Kerrigan Advisors has the honor of advising the industry's leading dealers through the lifecycle of growing, operating and, when the time is right, monetizing their businesses. In the last five years, we have represented on auto retail's largest transactions, including five of the Top 100 Dealership Groups, more than any other firm in the industry.

If you would like to learn more about Kerrigan Advisors, please contact Erin Kerrigan or Ryan Kerrigan at (949) 202-2200.
DEALERSHIP ACQUISITION ACTIVITY

The buy/sell market picked up pace in the third quarter of 2019 with 58 transactions completed. This compares to an average of 51 transactions closed in the prior two quarters. Based on the first three quarters, 2019 is pacing to be another 200+ transaction year, likely matching 2018’s high activity level (see Chart I). Kerrigan Advisors expects the third quarter’s deal momentum to increase in the fourth quarter as buyers and sellers are more motivated to close before year-end.

Today’s growing buy/sell market is supported by a healthy US economy, albeit one facing increased recession risk. GDP rose a moderate 1.9% in the third quarter, led by consumer spending which annualized at a 2.9% growth rate. Despite strong consumer spending, the third quarter showed weakness in business spending, weighed down by trade disputes and a slowing global economy. As a result, the Federal Reserve reduced the Federal Funds Rate by a quarter percentage point in the third quarter, its third rate reduction since July.

Declining interest rates will positively impact auto retail for the remainder of 2019 and into 2020. Supportive credit markets are the backbone of a healthy auto retail market, both for the consumer (auto loans) and the dealer (floorplan). Not surprisingly, with an improved interest rate outlook, the average dealer reported strong earnings growth through the third quarter of 2019, continuing last quarter’s trend. On an annualized basis, the average dealer is tracking to an impressive 9.3% earnings increase and is approaching 2015’s peak profit level of $1.5M (see Chart II on the following page).

Transaction activity, while down 10% year-to-date, picked up speed in the third quarter. Kerrigan Advisors expects the fourth quarter, which is traditionally the most active quarter of the year, to drive the number of completed transactions well above 200, making 2019 the sixth consecutive year at this high level.

“We took this step to help keep the US economy strong in the face of global developments and to provide some insurance against ongoing risks.”

Jerome Powell, Chairman
Federal Reserve
October 30, 2019
Average dealership earnings are pacing toward 2015’s peak level. Despite a 1.6% decline in new vehicle sales through the third quarter of 2019, dealerships are successfully growing their higher margin revenue streams (used vehicles and fixed operations), increasing their bottom line and demonstrating the sustainability of the dealership business model.

Auto retail's ability to grow earnings, despite a flat SAAR, reflects the resilience of the dealer business model. This resilience continues to impress many investors, including professionally managed capital and Wall Street, who increasingly see auto retail as a counter-cyclical investment. The best indication of today’s positive investor sentiment is the outperformance of The Kerrigan Index™, which is up an incredible 53% year-to-date through November, surpassing the S&P 500’s performance by 111% (see Chart III). The Kerrigan Index™ is now just 6% below its June 2015 peak.

Chart II
Average Dealership Pre-Tax Profit & Annual Percentage Change, $ in Millions
Source: NADA

Chart III
The Kerrigan Index™ (January – November 2019)
Source: Yahoo Finance and Kerrigan Advisors Analysis

Methodology:
The Kerrigan Index™ is composed of the seven publicly traded auto retail companies with operations focused on the US market, including CarMax, Penske Automotive Group, AutoNation, Lithia Motors, Asbury Automotive Group, Group 1 Automotive and Sonic Automotive. The Kerrigan Index™ is weighted by the market capitalization of each company and benchmarked at 100 on 1/3/2000.
The rise in The Kerrigan Index™ is consistent with the results of Kerrigan Advisors’ first-ever Dealer Survey published in October 2019. The purpose of the survey was to gauge dealer sentiment regarding valuation trends and expectations. According to our survey results, 86% of dealers believe the value of their business will increase or remain the same over the next 12 months, while only 14% predict a decline (see Chart IV). Dealers’ positive valuation expectations are a product of 2019’s improved profit levels and the anticipated durability of those profits into 2020.

Chart IV
2019 Kerrigan Dealer Survey Results
Source: Kerrigan Advisors

Kerrigan Advisors’ first-ever Dealer Survey was designed to gauge dealer sentiment about the future value of their business. The results found that dealers are largely optimistic about the valuation of their dealerships over the next 12 months. Of the 650+ responses, 86% of dealers expect the valuation of their dealerships to increase or remain the same in the next 12 months.

The increase in dealership earnings in 2019 is largely driven by two higher margin business segments: used vehicles and fixed operations, whose revenues increased 3.7% and 5.1%, respectively through the third quarter. The significant growth in these business segments reflects the flexibility of the dealer business model. Dealers can quickly redirect their management efforts to higher margin business segments when faced with lower profits from new vehicles. In this way, dealers are able to grow profits even when their largest revenue stream (new vehicles) declines.

Chart V
Average Dealership Used to New Retail Ratio vs. Annual Percentage Change
Source: NADA

The average dealer is approaching a 1:1 used to new ratio, having increased their used to new ratio by 9.8% since 2018. Dealers have successfully shifted their focus from new vehicle sales (5.4% average gross margin) to used vehicle sales (11.4% average gross margin), resulting in improved dealership profits, despite declining new vehicle sales.
The average dealer saw fixed operations revenue grow 5.1% through the third quarter of 2019. As a result, fixed absorption (the percentage of dealership operating costs covered by fixed operations gross profit) increased to the highest level since 2010. Today, dealers are less reliant on the new vehicle department to cover the costs of running their business.

As a result of the increase in average dealership earnings, Kerrigan Advisors saw a rise in average blue sky values in the third quarter after three years of declines (see Chart VII). Improved blue sky values are bringing more sellers to market, seeking to capitalize on today's high values. Kerrigan Advisors expects this trend to continue into 2020, as a growing number of auto retail families without a clear succession plan decide the time is right to monetize their valuable businesses.

Average dealership blue sky values increased 2.9% in 2019 due to improvements in earnings and relative stability in average blue sky multiples. Higher values are bringing more dealers to market, seeking to monetize their dealerships while their exits are attractively priced.
Even with the increase in sellers coming to market, the buy/sell market remains in equilibrium due to the growing number of buyers seeking acquisitions and investment in auto retail. These buyers are armed with attractively priced financing and in some cases equity capital partners. As our industry continues to consolidate, the expanding pool of well-funded buyers focused on enhancing their local and regional footprints, as well as investors seeking large acquisitions, will absorb the rising number of sellers looking to sell their dealerships. For this reason, Kerrigan Advisors expects the buy/sell equilibrium to continue into 2020.

For the third quarter, Kerrigan Advisors has identified the following three buy/sell trends, which will impact the market for the remainder of 2019 and into 2020.

- Top franchises still receive multiples on pro forma earnings
- Image requirements are a wild card in today's buy/sells
- Buyers increasingly focus on management in transactions

The Blue Sky Report® is informed by Kerrigan Advisors' experience enhancing the value of the industry's leading dealership groups through the lifecycle of growing, operating and, when the time is right, selling their businesses. In the past five years, our firm has represented on the sale of the industry's largest transactions, including five of the Top 100 Dealership Groups, more than any other firm in the industry. We do not take listings, rather we develop a customized sales approach for each client to achieve their transaction and financial goals.

We have had the honor of advising auto retail's leading families on their growth strategies, capital allocation plans, operations, real estate and the sale of their valuable businesses. Our team oversees and manages our client engagements from beginning through a successful outcome. In our view, dealerships are far too valuable to be advised any other way.

We hope you find the information presented in this quarter's report helpful to your business. We look forward to answering any questions you may have regarding The Blue Sky Report®, The Kerrigan Index™ or Kerrigan Advisors' strategic consulting, capital raising and sell-side services.
Total Acquisition Activity

According to Kerrigan Advisors’ research and The Banks Report, 161 dealership buy/sell transactions were completed in the first nine months of 2019 (see Chart VIII). This compares to 179 transactions in the first nine months of 2018, resulting in a decline of 10% year-over-year. Despite this decline, 2019 is tracking to 215 transactions for the year, which would mark the sixth consecutive year of over 200 transactions.

Chart VIII
Total Number of Completed Dealership Transactions
Source: The Banks Report and Kerrigan Advisors Analysis

In the third quarter, buy/sell activity picked up with 58 transactions closing, as compared to an average of 51 transactions for the first two quarters of the year. At this higher pace, Kerrigan Advisors expects 2019 to once again surpass 200 transactions for the year.

The number of multi-dealership transactions also declined through the third quarter of the year, both on an absolute basis and as a percentage of transactions completed (see Chart IX). 20% of the transactions completed during the first three quarters of 2019 were multi-dealership, as compared to 29% during the same period in 2018. Kerrigan Advisors believes the rise in single dealership transactions reflects the franchise pruning many organizations have undertaken in 2019. In today’s active buy/sell market, dealers are jettisoning underperforming dealerships and redeploying their capital into higher ROI acquisitions.

Chart IX
Total Number of Completed Multi-Dealership Transactions vs. Number of Completed Multi-Dealership Transactions as a Percentage of Total Completed Dealership Transactions
Source: The Banks Report and Kerrigan Advisors Analysis

Multi-dealership transactions declined 38% through the third quarter of 2019, as compared to 2018. Kerrigan Advisors expects this trend to reverse in 2020, as more dealership groups come to market and well-funded buyers seek to deploy significant capital.
Among the franchises being acquired, domestics materially grew their buy/sell market share in 2019 (see Chart X). Year-to-date, domestics’ share of the buy/sell market increased to 59%, as compared to 55% in 2018. At this level, domestic buy/sell market share is approaching its franchise market share of 67%. The success of the domestic franchise buy/sell market is largely a byproduct of increasing truck sales over the last three years. Truck sales usually achieve higher margins than car sales. Growing truck volumes have improved the profitability of many domestic dealerships over the last three years, and buyers have been attracted to the return on investment (“ROI”) of these franchises, given their lower blue sky multiples relative to top imports.

Chart X
Buy/Sell Market Share by Type of Franchise
Source: The Banks Report and Kerrigan Advisors Analysis

Despite the rise in domestic buy/sell market share over the last three years, Kerrigan Advisors has recently seen a shift in buyer interest in domestic franchises, resulting in a decline in certain domestic multiples (see Blue Sky Multiples Section on page 23). Increasingly, buyers are focused on acquiring franchises with the most sustainable business models, namely those with strong fixed operations and high new unit sales per franchise. Given the large number of domestic franchises in the US, domestics tend to have lower fixed operations revenue, and sales per franchise are much lower than many import brands. As such, import buy/sell market share is expected to grow in 2020 at the expense of domestic buy/sell market share, as buyers seek safer investments in a flat new vehicle sales environment.
Chevrolet, Ford and Chrysler/Jeep/Dodge/Ram ("CJDR") represented 43% of the buy/sell market through the first three quarters of 2019. This buy/sell market share, which is roughly in line with their franchise market share in the US, could be at peak levels, as buyer demand for import franchises is expected to grow over the next 12 months.
US Public Acquisition Activity

The public retailers’ US dealership acquisition spending decreased 33% in the third quarter, as compared to 2018. Kerrigan Advisors believes this decline reflects the lingering effect of the publics’ lower stock prices in the second half of 2018. Given their notable rebound in valuation year-to-date (see Chart III showing The Kerrigan Index™ increase of 53% on page 4), we expect the publics’ US dealership acquisition spending to rise over the next six months, as evidenced by the December announcement by Asbury Automotive of its billion dollar Park Place Motors acquisition, which is expected to close in the first quarter of 2020.

Since the first quarter of this year, the publics average blue sky multiple increased 48%, as a result of the rise in their market capitalizations. At the end of the third quarter, the publics’ blue sky multiples averaged 6.5x. At this high level, many US dealership acquisitions are accretive to earnings and thus more attractive targets for capital allocation.

Chart XII
US Public Dealership Groups’ US Dealership Acquisition Spending, $ in Millions
Source: SEC Filings for Asbury, AutoNation, Group 1, Lithia, Penske & Sonic

The publics reduced their spending on US dealership acquisitions in the first nine months of 2019. At an annualized pace, 2019 is tracking to be the lowest spending level since 2012. Kerrigan Advisors believes this spending contraction is the lagging effect of the steep decline in the publics’ market capitalizations in the second half of 2018.

Since the first quarter of this year, the publics average blue sky multiple increased 48%, as a result of the rise in their market capitalizations. At the end of the third quarter, the publics’ blue sky multiples averaged 6.5x. At this high level, many US dealership acquisitions are accretive to earnings and thus more attractive targets for capital allocation.

Chart XIII
US Public Dealership Groups’ Blue Sky Multiples Blended Average
Source: SEC Filings for Asbury, AutoNation, Group 1, Lithia, Penske & Sonic

The publics’ blue sky multiples have appreciated 48% since the first quarter of 2019. At an average 6.5x blue sky multiple, the publics will find more US dealership acquisitions accretive to earnings, particularly since the average private dealership blue sky multiple is 4.5x.
During the third quarter, Lithia, Asbury and Group 1 acquired auto retail dealerships in the US, while Penske acquired commercial truck dealerships in the US and New Zealand. Group 1 also acquired dealerships in the UK. The publics’ specific acquisitions for the third quarter are as follows:

- Lithia acquired its first Jaguar Land Rover dealership in Mission Viejo, California and a Honda dealership in Hazle Township, Pennsylvania;
- Asbury acquired a Toyota dealership in Indianapolis, Indiana and its first Subaru dealership in Denver, Colorado;
- Group 1 acquired five Volkswagen franchises in the UK and two BMW/MINI dealerships in New Mexico, and
- Penske acquired one commercial truck dealership in New Zealand and six retail commercial truck dealerships in Utah and Idaho.

During the third quarter, the publics continued disposing of under-performing dealerships and capitalizing on an active buy/sell market. Through the first nine months of 2019, they sold 26 dealerships (see Chart XIV below). The publics remain disciplined with their dealership portfolio review, choosing to prune franchises that do not meet their ROI expectations. Kerrigan Advisors expects this trend to continue while the buy/sell market is active and valuations support a sale of underperforming assets.

**Chart XIV**

**US Public Dealership Groups’ Dealership Acquisitions vs. Divestitures (Q3 2019 YTD)**

*Source: SEC Filings, Automotive News and Kerrigan Advisors Analysis*

```
Acquisitions | Divestitures  | Net Decline of 14 Dealerships
--- | --- | ---
12 | 26 | 14
```

"We’re really looking at all of our dealership locations and all of our businesses. Ones that basically meet our hurdle from the standpoint of return and ones that don’t. We’re going to put an action plan together and if that doesn’t work, then we’ll look to put it on a divestiture plan."

*Roger Penske, Chairman & CEO, Penske Automotive Group, Third Quarter 2019 Earnings Call*
The publics’ capital allocation strategy is focused on providing shareholders with the highest return on investment. These companies have many investment options for their capital (see Chart XV). To that point, while US dealership acquisition spending declined 33% through the third quarter, spending on international and other acquisitions increased 61%. Clearly, the publics are identifying higher ROI investment opportunities outside the US auto retail market. By way of example, in the third quarter Penske allocated over $300 million to commercial truck and international acquisitions due to their more attractive valuation multiples relative to US auto retail dealerships.

“When you look at it, the multiples probably are 40% to 50% less on a truck dealership than they would be on a premium luxury dealership.”  
Roger Penske, Chairman & CEO  
Penske Automotive Group  
Third Quarter 2019 Earnings Call

Chart XV
US Public Dealership Groups’ Capital Allocation, Q3 2018 YTD vs. Q3 2019 YTD, $ in Millions  
Source: SEC Filings and Kerrigan Advisors Analysis

For the first three quarters of 2019, the publics reduced their capital allocation to US dealership acquisitions, choosing to allocate an increased percentage of their capital to international and other acquisitions, primarily due to valuation. As these companies’ stock prices rise, they may find more US acquisitions accretive to earnings, which will likely result in an increased allocation to US dealership acquisitions, as seen with Asbury’s recent transaction announcement.

“Our job is to be great capital allocators and really strong operators.”  
David Hult, President & CEO  
Asbury Automotive Group  
Third Quarter 2019 Earnings Call

Notable during the first three quarters of 2019 was the decline in the publics’ stock buyback activity. The publics reduced their allocation to stock buybacks by $154 million or 36% through the third quarter of 2019, as compared to the same period in 2018. As their stock prices continue to rise, Kerrigan Advisors expects these companies will make fewer stock buybacks.
Private Acquisition Activity

Private dealership groups represent the majority of dealership acquirers and are expected to do so for the foreseeable future. Of the estimated 232 franchises which changed hands in the first nine months of the year, only 6% were acquired by public companies (see Chart XVI). The remaining 94% were acquired by existing dealers, some of whom are now backed by professionally managed capital, including family offices and private equity groups.

Since 2010, the number of dealership groups with fewer than five dealerships has declined, while the number of groups with greater than six dealerships has risen over 75% and the number with greater than 11 dealerships has risen the most, at 82% (see Chart XVII). Many private dealers recognize the importance of a growth plan to increase their economies of scale and scope. These growing groups seek to protect the viability of their business model for the future, while also achieving an attractive ROI on their investments. Increasingly, a no-growth plan is considered a risky strategy, particularly given the potentially dramatic evolution of the auto retail business model over the next two decades.

The consolidation trend in US auto retail continues. The fastest growing groups have greater than 11 dealerships, while those groups with fewer than 5 dealerships are on the decline. As the auto retail industry evolves, scale will be a key differentiator and size could be the biggest driver of success.
Increasingly, private dealers recognize the limitations of their own balance sheets, particularly as the average transaction price rises to over $17.4 million and many transactions include multiple dealerships. Though the debt markets remain an attractive source of acquisition funding, the risks associated with high levels of leverage, even on desirable terms, strengthen the case for an equity partner.

Kerrigan Advisors’ capital raising services assist dealers who are seeking to raise sizable amounts of capital (greater than $30 million) to grow their group or buy-out an existing partner. If you are a dealer interested in raising capital or an investor seeking to invest in a successful auto retail consolidation strategy, we look forward to speaking with you and learning how our firm can assist with your investment plans.
Dealership Real Estate

Average dealership rents moderated in 2019 (see Chart XVIII). Kerrigan Advisors believes the slight decline in average rents reflects this year’s reduction in the federal funds rate and the concomitant decline in capitalization and mortgage rates in the industry.

Chart XVIII
Average Dealership Rent Expense vs. Annual Percentage Change, $ in Thousands
Source: NADA

In 2019, average dealership rents declined for the first time since the Great Recession. The decline in rent is a result of a reduction in capitalization and mortgage rates, consistent with this year’s decline in the Fed Funds rate.

The reduction in average rents combined with the increase in average dealership gross profits have resulted in a noticeable improvement in average rent to gross profit (see Chart XIX). On a last twelve-month basis (“LTM”), rent to gross is now 11%, a 4.3% decline from 2018 and in line with 2017’s level. With rent absorbing less of the average dealership’s gross profit, the dealership risk profile improves due to a lower fixed expense structure. This improvement is also reflected in the significant increase in industry fixed absorption, discussed in the Executive Summary (see Chart VI on page 6).

Chart XIX
Average Dealership Rent Expense as a Percentage of Gross Profit
Source: NADA

The industry’s rent to gross profit ratio improved significantly in 2019. Through the twelve months ending in the third quarter 2019, rent to gross profit declined 4.3% to 11%. Rent is one of the biggest fixed expenses a dealership inures. As it declines, the risk profile of the auto retail business improves.
As can be seen in Chart XX, dealership rents and fixed absorption vary by dealership type. Though rents are higher for import and luxury franchises, their ability to cover those rents is also better. Contrary to what one would expect, there is a surprising correlation between higher rents and higher fixed absorption. This is due to higher service and parts revenue, and service retention rates, relative to the industry average and domestic dealerships.

Chart XX
Rent Expense and Fixed Absorption by Dealership Type (2019 LTM)
*Source: NADA*

<table>
<thead>
<tr>
<th>Fixed Absorption</th>
<th>Domestic</th>
<th>Average</th>
<th>Import</th>
<th>Luxury</th>
</tr>
</thead>
<tbody>
<tr>
<td>56.6%</td>
<td>58.1%</td>
<td>59.4%</td>
<td>66.1%</td>
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</table>

While the average domestic dealership's rent is 47% lower than the average luxury dealership's rent, the average luxury dealership absorbs 17% more of its operating costs with its service and parts business due to higher service retention rates and more lucrative service and parts business.
THIRD QUARTER 2019 BUY/SELL TRENDS

Kerrigan Advisors’ experience providing strategic consulting services to growing dealership groups, as well as our successful sell-side representation on the industry’s largest transactions gives us a unique perspective on the trends shaping today’s buy/sell market. Our advisory work provides our firm with first-hand knowledge of the events affecting franchise values and informs our views on the buy/sell market.

Kerrigan Advisors has identified the following three trends, which we expect to shape the buy/sell market into 2020.

- Top franchises still receive multiples on pro forma earnings
- Image requirements are a wild card in today’s buy/sells
- Buyers increasingly focus on management in transactions

Top Franchises Still Receive Multiples on Pro Forma Earnings

A blue sky multiple reflects a buyer's earnings growth expectation for an acquired dealership, as well as the strength or weakness of the underlying franchise. Historically, underperforming dealerships were priced based on a buyer's pro forma earnings expectations. However, as the SAAR started to decline in 2016 and industry earnings followed suit, Kerrigan Advisors found fewer buyers willing to value dealerships on a pro forma basis. Today, buyers are less confident in their pro forma earnings and thus less willing to base their valuations upon them.

Top franchises are the exception to this rule. Kerrigan Advisors finds that the franchises most expected to increase in value per our 2019 Dealer Survey (see Chart XXI on the following page) are still being priced based on pro forma earnings, even in a contracting new vehicle market. Buyers feel more confident in the projected return on investment for these top franchises and believe the risk to their future earnings and value is low. This is particularly true for certain luxury franchises with strong service and parts revenue and high fixed absorption rates.

“We have a higher hurdle rate of return when acquiring an underperforming import or acquiring a significant turnaround investment then we would for a luxury store with a loyal customer base, high margin and a solid parts and service business.”

Sean Goodman, Senior Vice President & CFO
Asbury Automotive Group
Third Quarter 2019 Earnings Call
The Kerrigan Dealer Survey also shows that the top five franchises least expected to change in value (or most expected to retain their value) are also most likely to be priced based on pro forma earnings. Kerrigan Advisors believes this is in large part due to buyers’ confidence in the sustainability of these franchise values. By contrast, franchises that are projected to decline in value are priced based on current earnings or in some cases a discount to current earnings if the dealership is overperforming.

Chart XXI
2019 Kerrigan Dealer Survey Results
Source: Kerrigan Advisors

Kerrigan Advisors’ first-ever Dealer Survey was designed to gauge dealers’ perspectives on franchise valuation trends. The Kerrigan Dealer Survey results show a high correlation between a franchise’s expected future value and a buyer’s willingness to value a dealership based on pro forma earnings. Kerrigan Advisors finds that franchises which are expected to increase in value are priced based on pro forma earnings, while franchises that are expected to decline in value are not.

The Kerrigan Dealer Survey also shows that the top five franchises least expected to change in value (or most expected to retain their value) are also most likely to be priced based on pro forma earnings in a buy/sell. Kerrigan Advisors believes this is in large part due to buyers’ confidence in the sustainability of these franchise values. By contrast, franchises that are projected to decline in value are priced based on current earnings or in some cases a discount to current earnings if the dealership is overperforming.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Franchise</th>
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<tr>
<td>1</td>
<td>Honda</td>
<td>68%</td>
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<tr>
<td>2</td>
<td>Toyota</td>
<td>64%</td>
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<td>Mercedes-Benz</td>
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<tr>
<td>5</td>
<td>Acura</td>
<td>62%</td>
</tr>
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“As some of the stronger brands and luxury brands are holding their multiples well. Some of the more struggling brands right now, the multiples have come down pretty good.”

David Hult, President & CEO
Asbury Automotive Group
Third Quarter 2019 Earnings Call
Image Requirements are a Wild Card in Today’s Buy/Sells

It is a well-known industry phenomena that OEMs can exert their will when it comes to approving a buy/sell. This is particularly true with facility requirements. Despite state dealer associations’ attempts to limit OEM image programs, the manufacturers continue to demand costly bricks and mortar investments as part of approving a buy/sell, often reducing a seller’s blue sky or adding risk to a sale.

The challenge for buyers and sellers is facility upgrade costs are hard to predict when entering into a transaction, and thus difficult to price. What is required of a seller can be quite different for a buyer. Given this asymmetry, the OEM’s image requirements can make or break a deal, particularly when the buyer’s facility requirements are unknown until OEM approval.

In many cases, the OEMs themselves seem uncertain which direction they are headed when it comes to dealership facilities, adding further confusion to a buy/sell. Some OEMs have shared with Kerrigan Advisors their discomfort in asking for expensive facilities while also demanding significant investment in digital retailing. They are sensitive to the potential hypocrisy of these facility requirements in an Amazon era.

“I mean I think the manufacturers are thinking outside of the box and are not so focused on these huge facilities, much more on technology and efficiencies.”

Jeff Dyke, President
Sonic Automotive
Third Quarter 2019 Earnings Call

When buyers are being asked to invest in facility improvements as part of a buy/sell, some are considering the ROI of those investments. Chart XXII shows the potential loss of blue sky value if the increased rent associated with a $1 million facility investment does not produce a future increase in revenue. As can be seen in this analysis, the more valuable the franchise, the larger the potential decrease in blue sky value. Simply put, if a facility investment does not result in higher future revenue, it may be an unprofitable investment with a negative return profile. OEMs should not be surprised that some buyers are unwilling to make negative ROI investments.

Chart XXII
Potential Loss of Blue Sky, Assuming $1M Image Upgrade Results in No Increase in Revenue
Source: Kerrigan Advisors
Note: Assumes 7% capitalization rate on real estate to calculate increased rent expense.

<table>
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<tr>
<th>Blue Sky Multiple</th>
<th>$(280,000)</th>
<th>$(350,000)</th>
<th>$(420,000)</th>
<th>$(490,000)</th>
<th>$(560,000)</th>
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If buyers do not foresee a revenue increase as a result of an image upgrade, they are less likely to move forward with a transaction for fear they could be making a negative ROI investment and reducing their blue sky post-transaction.
Buyers Increasingly Focus on Management in Transactions

Management is a key driver of a dealership's success. More so than in other industries, auto retail profits are heavily reliant on the entrepreneurial spirit and leadership knowhow of the dealer operator. With a capable operator, most franchises can find a path to profit, regardless of franchise. This is due to the many revenue streams that drive dealership profitability. A manager who knows how to operate a strong used car business and drive up F&I revenue can succeed with almost any franchise. The key is finding those managers.

Today, unemployment is at record low levels (see Chart XXIII), resulting in a very tight labor market. Increasingly, dealers find themselves in a war for talent. In this environment, it is not surprising to see buyers focused on key employee retention as part of an acquisition.

Chart XXIII
US Unemployment Rate (January 2009-November 2019)

Kerrigan Advisors sees the war for talent playing out in several ways in the buy/sell market. In the case of a highly profitable dealership acquisition, buyers often see management retention as an important closing condition. This is a challenging requirement, as the seller cannot necessarily control whether a manager is willing to work for the buyer.

In some instances, buyers are also asking the seller's key manager to become an equity owner of the buying entity in order to ensure the manager’s commitment post-transaction. This scenario adds risk to a transaction, as the buyer is negotiating both with the seller and the seller’s manager in order to complete the purchase. Also, the seller and key manager may have different and sometimes competing goals, adding complexity to the sale.

“When we find the right geographies and management team, we should be able to step up and be able to put those transactions together.”

Bryan DeBoer, President & CEO
Lithia Motors
Third Quarter 2019 Earnings Call
In the case of underperforming dealerships, Kerrigan Advisors finds that certain buyers will pass on an acquisition if they do not have a manager available to replace the underperforming operator. As the quote below from David Hult, President & CEO of Asbury Automotive, aptly points out, the biggest risk to an acquisition is operating the business post-close. Thus, if the right management is not in place after completing an acquisition, the acquired dealership will likely underperform and provide a poor return to the buyer. Kerrigan Advisors expects dealership management post-transaction to be an important deal point in most transactions in 2020.

“It’s very easy to buy something, much harder to run it.”

David Hult, President & CEO
Asbury Automotive Group
Third Quarter 2019 Earnings Call
KERRIGAN ADVISORS BLUE SKY MULTIPLES

Kerrigan Advisors’ Blue Sky Charts outline the high, average and low blue sky multiples for each franchise in the luxury and non-luxury segments. Most dealerships are valued based on their assets plus blue sky, excluding working capital. Kerrigan Advisors’ blue sky multiples should be applied to trailing twelve month adjusted pre-tax dealership earnings.

Kerrigan Advisors’ blue sky multiples are based on our view of franchise values in the current buy/sell market. **These multiples should be considered guideposts to estimate a dealership's blue sky value.** Each dealership has its own unique valuation drivers and significant analysis should be done to determine the market clearing price for a dealership’s blue sky. Accurately adjusting earnings, for instance, is critical in determining blue sky value.

Kerrigan Advisors’ high, average and low multiples reflect the variability in dealership values. In our experience, there are six key factors that drive where a franchise will sell within the range: (i) earnings growth expectations; (ii) buyer demand; (iii) real estate; (iv) market vehicle preference; (v) franchise market representation and (vi) customer relations. The combination of these six factors determines the blue sky multiple a buyer is ultimately willing to pay.

### Higher Multiple
- **High Growth**
- **High Demand**
- **Low Rent/ Image Compliant**
- **Franchise Highly Suitable**
- **Single-Point Market**
- **High CSI & SSI**

### Adjusted Blue Sky Multiple

### Lower Multiple
- **Low/No Growth**
- **Low Demand**
- **High Rent/ Building Project**
- **Franchise Unsuitable**
- **Over-Franchised**
- **Low CSI & SSI**

#### Factor One: Earnings Growth Expectations

- **Higher Growth = Higher Multiple**: Dealerships in high growth markets have higher earnings growth expectations and often command higher multiples. By way of example, Florida and Texas are high-growth markets where dealerships often command premium multiples. Over the last decade, underperforming dealerships have also commanded higher multiples. However, as industry sales slow, buyers are less willing to pay an underperformer a high multiple, particularly in the case of weaker franchises.

- **Lower Growth = Lower Multiple**: Overperforming dealerships can experience below average earnings growth post-sale. Ironically, a dealership that is overperforming, meaning its profitability and/or sales are above market expectations, often commands a lower blue sky multiple.
Factor Two: Buyer Demand

- **Higher Demand = Higher Multiple**: Certain markets are in higher demand than others. For instance, there is a significant number of buyers seeking dealerships in the “smile states”. Dealerships in these markets often command higher multiples than dealerships in more seasonal climates. High buyer demand, with limited seller supply, drives up price.

- **Lower Demand = Lower Multiple**: Less demand means less competition and lower blue sky multiples. As an example, there are fewer buyers seeking dealerships in smaller/rural markets, resulting in lower multiples.

Factor Three: Real Estate

- **Image Compliant Facilities & Low Rent = Higher Multiple**: Image compliant dealerships with low rent command higher multiples. These dealerships are highly attractive to buyers because they require no additional investment and they have an attractive rent factor, thus low fixed expenses and less risk. In general, if a dealership is image compliant and its rent to gross profit is below 10%, then it is considered to have low rent.

- **Real Estate Investment Required and/or High Rent = Lower Multiple**: Dealerships that require major real estate investments or have high rent command lower multiples. Most buyers are not looking for real estate development projects. When a dealership requires a significant real estate investment, both known and unknown costs are created. These costs result in increased future rent, which could reduce future earnings. As such, buyers often price non-image compliant franchises or franchises with high rent at lower multiples to take into account the risk to future earnings.

Factor Four: Market Vehicle Preference

- **Highly Suitable Franchise for a Market = Higher Multiple**: Franchises that are highly suitable for a market receive higher multiples. For example, a domestic franchise located in a truck market, such as Colorado or Texas, is more valuable than the average domestic franchise in the US, and thus will likely command a higher multiple. This is because unit sales volume and dealership earnings in those markets are expected to be far above the average domestic franchise.

- **Unsuitable Franchise for a Market = Lower Multiple**: Franchises that are unsuitable for a market receive lower multiples. For example, a luxury franchise in a small city with few high-income wage earners will be much less valuable than the average luxury franchise located in a major metro.

Factor Five: Franchise Market Representation

- **Single Point Market = Higher Multiple**: A franchise with no like-franchise competition in its market will usually sell at a higher multiple than a franchise which competes with one or more other like-franchises. The exception to this rule is if a buyer knows a franchise will be added to a market in the near future. In that instance, the price premium would be reduced, as the buyer would expect sales and margins to decline when a competitor enters the market.

- **Over-Dealed Market = Lower Multiple**: Markets with too many like-franchises command much lower multiples. These franchises face higher competition and typically lower margins, thus lower profits.
**Factor Six: Customer Relations**

- **High CSI/Dealer Rating/Customer Retention = Higher Multiple:** A dealership's brand and reputation is playing an increasingly important role in franchise value. Dealerships with high customer retention and exceptional customer relations will command higher multiples, as the profits associated with those businesses are more sustainable. Kerrigan Advisors believes a dealership's social media brand will become increasingly important to franchise value in the future.

- **Low CSI/Dealer Rating/Customer Retention = Lower Multiple:** Dealerships with poor online reputations, coupled with low CSI and SSI, receive lower blue sky multiples. Buyers of these dealerships are concerned about the time and capital required to change customer perceptions. Furthermore, low customer retention results in higher customer acquisition costs and a less efficient business model. With social media's growing commercial importance, poor dealer ratings will also have an increasingly negative effect on franchise value.

It is important to keep in mind that our published blue sky multiples reflect a buyer’s expected or required return on investment in exchange for the perceived risk associated with a franchise’s future income stream. Franchises with higher operational risk command lower multiples, while franchises with lower operational risk command higher multiples.

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**Chart XXIV**

**Expected Return on Investment Based on Blue Sky Multiple**

*Source: Kerrigan Advisors Analysis*

*Note: Analysis excludes real estate and assumes working capital and fixed assets represent a single turn of earnings. Analysis also assumes there is no change in dealership earnings post-transaction.*

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For the third quarter of 2019, Kerrigan Advisors’ blue sky multiples had several adjustments with one multiple increase and three multiple decreases. Specifically, we increased Volkswagen’s lower end multiple from 2.0 to 2.5. This increase is a result of several positive indicators for the franchise, including: (i) rising buyer demand, (ii) 2019 sales growth, and (iii) the OEM’s renewed focus on dealership profitability. Volkswagen dealers are also optimistic about the leadership of Scott Keogh, the recently appointed CEO of Volkswagen of America, and his commitment to increase franchise value. The results of the Kerrigan Dealer Survey further support Volkswagen’s higher valuation outlook - Volkswagen ranked 4th highest amongst all franchises for expected valuation improvement.
Kerrigan Advisors’ three multiple downgrades this quarter were for Chevrolet, Ford and Nissan. Chevrolet and Ford’s high-end multiples were downgraded from 5.0 to 4.5 and their low-end multiples were downgraded from 4.0 to 3.75. Buyers’ willingness to pay higher multiple for these franchises is beginning to diminish in part due to their increasing reliance on truck sales (see Chart XXV), which are considered more economically cyclical.

<table>
<thead>
<tr>
<th>Year</th>
<th>Chevrolet Truck Sales</th>
<th>Ford Truck Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>2014</td>
<td>56.7%</td>
<td>67.9%</td>
</tr>
<tr>
<td>2015</td>
<td>63.9%</td>
<td>69.6%</td>
</tr>
<tr>
<td>2016</td>
<td>64.9%</td>
<td>73.7%</td>
</tr>
<tr>
<td>2017</td>
<td>69.0%</td>
<td>77.4%</td>
</tr>
<tr>
<td>2018</td>
<td>75.7%</td>
<td>80.8%</td>
</tr>
<tr>
<td>2019 LTM</td>
<td>80.1%</td>
<td>84.1%</td>
</tr>
</tbody>
</table>

Some buyers are concerned about the sustainability of the domestic truck market, particularly given rising gas prices, an uptick in auto loan default rates, and existing recession risks in today’s economy. Also, with many competitors introducing new truck, SUV and CUV models in 2020, Chevrolet and Ford’s market share in this segment could diminish. Both Ford and Chevrolet have seen their sales decline 4.1% and 3.4%, respectively, through the third quarter 2019, reducing average dealership profitability. For these reasons, Kerrigan Advisors has downgraded both franchises’ blue sky multiples. With this change in multiple, Chevrolet’s negative multiple outlook has been changed to steady.

Kerrigan Advisors also downgraded Nissan’s low-end multiple this quarter from 3.0 to 2.5. This decline reflects the continued challenges faced by the franchise, both from an OEM management standpoint and a buyer demand perspective. 65% of dealers surveyed in the 2019 Kerrigan Dealer Survey expect the value of the Nissan franchise to decline in the next 12 months. Until news improves for the franchise, Nissan’s multiple outlook will remain negative.

In addition to these multiple adjustments, Kerrigan Advisors downgraded the multiple outlook for Audi this quarter. Audi sales are underperforming the luxury market in 2019, down 5.3% year-to-date, versus a luxury sales decline of 1.3%. In the 2019 Kerrigan Dealer Survey, 29% of dealers surveyed believed Audi’s franchise would decline in value in the next 12 months, versus just 14% who thought the franchise would increase in value. Kerrigan Advisors expects Audi’s expensive facility requirements, as well as declines in dealer profitability are the primary reasons for the negative sentiment.

This summarizes the changes to Kerrigan Advisors’ blue sky multiples and our outlooks for the third quarter of 2019.
Chart XXVI
Kerrigan Advisors Blue Sky Multiples: Non-Luxury Average
Source: Kerrigan Advisors Analysis

* In Q4 2018, the low-end multiple for Land Rover increased from 6.0 to 7.0. This change did not change the average multiple for JLR, because the combined brand’s high and low multiple did not change.
Chart XXVIII
Kerrigan Advisors Third Quarter 2019 Blue Sky Multiples and Analysis: Non-Luxury
Source: Kerrigan Advisors Analysis, Automotive News and Moody’s

<table>
<thead>
<tr>
<th>Franchise</th>
<th>Buyer Demand</th>
<th>Change in Sales Q3 19 YTD vs. Q3 18 YTD</th>
<th>Sales Per Dealership LTM</th>
<th>Average Dealership Profitability</th>
<th>Buy/Sell Market Share</th>
<th>Kerrigan Dealer Survey (Positive Franchise Valuation Expectations)</th>
<th>Moody’s Credit Rating</th>
<th>Multiple Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td>Toyota</td>
<td>High</td>
<td>-2.5%</td>
<td>1,686</td>
<td>Consistently High</td>
<td>4.8%</td>
<td>30% Aa3 Steady</td>
<td></td>
<td>Steady</td>
</tr>
<tr>
<td>Honda</td>
<td>High</td>
<td>+0.1%</td>
<td>1,382</td>
<td>Consistently High</td>
<td>7.1%</td>
<td>22% A2 Steady</td>
<td></td>
<td>Steady</td>
</tr>
<tr>
<td>Subaru</td>
<td>High</td>
<td>+4.4%</td>
<td>1,114</td>
<td>Consistently High</td>
<td>1.9%</td>
<td>43% Not Rated Steady</td>
<td></td>
<td>Steady</td>
</tr>
<tr>
<td>Chevrolet</td>
<td>Average</td>
<td>-3.4%</td>
<td>665</td>
<td>Variable</td>
<td>15.2%</td>
<td>12% Baa3 Steady</td>
<td></td>
<td>Steady</td>
</tr>
<tr>
<td>CJDR</td>
<td>Average</td>
<td>-4.1%</td>
<td>765</td>
<td>Variable</td>
<td>14.8%</td>
<td>14% Ba1 Steady</td>
<td></td>
<td>Steady</td>
</tr>
<tr>
<td>Jeep</td>
<td>Improving</td>
<td>-0.6%</td>
<td>883</td>
<td>Variable</td>
<td>12.9%</td>
<td>13% Ba1 Positive</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ford</td>
<td>Low</td>
<td>+4.4%</td>
<td>407</td>
<td>Variable</td>
<td>11.9%</td>
<td>4% Baa3 Negative</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Buick/GMC</td>
<td>Low</td>
<td>-6.2%</td>
<td>1,178</td>
<td>Variable</td>
<td>7.1%</td>
<td>8% A3 Negative</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nissan</td>
<td>Low</td>
<td>+2.8%</td>
<td>812</td>
<td>Variable</td>
<td>2.4%</td>
<td>19% Baa1 Steady</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hyundai</td>
<td>Low</td>
<td>+2.6%</td>
<td>777</td>
<td>Variable</td>
<td>2.4%</td>
<td>19% Baa1 Steady</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kia</td>
<td>Low</td>
<td>+4.5%</td>
<td>561</td>
<td>Consistently Low</td>
<td>1.9%</td>
<td>24% A3 Steady</td>
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<td></td>
</tr>
<tr>
<td>VW</td>
<td>Low</td>
<td>-11.5%</td>
<td>470</td>
<td>Consistently Low</td>
<td>1.0%</td>
<td>13% Not Rated Steady</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mazda</td>
<td>Low</td>
<td>-11.5%</td>
<td>470</td>
<td>Consistently Low</td>
<td>1.0%</td>
<td>13% Not Rated Steady</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Chart XXIX
Kerrigan Advisors Third Quarter 2019 Blue Sky Multiples and Analysis: Luxury

Source: Kerrigan Advisors Analysis, Automotive News and Moody’s

<table>
<thead>
<tr>
<th>Franchise</th>
<th>Buyer Demand</th>
<th>Change in Sales Q3 19 YTD vs. Q3 18 YTD</th>
<th>Sales Per Dealership LTM</th>
<th>Average Dealership Profitability</th>
<th>Buy/Sell Market Share</th>
<th>Kerrigan Dealer Survey (Positive Franchise Valuation Expectations)</th>
<th>Moody’s Credit Rating</th>
<th>Multiple Outlook</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Porsche</strong></td>
<td>High</td>
<td>+5.7%</td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>Average</td>
<td>8.25</td>
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<td></td>
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<tr>
<td></td>
<td>Low</td>
<td>7.5</td>
<td></td>
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</tr>
<tr>
<td><strong>Mercedes</strong></td>
<td>High</td>
<td>-0.1%</td>
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<tr>
<td></td>
<td>Average</td>
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<tr>
<td></td>
<td>Low</td>
<td>7.0</td>
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</tr>
<tr>
<td><strong>Lexus</strong></td>
<td>High</td>
<td>+3.3%</td>
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<tr>
<td></td>
<td>Average</td>
<td>8.75</td>
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<td></td>
<td>Low</td>
<td>7.0</td>
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<tr>
<td><strong>BMW</strong></td>
<td>High</td>
<td>-1.9%</td>
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<td></td>
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<tr>
<td></td>
<td>Average</td>
<td>8.5</td>
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<td></td>
<td>Low</td>
<td>7.0</td>
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</tr>
<tr>
<td><strong>Audi</strong></td>
<td>Declining</td>
<td>-5.3%</td>
<td></td>
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<tr>
<td></td>
<td>Low</td>
<td>7.0</td>
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</tr>
<tr>
<td><strong>Land Rover - Jaguar</strong></td>
<td>High</td>
<td>+2.3% LR +5.9% Jag</td>
<td></td>
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<td></td>
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<tr>
<td></td>
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<td></td>
<td>Low</td>
<td>3.0</td>
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</tr>
<tr>
<td><strong>Volvo</strong></td>
<td>High*</td>
<td>9.0</td>
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<tr>
<td></td>
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<tr>
<td></td>
<td>Low</td>
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</tr>
<tr>
<td><strong>Infiniti</strong></td>
<td>High</td>
<td>+4.7%</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>Average</td>
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<tr>
<td></td>
<td>Low</td>
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<tr>
<td><strong>Acura</strong></td>
<td>Low</td>
<td>-16.5%</td>
<td></td>
<td></td>
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<td>Average</td>
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<tr>
<td></td>
<td>Low</td>
<td>3.5</td>
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</tr>
<tr>
<td><strong>Cadillac</strong></td>
<td>Low</td>
<td>-1.5%</td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td></td>
<td>Average</td>
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<td>Low</td>
<td>3.0</td>
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</tr>
</tbody>
</table>

* When including Land Rover
In closing, we hope you find The Blue Sky Report® for the third quarter of 2019 informative and helpful to your business. Kerrigan Advisors is the leading strategic advisory firm to growing dealership groups, working as a thought partner to key executives and owners as they consider their capital allocation and expansion strategies. Our firm’s mission is to add value to dealers and their families as they grow, operate and, only when the time is right, sell their business.

We are honored to be the top sell-side advisor to owners of higher value dealerships and dealership groups. **In the last five years, we have advised on the highest value transactions in the industry, including five of the Top 100 Dealership Groups, more than any other firm in the industry.** Kerrigan Advisors has had the honor of working with auto retail’s leading dealers in determining the right time to sell and the most appropriate buyer for their dealerships. We do not take listings, or maintain an inventory of sell-side clients, rather we focus on a select number of higher value transactions, devoting our team’s time and energy to ensure the sale process is well-run and successful. In our view, dealerships are far too valuable to be advised any other way.

We look forward to seeing you at one of our upcoming industry events and scheduling a confidential conversation about how we can assist as you navigate the ever-changing auto retail environment.

**KERRIGAN ADVISORS’ UPCOMING SPEAKING EVENTS**

**WOMEN DEALERS DINNER**
Women Dealers Dinner at NADA
February 13, 2020
Las Vegas, NV

**NADA 2020 Super Session Workshop**
February 14, 2020 (12:15-2:00)
Las Vegas, NV

Houston Automobile Dealers Association
Spring Luncheon
April 22, 2020
Houston, TX

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In today's buy-sell market, new vehicle sales may be declining, but interest in auto retail acquisitions is not. This workshop will review value drivers like current dealership profitability, ROI goals, the franchise business model and acquisition financing terms, as well as the interplay between “blue sky” and real estate in today's transaction pricing. We will also discuss how dealers can strategically grow their business to enhance total enterprise value.

- Capital allocation strategies to enhance dealership value
- ROI analytics to determine blue sky and real estate pricing
- Identifying franchises with higher value business models
At Kerrigan Advisors, we pride ourselves on our singular focus—working with dealers and their families to increase the value of their business. From growth through exit, our firm supports generations of dealers through the lifecycle of owning and operating their businesses with our buy/sell advisory, capital-raising, and consulting services. We hope for the opportunity to work with you as you chart your course in a changing auto retail landscape.

A Leading Sell-Side Advisor and Thought Partner to Auto Dealers

Erin Kerrigan
Founder & Managing Director

Ryan Kerrigan
Managing Director

Mercedes Hendricks
Vice President

Gabe Robleto
Vice President

Wayne Meyer
Senior Operations Advisor

Marie Brashears
Senior Associate

Pierre Dempsey
Associate

Ellen Kulla
Marketing Coordinator

Professional. Confidential. Proven.

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