Auto Dealers

Driving Profits from Dealerships

by Tim Eriksen, m100 member

As a nation we love our cars and the freedom they represent. And despite the current high prices at the pump and all the talk about the need for alternative modes of transportation, our usage of the automobile is unlikely to change in the near future.

Long-term, domestic demand for autos should slowly increase as the population increases. Worldwide growth rates are expected to be higher due to the economic development of India and China. Two manufacturers are well positioned to benefit from growth: Toyota (nyse: TM) and Honda (nyse: HMC). Both companies have shown the ability to develop cars that are visually appealing, fun to drive, and innovative, such as the new hybrids. In addition, neither is burdened by the massive health and pension obligations that Ford and GM face.

Honda and Toyota trade at just over ten times expected earnings for 2005, which is cheap considering the greater earnings predictability and better outlook the two enjoy versus other manufacturers. While neither one is likely to post exceptional returns, neither carries great risk either. Both should yield a solid investment return over time.

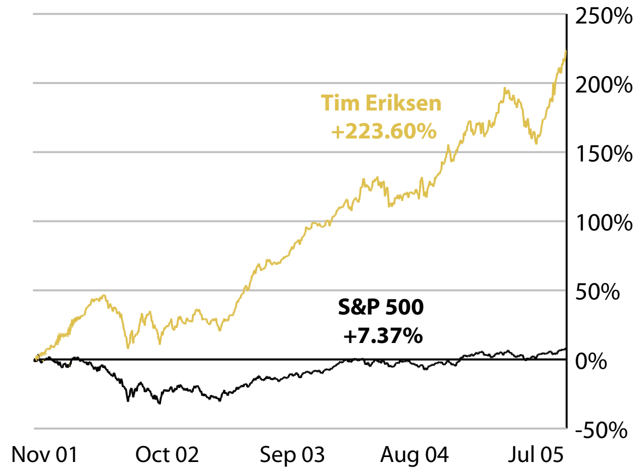
A more exciting way to play the automotive industry is through auto dealers. In recent years a few companies have begun acquiring dealerships across the country, growing earnings faster than the industry and gaining economies of scale. Yet today most dealerships are still locally owned, so the consolidation trend has much further to go.

Dealers also have downside protection that manufacturers do not have. If auto sales slump, manufacturers increase incentives in order to sell the cars. Dealers typically end up with similar margins regardless. Dealers also benefit from the complexity of today's auto. Most people don't have the knowledge or equipment to do major repairs on newer autos, so dealers are able to charge high prices for their service departments.

To Wall Street, auto dealers are boring and under followed. This creates opportunity for investors. There are six major auto retailers (AN, UAG, SAH, GPI, LAD and ABG) each with a different emphasis. Lithia Motors (nyse: LAD), for example is focused on selling domestic autos primarily in the western United States. In fact, over 70% of its new car sales were domestic products. United Auto Group (nyse: UAG) is at the other end of the spectrum. Japanese and German manufacturers account for 80% of UAG's new car sales. UAG has even expanded its dealerships beyond the United States. A third of UAG's new car sales in 2004 were from the United Kingdom.

The Author's Performance

Cumulative Returns since Inception
11/27/2001 to 7/31/2005



The differences in emphasis and dealership location provide an avenue for investors to invest based not just on the popularity of certain auto manufacturers but also on the growth of certain regions of the country as well. Population within the country is slowly shifting to the South and the West. Thus, while sales nationally may only climb a few percent, the South and West will show a higher growth rate. I favor dealers whose operations are focused in the South and West and that primarily sell Toyota and Honda, as well as other luxury autos.

Two auto dealers stand out, in my opinion. Sonic Automotive (nyse: SAH) and Asbury Automotive Group (nyse: ABG). Excluding sales of Cadillac, both companies get just 25% of new car sales from domestic brands, and both are primarily located in the South and West, thus matching the exact profile of the auto retailer I think will prosper the most. In addition, both sell for just ten times 2005 earnings estimates and nine times 2006 estimates, and are expected to enjoy growth rates above ten percent over the next five years. Sonic has the additional benefit of a current two percent dividend yield, while Asbury does not pay a dividend. The result is investors can buy a steadily growing company at an attractive price, and possibly not complain as much when taking their car to the dealer for service.