's platform TRONIX improves customer satisfaction during the car-buying process while providing increased transparency in and accessibility of customer data. Dealerships must continue to adapt new technologies and partners to efficiently monetize their investments in advertising.

When it comes to marketing, bigger is better. For example, advertising to a dealership group versus single stores is more efficient. Furthermore, capturing marketing synergies will be an increasingly important factor in M&A transactions.

[11]Source: NADA

5 EVOLVING SALES MODELS PROVIDES OPPORTUNITY & CHALLENGES

The industry is experiencing permanent shifts in auto retailing. Today, up to 40% of vehicles in-transit to dealerships are sold before they arrive on the lots[12]. Tesla broke decades-old precedent when it moved solely to selling cars directly to consumers and not through third-party dealerships. Currently, 48 states have laws mandating vehicle sales through third-party dealerships, but only 10 of those have banned Tesla from selling directly. Other EV startups have followed this direct sales model, and now the OEMs are beginning to disrupt the traditional sales model.

GM and Volvo are actively discussing how to disrupt the existing sales channel. GM intends to reduce inventory on dealership lots thereby increasing efficiency. It is planning regional distribution centers to hold inventory and which it will distribute to dealerships as customers order vehicles. The expectation is Dealerships will maintain limited inventory for customers to "kick the tires". Likewise, Volvo is actively pursuing ways to insert themselves into customer relationships and drive more direct-to-consumer sales.

"Look, our customer is changing, our business is changing, we think you're a competitive advantage, but you've got to change with us. If you try to cling to business the way it was five to 10 years ago, it's not going to turn out very well... A lot of our dealers are coming along. The dealers who are saying, 'Hey I just don't want to be in this business.' There's an offering for them."

-Mary Barra, CEO
General Motors

"It seems strange for me coming from the consumer electronics and technology industry that you can sell a product which is $40, $50, $60 thousand of value to a customer that you never speak to pre-sales and you never speak to post-sales... That's a flawed business model, especially in today's world when we've got so much connectivity at our fingertips. We need to be part of that conversation."

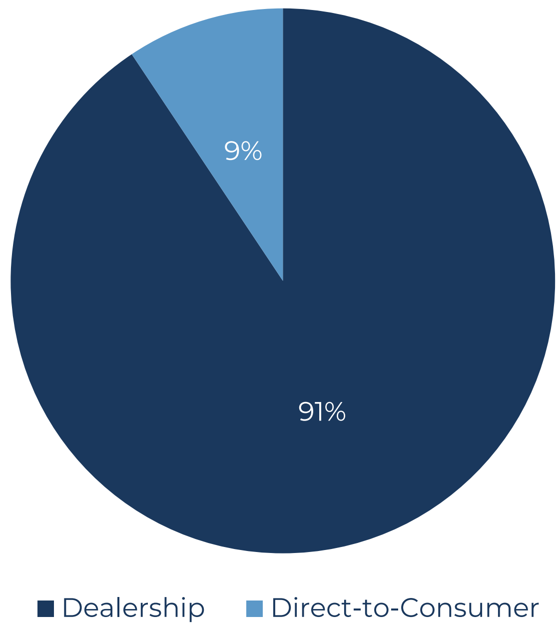
-Jim Rowan, CEO
Volvo Cars

[12]Source: Investor Observer February 2023
Mary Barra photo by Marco Grob—TRUNK

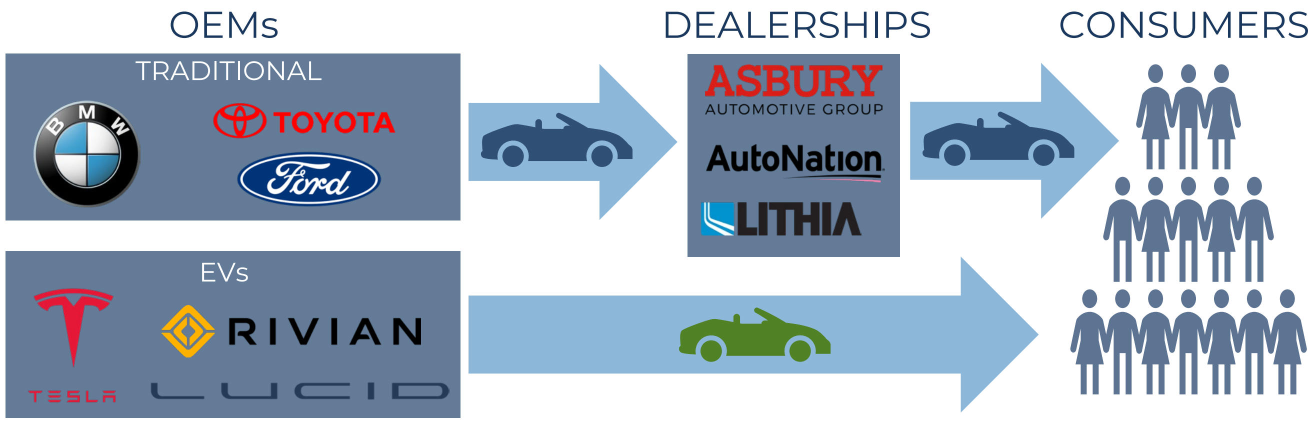
Regardless of what changes the OEMs plan for their dealership relationships in the future, dealerships must seize the opportunity during this period of disruption and innovation to future-proof the business model and redefine its role in the auto sale ecosystem.

One recent development towards that future-proofing is transitioning away from physical inventory at stores and moving towards an omnichannel sales model. Dealerships' new vehicle inventories have increased year over year, primarily caused by in-transit vehicles.

2022 SET RECORD FOR D2C SALES[13]



According to research conducted by Cloud Theory, over 25% of new vehicles listed on dealerships' websites are classified as in-transit. However, due to elevated demand, dealerships are having great success moving these in-transit vehicles, with up to 40% already sold before they hit the lot in 2023. As a result, the average days-to-move in-transit vehicles is ten days less than in-stock vehicles. This environment, characterized by an elevated level of cars sold before hitting the lot, has created new processes within dealerships and positioned some to easily transition to selling more online, mobile, and through other channels. In addition, by expanding where they engage with customers, dealerships will be able to push off encroachment by the new and legacy OEMs looking to capture direct-to-consumer market share.



[13]Sources: IBIS Report, Tesla Annual Report, Rivian Annual Report, Lucid Annual Report

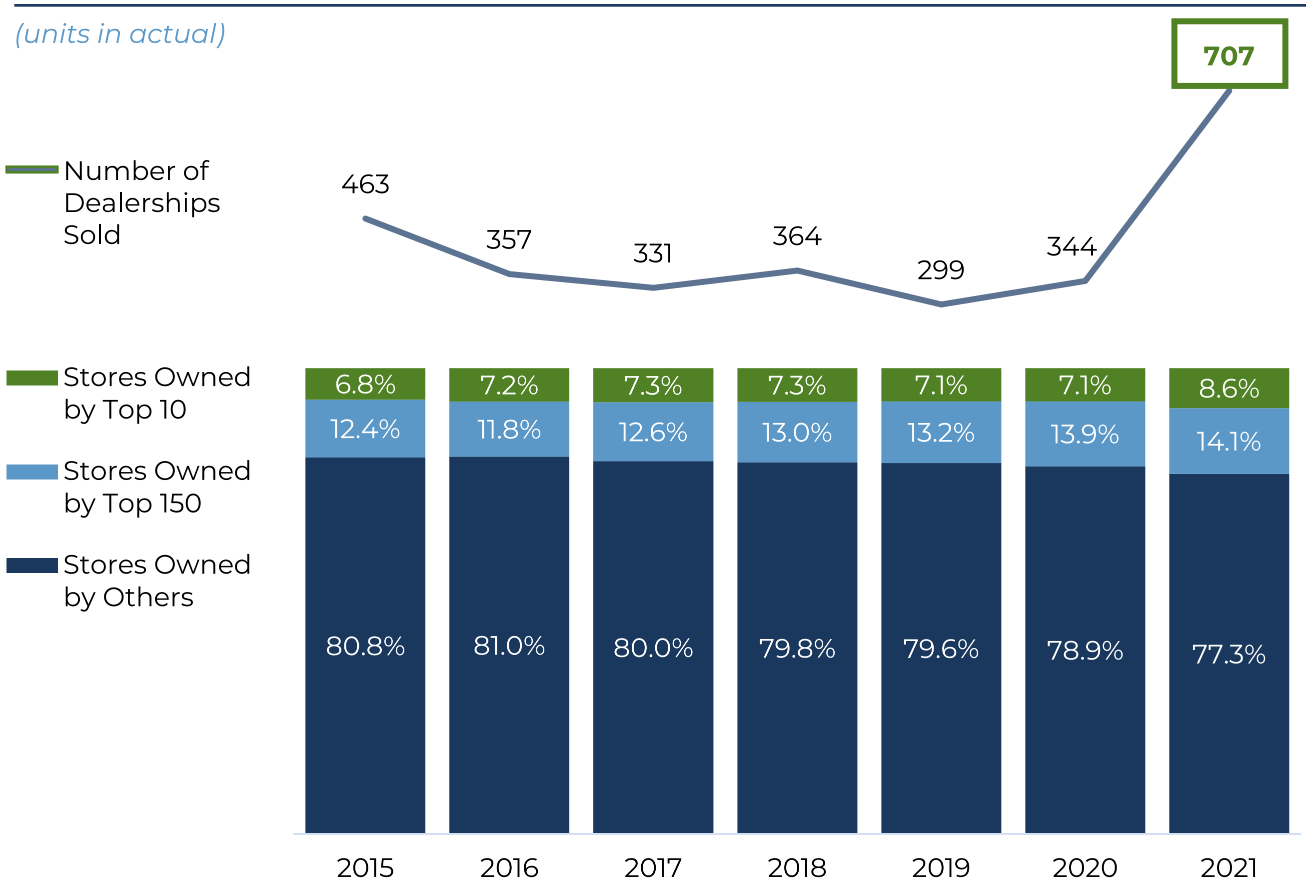
CONCLUSION

M&A ACTIVITY REMAINS HIGH

Dealership consolidation continued at a strong pace throughout 2022, with large dealership groups continuing to acquire small dealership groups and individual stores. In addition, some of the largest dealership groups focused on expanding into new markets in 2022 with Lithia officially surpassing AutoNation as the largest dealership group in the United States. Based on acquisitions in 2022 and historical dealership volumes, Colonnade estimates that the top 10 largest dealership groups' footprint grew just over 5% in 2022. This growth represents a 47 bps increase in concentration within the top 150 dealership group's store ownership volumes.

DEALERSHIP CONSOLIDATION[14]

(units in actual)



[14]Sources: Automotive News Research & Data Center, Reuters, U.S. Bureau of Labor Statistics, Haig Report

The valuation landscape has changed since the onset of COVID-19. Given the significant increase in store profitability and the uncertainty of how long these profit levels will remain, buyers are considering average profits over a historical period rather than a recent trailing period when valuing a target. However, over the last four years, the Blue Sky Value for dealerships has been increasing, reaching record highs in 2022 based on the estimated Blue Sky Values of public dealership groups.

On a forward basis, the market anticipates buyers continuing to become more comfortable with elevated profit levels in valuations. The valuation of a dealership is impacted by its franchise, as not all franchises are valued the same in the market. However, multiples can be affected by additional factors, including market location, surrounding competition, demographics of local buyers, and the dealership's real estate.

The landscape of the Auto Dealership Industry is in the midst of seismic changes. The relationships with the OEMs and consumers are evolving at a rapid pace and the long-term players will need to invest to stay relevant to their suppliers and customers. Affordability and supply chain challenges also seem likely to remain in the center of the conversation around car sales for the foreseeable future. For those operators who are skeptical of their long-term position, there may be no better time to consider an exit as capital remains robust and many large players are committed to expanding their footprints through acquisitions to achieve their lofty growth objectives.

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Streamline Recon *has been acquired by* SolutionWorks COLONNADE SECURITIES LLC	Reynolds & Reynolds *has acquired* AGWS Every Way Forward COLONNADE SECURITIES LLC	Matrix Warranty Solutions Inc *has completed a strategic refinancing with* CIBC COLONNADE SECURITIES LLC	OpenRoad Lending *has been acquired by* Clarion Capital Partners, LLC COLONNADE SECURITIES LLC	Matrix Warranty Solutions Inc *has acquired* MediaStratX COLONNADE SECURITIES LLC
SkyAuto Protection *has been acquired by* smart autocare COLONNADE SECURITIES LLC	Caltex *has been acquired by* Spectrum Automotive Holdings COLONNADE SECURITIES LLC	Milestone Marketing Solutions *has been acquired by* Spectrum Automotive Holdings COLONNADE SECURITIES LLC	smart autocare *has been acquired by* Tiptree Inc. COLONNADE SECURITIES LLC	PMC Protect My Car *has acquired* Direct Media Partners, LLC COLONNADE SECURITIES LLC
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tricolor auto *has been acquired by* Ganas Auto COLONNADE SECURITIES LLC	Southfield *has acquired with management* Vanguard Dealer Services COLONNADE SECURITIES LLC	Endurance *has been acquired by* TRP Capital Partners COLONNADE SECURITIES LLC	Omnisure *has been acquired by an investment group led by management and* Fortress COLONNADE SECURITIES LLC	PACCO Preferred Automobile Credit Co. *has been acquired by* AFS Acceptance Surprime Automobile Financing COLONNADE SECURITIES LLC
PWI Preferred Warranties Inc. *has been acquired by* KAR Auction Services COLONNADE SECURITIES LLC	PayLink Direct *has been acquired by* Oxford Financial Group, Ltd COLONNADE SECURITIES LLC	MEPCO insurance premium financing *has been acquired by* Independent Bank COLONNADE SECURITIES LLC	VSC Marketer *has been acquired by* Strategic COLONNADE SECURITIES LLC	Automotive Digital Marketer *has been acquired by* Private Party COLONNADE SECURITIES LLC

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Sources: SEC filings, regulatory filings, company presentations, FRED, NADA, KBB, Zebra, CBS, Edmunds, Cox Automotive, Hedges Company, JM&A Group, Investor Observer, IBIS Report, Automotive News Research & Data Center, Reuters, U.S. Bureau of Labor Statistics, Haig Report, public disclosure, and Colonnade research