

Consumer: Automotive Retail

For proof that dealer service can continue to thrive in the transition to EVs, look to Scandinavia

Summary:

One of several investor concerns we often field regarding the franchise auto retailers is that related to their Service & Parts businesses and the potential risk presented by the transition to EVs given their lower susceptibility to repair versus ICE vehicles. There are however, factors such as higher average EV repair costs and higher dealer service retention rates (given their increased complexity and the investment and specialized training, tools and equipment that they require) that could likely mitigate any potential headwind. Indeed, one need only to look at the development of the Service business at Bilia, one of the largest dealer groups in Europe and the largest in Scandinavia where EV sales penetration is the highest in the world. Throughout the last 10 years when EV sales penetration increased rapidly, Bilia managed to both continuously grow its Service business revenue and increase its profitability as well.

We believe Bilia's experience and success in navigating the transition to EVs could serve as an important proxy for how the EV transition plays out for other dealer groups and in other markets -- in particular, the U.S. Thus, we believe this should significantly ease investor concern regarding risk to the franchise dealers' Service & Parts business, which, in our view, is overblown and yet another reason why we remain broadly bullish on the group (we have Buy ratings on ABG, AN, GPI, LAD and PAG). **Please refer to the full report for details.**

We plan to discuss these and other issues at upcoming meetings we are hosting with Penske Automotive Group (PAG - Buy) on June 15th and AutoNation (AN - Buy) on June 20th. Please contact your SRP sales rep to register.

Highlights

One of several investor concerns we often field regarding the franchise auto retailers is that related to their Service & Parts businesses and the potential risk presented by the transition to EVs given their lower susceptibility to repair versus ICE vehicles. As we outlined recently, this segment generates high margins and the group has been growing it at double-digit rates in recent years ([Despite double-digit Service & Parts revenue growth for the dealers, data suggests there's plenty more left in the tank](#)), and has been a significant driver of earnings growth, thus this risk is not easily dismissed:

Table 1 - Same-store y/y Service & Parts revenue growth

| | 2021 | 2022 | 1Q23 |
|----------------------|------------|------------|------------|
| ABG | 15% | 12% | 12% |
| AN | 15% | 9% | 8% |
| GPI* | 15% | 17% | 13% |
| LAD | 11% | 10% | 9% |
| PAG* | 15% | 8% | 10% |
| SAH** | 12% | 10% | 11% |
| Group Average | 14% | 11% | 11% |

* total company, incl. U.K. stores

** franchise stores only

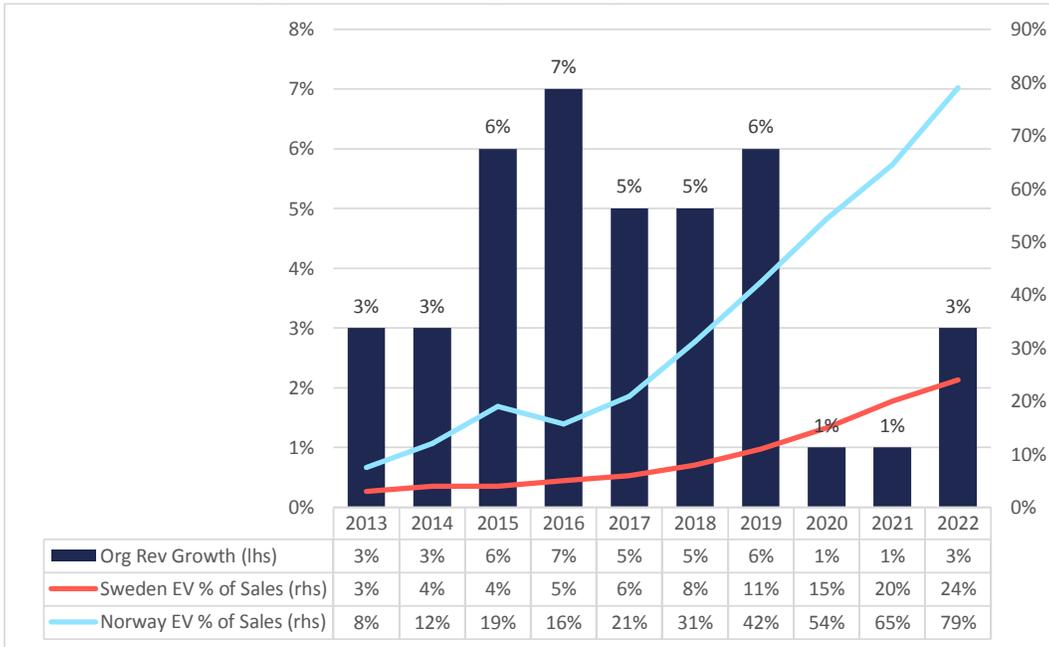
That said, there are potential mitigating factors, such as higher average repair costs and higher dealer service retention rates associated with EVs (given their increased complexity and the investment and specialized training, tools and equipment that they require) that could likely offset - and potentially overwhelm -- any potential headwind. Indeed, one need only to look at the development of the Service business at Bilia, one of the largest dealer groups in Europe and the largest in Scandinavia where EV sales penetration is the highest in the world (~25% Sweden, ~80% Norway in 2022).

Background on Bilia

According to Automotive News, Bilia is the 13th largest dealer in Europe by revenue (SEK 35.3B in 2022), having delivered 84,890 new and used vehicles in 2022. It is the largest dealer in Scandinavia, with 151 stores in Sweden and Norway, and importantly, for this analysis, generated 93% of its Service revenue in these two markets in 2022. Bilia's Service business includes service centres, damage centres, new and used spare parts, stores and e-commerce, tyre centres, tyre hotel (wheel storage/rim repair), glass centres, accessory services and car dismantling.

As seen in the chart below, over the last 10 years, along with the proliferation of EVs in its two primary markets Sweden and Norway, Bilia grew its Service business revenue on an organic basis every year -- including in 2020 during the height of the pandemic:

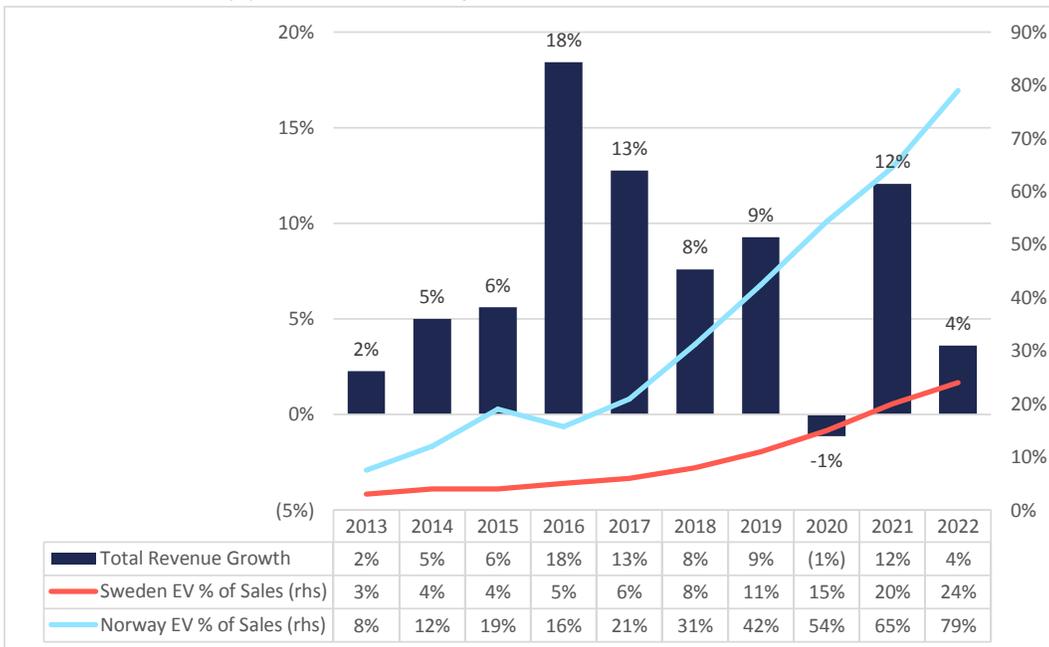
Chart 1 - Bilia y/y Service revenue growth (organic) vs. EV sales penetration



Source: Company data, Norwegian Road Federation

Organic growth over the 10 years averaged 4% annually. Similar to its U.S.-based peers, a key element of Bilia's growth strategy is M&A, and thus on a consolidated basis, the growth of its Service business was even higher over that 10-yr period, averaging 7.5% annually:

Chart 2 - Bilia y/y Service revenue growth (consolidated) vs. EV Sales penetration



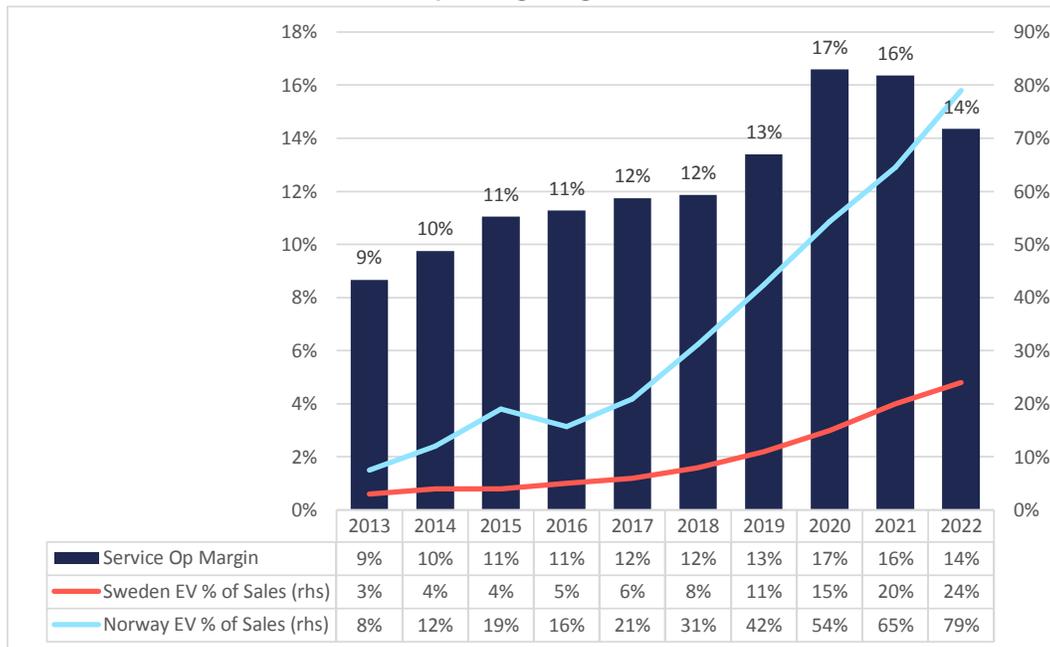
Source: Company data, Norwegian Road Federation

One may note the -1% consolidated growth in 2020 -- this was due to disposition of some sizable stores in Denmark.

Bilia acknowledges the risk that the transition to EVs presents to its Service business stating in its 2022 Annual Report: "The total value for the service market, including claims handling, is estimated to decrease in the long-term by approximately 15 per cent, but based on a larger fleet of cars and the ongoing consolidation of service workshops, the total service market is expected to be stable moving forward. Bilia, which is a large player on the market, has good opportunities to develop new services for car owners and to

continue to take market share as industry conditions change." And indeed, as Bilia's track record over the past 10 years demonstrates, despite the proliferation of EVs, it has been able to continuously organically grow its Service business. Importantly, due to the different and more lucrative service work performed over this transition period, Bilia has managed to increase the overall profitability of its Service segment:

Chart 3 - Bilia Service Operating Margin vs. EV Sales Penetration



Source: Company info, Norwegian Road Federation

Indeed, Bilia also noted in its 2022 Annual Report: *"The proportion of electric cars is increasing rapidly in the countries where we operate, which means partly lower servicing turnover compared with cars that run on fossil fuels. New services are, however, increasing and to date the rising stock of electric cars has not had an adverse impact on the Service Business's profitability".*

We believe Bilia's experience and success in navigating the transition to EVs could serve as an important proxy for how the EV transition plays out for other dealer groups and in other markets -- in particular, the U.S. And thus, we believe this should significantly ease investor concern regarding risk to the franchise dealers' Service & Parts business, which we believe is overblown. With the group trading at just ~6.5x 2023 EPS and inexpensive on what we view as normalized earnings, this is yet another reason we remain broadly bullish on the group.

Consumer Disclosures

I, Glenn Chin, hereby certify: (1) that all of the views expressed in this report accurately reflect my personal views about any and all of the subject securities or issuers; and (2) that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

As with all employees of Seaport Global Securities LLC, a portion of our analysts' compensation is paid from the total collection of revenues from all areas of the firm including but not limited to Investment Banking and Sales and Trading departments. In no instance are research analysts' compensation directly derived from Investment Banking revenues.

Risks & Considerations for Asbury Automotive Group Inc. (ABG)

Macro slowdown/deterioration. Although the auto retailers' revenue tends to be less cyclical than their OEM and supplier peers due to the somewhat counter-cyclical nature of their Service & Parts businesses (the greatest contributor to their gross profit) and their more flexible cost structures, they are still susceptible to economic volatility.

Accelerating shift to EVs. Despite claims to the contrary by some, we believe that the shift to EVs could prove detrimental to the auto retailers' Service & Parts business. In fact, highly regarded Consumer Reports recently published the results of a study which showed that lifetime maintenance and repair costs for EVs and PHEVs were 50% lower than those for ICE vehicles (\$4,600 vs. \$9,200):

| Powertrain Type | Vehicle Mileage | | | Lifetime Average |
|-----------------|-----------------|----------|-----------|------------------|
| | 0-50k | 50k-100k | 100k-200k | |
| BEV | \$0.01 | \$0.03 | \$0.04 | \$0.03 |
| PHEV | \$0.02 | \$0.03 | \$0.03 | \$0.03 |
| ICE | \$0.03 | \$0.06 | \$0.08 | \$0.06 |

| Powertrain Type | Lifetime Maintenance & Repair Cost |
|-----------------|------------------------------------|
| BEV | \$4,600 |
| PHEV | \$4,600 |
| ICE | \$9,200 |

This could impact the dealers as the Service & Parts business 1) is typically the most recession resistant of all their businesses and 2) comprises the greatest proportion of gross profit. Thus, a decline in Service & Parts revenue could both diminish the overall profitability of these companies, and make them more cyclical. That said, there are mitigating factors such as 1) the continued significant increase in vehicle complexity with increased electronic content and electrification, could enable the dealers to capture an increasing proportion of total Service and Parts revenue, and 2) with EV penetration in the US and globally now in just the low single digit range, the path to significant EV penetration is likely to be a long one, giving this group many years to adjust and adapt. Note that increased vehicle complexity has helped drive mid-single digit revenue growth for nearly all the dealers for the past several years and it is expected to continue.

Slowing of/an inhospitable M&A environment. Given their significant free cash flow generation, one of the reliable avenues for growth for Auto Retailers has been M&A. For example, ABG recently closed on the acquisition of Park Place, its biggest in its history, growing its revenue base by nearly 25%. Thus, to the extent that the M&A environment becomes less friendly, either via fewer/less willing sellers, higher prices, or both – this could unfavorably impact growth plans. That said, while interest in selling amongst smaller operators was robust even pre-pandemic as many of them faced generational succession issues, interest has reportedly spiked higher post-pandemic as many small operators have found it difficult to compete with larger dealer groups as their resources, online capabilities, etc. pale in comparison -- very similar to the dynamics in the dining and broader retail sectors where the largest entities are thriving while smaller ones face difficulty keeping pace.

Higher U.S. tax rates. As these companies are very profitable, the auto retailers were large beneficiaries of the reduction in U.S tax rates a few years ago. Thus, the potential for higher tax rates under a new administration could be punitive to the auto retailers given their significant profit bases and having few, if any, Deferred Tax Assets to mitigate the impact.

Stall in Finance & Insurance revenue growth. The continued unrelenting growth of F&I revenue (well beyond what many investors believed was possible) has essentially offset the secular compression in new and used vehicle margins such that "front-end yields" have remained relatively stable. However, if vehicle margins continue to compress and F&I revenue growth stalls, both revenue and earnings for the group would be impacted unfavorably.

Risks & Considerations for AutoNation Inc. (AN)

Macro slowdown/deterioration. Although the auto retailers tend to be less cyclical than their OEM and supplier peers due to the somewhat counter-cyclical nature of their Service & Parts businesses (the greatest contributor to their Gross Profit) and their more flexible cost structures, they are still susceptible to economic volatility.

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Slowing of/an inhospitable M&A environment. Given their significant free cash flow generation, one of the reliable avenues for growth for Auto Retailers has been M&A. For example, many of these companies are strong cash generators which often deploy that cash to acquire stores to generate growth. Thus, to the extent that the M&A environment becomes less friendly, either via fewer/less willing sellers, higher prices, or both – this could unfavorably impact growth plans. That said, while interest in selling amongst smaller operators was robust even pre-pandemic as many of them faced generational succession issues, interest has reportedly spiked higher post-pandemic as many small operators have found it difficult to compete with larger dealer groups as their resources, online capabilities, etc. pale in comparison -- very similar to the dynamics in the dining and broader retail sectors where the largest entities are thriving while smaller ones face difficulty keeping pace.

Higher U.S. tax rates. As these companies are very profitable, the auto retailers were large beneficiaries of the reduction in U.S tax rates a few years ago (for examples, PAG effective tax rate declined from 32.6% in 2017 to 24.3% in 2018). Thus, the potential for higher tax rates under a new administration could be punitive to the auto retailers given their significant profit bases and having few, if any, Deferred Tax Assets to mitigate the impact.

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Risks & Considerations for Group 1 Automotive Inc. (GPI)

Macro slowdown/deterioration. Although the auto retailers' revenue tends to be less cyclical than their OEM and supplier peers due to the somewhat counter-cyclical nature of their Service & Parts businesses (the greatest contributor to their gross profit) and their more flexible cost structures, they are still susceptible to economic volatility.

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Slowing of/an inhospitable M&A environment. Given their significant free cash flow generation, one of the reliable avenues for growth for Auto Retailers has been M&A. For example Lithia has been a chronic and successful acquiror and plans to acquire an additional \$20B in revenue over the next five years (in addition to other growth initiatives). Thus, to the extent that the M&A environment becomes less friendly, either via fewer/less willing sellers, higher prices, or both – this could unfavorably impact growth plans. That said, while interest in selling amongst smaller operators was robust even pre-pandemic as many of them faced generational succession issues, interest has reportedly spiked higher post-pandemic as many small operators have found it difficult to compete with larger dealer groups as their resources, online capabilities, etc. pale in comparison -- very similar to the dynamics in the dining and broader retail sectors where the largest entities are thriving while smaller ones face difficulty keeping pace.

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Risks & Considerations for Lithia Motors Inc. CI A (LAD)

Macro slowdown/deterioration. Although the auto retailers' revenue tends to be less cyclical than their OEM and supplier peers due to the somewhat counter-cyclical nature of their Service & Parts businesses (the greatest contributor to their gross profit) and their more flexible cost structures, they are still susceptible to economic volatility.

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Risks & Considerations for Penske Automotive Group Inc. (PAG)

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Slowing of an inhospitable M&A environment. Given their significant free cash flow generation, one of the reliable avenues for growth for Auto Retailers has been M&A. For example:

- Asbury Automotive (ABG) recently closed on the biggest acquisition in its history, growing its revenue base by nearly 25%,
- Penske Automotive (PAG) entered the standalone used vehicle market via acquisition and is consolidating the commercial vehicle market,
- Lithia Automotive (LAD) has been a chronic and successful acquirer and plans to acquire an additional \$20B in revenue over the next five years (in addition to other growth initiatives).

Thus, to the extent that the M&A environment becomes less friendly, either via fewer/less willing sellers, higher prices, or both – this could unfavorably impact growth plans. That said, while interest in selling amongst smaller operators was robust even pre-pandemic as many of them faced generational succession issues, interest has reportedly spiked higher post-pandemic as many small operators have found it difficult to compete with larger dealer groups as their resources, online capabilities, etc. pale in comparison -- very similar to the dynamics in the dining and broader retail sectors where the largest entities are thriving while smaller ones are suffering.

Companies Mentioned in This Report

- Asbury Automotive Group Inc. (ABG: \$220.16, Buy, PT \$275)
- AutoNation Inc. (AN: \$140.06, Buy, PT \$180)
- Group 1 Automotive Inc. (GPI: \$238.29, Buy, PT \$300)
- Lithia Motors Inc. CI A (LAD: \$249.35, Buy, PT \$315)
- Penske Automotive Group Inc. (PAG: \$147.03, Buy, PT \$150)

Price Target Metrics for Asbury Automotive Group Inc. (ABG)

10x our estimate of normalized earnings

Price Target Metrics for AutoNation Inc. (AN)

10x normalized earnings

Price Target Metrics for Group 1 Automotive Inc. (GPI)

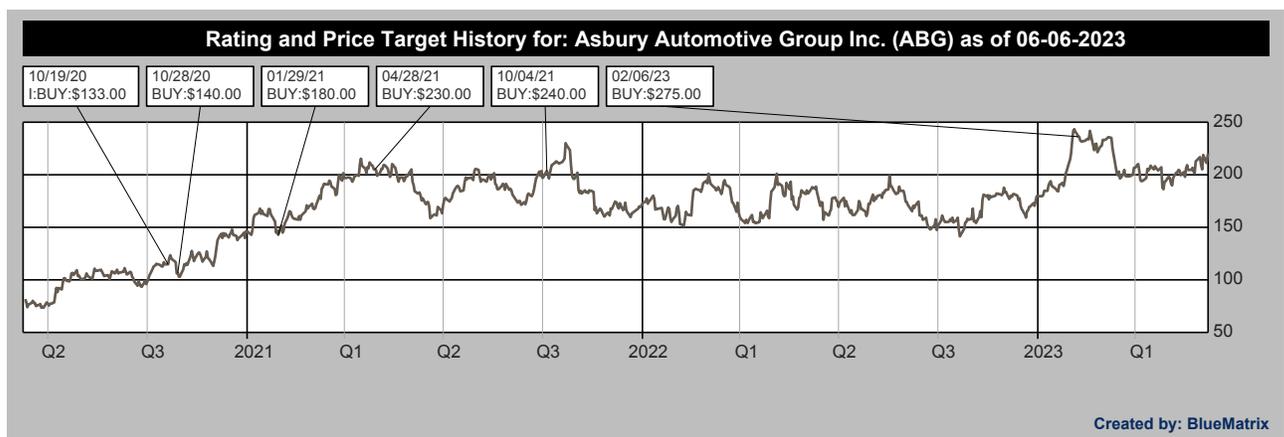
7.5x projected 2023 EPS / 10x normalized earnings

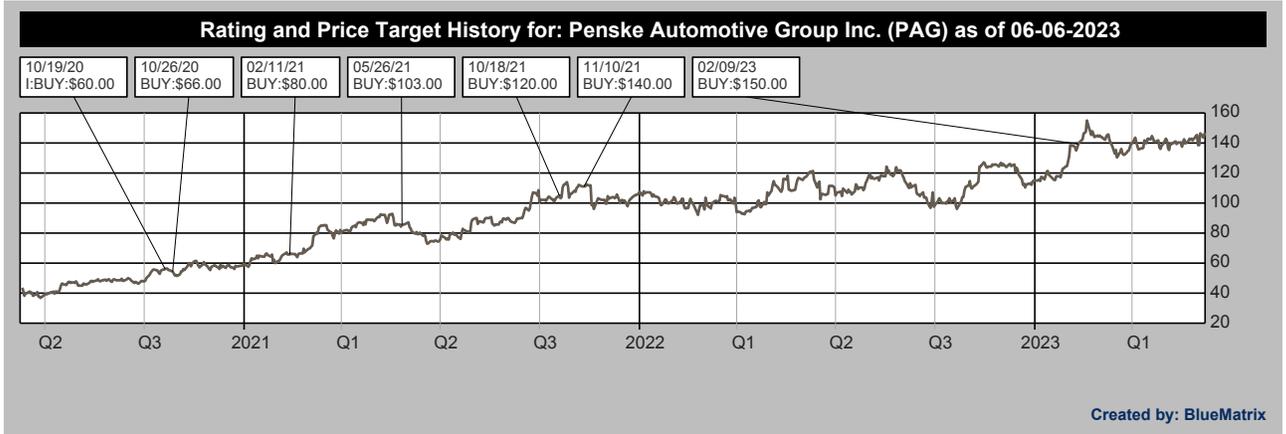
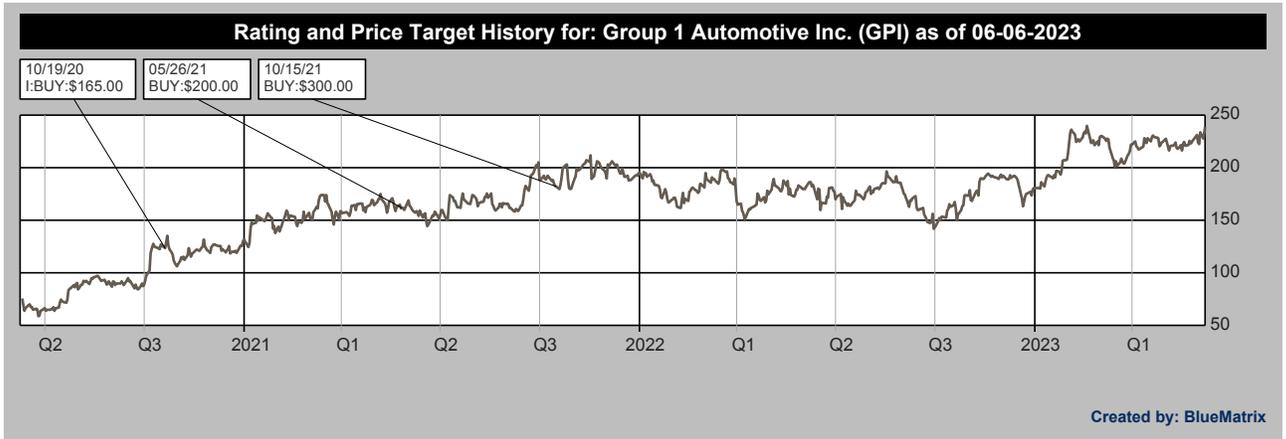
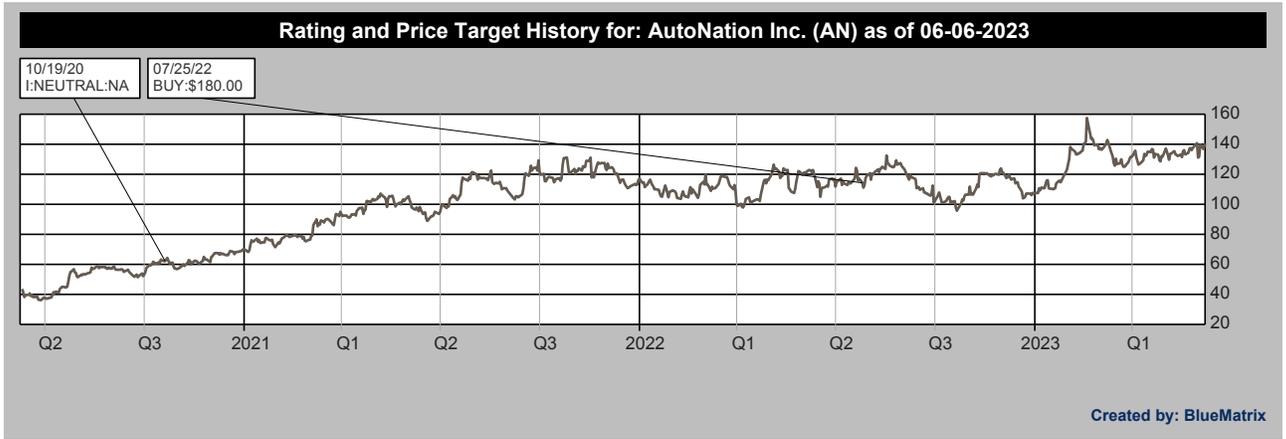
Price Target Metrics for Lithia Motors Inc. CI A (LAD)

8x our 2024 EPS estimate

Price Target Metrics for Penske Automotive Group Inc. (PAG)

10x our estimate of normalized earnings





Please contact Seaport Global Securities LLC, for important disclosure information for covered companies. Contact the Director of Equity Research at (949) 274-8052 or write to Seaport Global Securities LLC, 100 Bayview Circle, Suite 100, Newport Beach, CA 92660.

Clients should also refer to <https://sgsecurities.bluematrix.com/sellside/Disclosures.action> for price charts, as well as specific disclosures for covered companies.

Explanation of Ratings

Seaport Global Securities analyst ratings include (effective Feb. 1, 2017):

Buy - The investment outlook and risk/reward over the following 12 months are favorable on an absolute basis and relative to the peer group.

Neutral - The investment outlook and risk/reward over the following 12 months are neutral on an absolute basis and relative to the peer group.

Sell - The investment outlook and risk/reward over the following 12 months are unfavorable on an absolute basis and relative to the peer group.

NA - A rating is not assigned.

Prior to Feb 1., 2017, Seaport Global Securities analyst ratings included:

Buy - The investment outlook and risk/reward over the following 12 months are very favorable on an absolute basis and relative to the peer group.

Speculative Buy - The investment outlook over the following 12 months is very favorable on an absolute basis and relative to the peer group, however, there is higher than average risk associated with the investment that could result in material loss.

Accumulate - The investment outlook and risk/reward over the following 12 months are favorable on an absolute basis and relative to the peer group.

Neutral - The investment outlook and risk/reward over the following 12 months are neutral on an absolute basis and relative to the peer group.

Reduce - The investment outlook and risk/reward over the following 12 months are unfavorable on an absolute basis and relative to the peer group.

Sell - The investment outlook and risk/reward over the following 12 months are very unfavorable on an absolute basis and relative to the peer group.

NA - A rating is not assigned.

| Rating | Ratings Distribution | | Investment Banking Clients* | | |
|----------------|----------------------|------------|-----------------------------|------------|----------------------|
| | Research Coverage | | Count | % of Total | % of Rating Category |
| | Count | % of Total | Count | % of Total | % of Rating Category |
| Buy | 146 | 66.1% | 6 | 100.0% | 4.1% |
| Neutral | 75 | 33.9% | 0 | 0.0% | 0.0% |
| Sell | 1 | 0.5% | 0 | 0.0% | 0.0% |
| Total | 221 | 100.0% | 6 | 100.0% | 2.7% |

*Investment banking clients are companies for which Seaport Global Securities LLC provided investment banking services to in the last 12 months.

Note: Ratings Distribution as of March 31, 2023

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