

GROUP 1 AUTOMOTIVE INC

Form 10-K

February 27, 2007

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-K**

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2006**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the transition period from        to**

**Commission file number: 1-13461**  
**Group 1 Automotive, Inc.**  
*(Exact name of registrant as specified in its charter)*

**DELAWARE**  
*(State or other jurisdiction of  
incorporation or organization)*

**76-0506313**  
*(I.R.S. Employer  
Identification No.)*

**950 Echo Lane, Suite 100  
Houston, Texas 77024**  
*(Address of principal executive  
offices, including zip code)*

**(713) 647-5700**  
*(Registrant's telephone  
number including area code)*

**Securities registered pursuant to Section 12(b) of the Act:**

<b><u>Title of each class</u></b>	<b><u>Name of exchange on which registered</u></b>
<b>Common stock, par value \$0.01 per share</b>	<b>New York Stock Exchange</b>

**Securities registered pursuant to Section 12(g) of the Act: None.**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements

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incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of common stock held by non-affiliates of the Registrant was approximately \$1,307.7 million based on the reported last sale price of common stock on June 30, 2006, which is the last business day of the registrant's most recently completed second quarter.

As of February 23, 2007, there were 24,264,600 shares of our common stock, par value \$0.01 per share, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's definitive proxy statement for its 2007 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission within 120 days of December 31, 2006, are incorporated by reference into Part III of this Form 10-K.

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**Cautionary Statement About Forward-Looking Statements**

This Annual Report on Form 10-K includes certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended. We have attempted to identify forward-looking statements by terminology such as expect, may, will, intend, anticipate, believe, could, possible, plan, project, forecast and similar expressions. These statements include statements regarding our plans, goals or current expectations with respect to, among other things:

our future operating performance;

our ability to improve our margins;

operating cash flows and availability of capital;

the completion of future acquisitions;

the future revenues of acquired dealerships;

future stock repurchases and dividends;

capital expenditures;

changes in sales volumes in the new and used vehicle and parts and service markets;

business trends in the retail automotive industry, including the level of manufacturer incentives, new and used vehicle retail sales volume, customer demand, interest rates and changes in industrywide inventory levels; and

availability of financing for inventory, working capital and capital expenditures.

Any such forward-looking statements are not assurances of future performance and involve risks and uncertainties. Actual results may differ materially from anticipated results in the forward-looking statements for a number of reasons, including:

the future economic environment, including consumer confidence, interest rates, the price of gasoline, the level of manufacturer incentives and the availability of consumer credit may affect the demand for new and used vehicles, replacement parts, maintenance and repair services and finance and insurance products;

adverse international developments such as war, terrorism, political conflicts or other hostilities may adversely affect the demand for our products and services;

the future regulatory environment, unexpected litigation or adverse legislation, including changes in state franchise laws, may impose additional costs on us or otherwise adversely affect us;

our principal automobile manufacturers, especially Toyota/Lexus, Ford, DaimlerChrysler, General Motors, Honda/Acura and Nissan/Infiniti, because of financial distress or other reasons, may not continue to produce or make available to us vehicles that are in high demand by our customers or provide financing, advertising or other assistance to us;

requirements imposed on us by our manufacturers may limit our acquisitions and require us to increase the level of capital expenditures related to our dealership facilities;

our dealership operations may not perform at expected levels or achieve expected improvements;

our failure to achieve expected future cost savings or future costs being higher than we expect;

available capital resources and various debt agreements may limit our ability to complete acquisitions, complete construction of new or expanded facilities and repurchase shares;

our cost of financing could increase significantly;

new accounting standards could materially impact our reported earnings per share;

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our inability to complete additional acquisitions or changes in the pace of acquisitions;

the inability to adjust our cost structure to offset any reduction in the demand for our products and services;

our loss of key personnel;

competition in our industry may impact our operations or our ability to complete acquisitions;

the failure to achieve expected sales volumes from our new franchises;

insurance costs could increase significantly and all of our losses may not be covered by insurance; and

our inability to obtain inventory of new and used vehicles and parts, including imported inventory, at the cost, or in the volume, we expect.

The information contained in this Annual Report on Form 10-K, including the information set forth under the headings Risk Factors and Management's Discussion and Analysis of Financial Condition and Results of Operation, identifies factors that could affect our operating results and performance. We urge you to carefully consider those factors.

All forward-looking statements attributable to us are qualified in their entirety by this cautionary statement. We undertake no responsibility to update our forward-looking statements.

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**PART I**

**Item 1. Business**

**General**

Group 1 Automotive, Inc. is a leading operator in the \$1.0 trillion automotive retail industry. We own and operate 143 franchises at 105 dealership locations and 30 collision centers as of December 31, 2006. Through our operating subsidiaries, we market and sell an extensive range of automotive products and services including new and used vehicles and related financing, vehicle maintenance and repair services, replacement parts, and warranty, insurance and extended service contracts. Our operations are primarily located in major metropolitan areas in Alabama, California, Florida, Georgia, Louisiana, Massachusetts, Mississippi, New Hampshire, New Jersey, New Mexico, New York, Oklahoma and Texas.

Prior to January 1, 2006, our retail network was organized into 13 regional dealership groups, or platforms. In 2006, we reorganized our operations and as of December 31, 2006, the retail network consisted of the following four regions (with the number of dealerships they comprised): (i) Northeast (23 dealerships in Massachusetts, New Hampshire, New Jersey and New York), (ii) Southeast (19 dealerships in Alabama, Florida, Georgia, Louisiana and Mississippi), (iii) Central (51 dealerships in New Mexico, Oklahoma and Texas) and (iv) West (12 dealerships in California). Each region is managed by a regional vice president reporting directly to the Company's Chief Executive Officer, as well as a regional chief financial officer reporting directly to the Company's Chief Financial Officer.

**Business Strategy**

Our business strategy is to leverage one of our key strengths—the considerable talent of our people to sell new and used vehicles; arrange related financing, vehicle service and insurance contracts; provide maintenance and repair services; and sell replacement parts via an expanding network of franchised dealerships located in growing regions of the United States. We believe over the last two years we have developed one of the strongest management teams in the industry, adding seasoned veterans with automotive retailing experience, starting with our:

President and Chief Executive Officer;

Senior Vice President, Operations and Corporate Development;

Senior Vice President and Chief Financial Officer;

Vice President, General Counsel and Corporate Secretary;

Vice President of Fixed Operations;

four regional vice presidents; and

operators of our individual store locations.

With this level of talent, we plan to continue empowering our operators to make appropriate decisions as close to our customers as possible. We believe this approach allows us to continue to attract and retain talented employees, as well as provide the best possible service to our customers. At the same time, however, we also recognize that the six-fold



growth in revenues we have experienced since our inception in 1997 has brought us to a transition point.

To fully leverage our scale, reduce costs, enhance internal controls and enable further growth, we are taking steps to standardize key operating processes. First, we effected the management consolidation through the reorganization described above. This move supports more rapid decision making and speeds the roll-out of new processes. Additionally, we are consolidating our dealer management system suppliers and implementing a standard general ledger layout throughout our dealerships. As of December 31, 2006, approximately 87% of our dealerships utilized the same dealer management system offered by Dealer Services Group of Automatic Data Processing Inc. We expect that all of our dealerships will be on the same dealer management system by June 30, 2007 and standard general ledger layout by December 31, 2007. These actions represent key building blocks that will not only enable us to bring more efficiency to our accounting and information technology processes, but will

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support further standardization of critical processes and more rapid integration of acquired operations going forward, and significantly reduce technology costs.

We continue to believe that substantial opportunities for growth through acquisition remain in our industry. We intend to continue focusing on growing our portfolio of import and luxury brands, as well as targeting that growth to provide geographic diversity in areas with bright economic outlooks over the longer-term. We completed acquisitions comprising in excess \$700 million in estimated aggregated annualized revenues for 2006. We are targeting acquisitions of at least \$600 million in estimated aggregated annualized revenues for 2007.

Despite our desire to continue to grow through acquisitions, we continue to primarily focus on the performance of our existing stores to achieve internal growth goals. We believe further revenue growth is available in our existing stores and plan to utilize enhancements to our technology to help our people deliver that anticipated growth. In particular, we continue to focus on growing our higher margin used vehicle and parts and service businesses, which support growth even in the absence of an expanding market for new vehicles. To this end, we implemented an internet based used vehicle inventory management system, American Auto Exchange or AAX, enabling us to:

make used vehicle inventory decisions based on real time market valuation data;

leverage our size and local market presence; and

better control our exposure to used vehicles.

The use of our software products tool in conjunction with our management focus in the used vehicle operations has helped to increase retail sales and improve margins. We are also continuing to improve service revenue by further capital investment in our facilities. In addition, in 2006, we hired a senior executive to oversee our parts and services operations.

To further strengthen our management team, we created two additional management positions late in the year, which we believe will lead to further efficiencies and streamlined management of costs. First, for the first time we formed the office of General Counsel, and empowered the office with the responsibility of managing our numerous legal matters, including our legal expenditures and monitoring the costs efficiency of our outside legal counsel fees. Secondly, we created the position of vice president purchasing which will be responsible for centralizing our purchasing department in an attempt to fully utilize our buying power in the marketplace and to take advantage of certain economies of scale.

For 2007, we are focusing on four areas as we continue implementing steps to become a best-in-class automotive retailer. These areas are:

Greater emphasis on increasing same-store revenue growth;

Completion of the transition to an operating model with greater commonality of key operating processes and systems that support the extension of best practices and the leveraging of scale;

Continued emphasis on cost reduction and operating efficiency efforts; and

Increased ownership of our real estate holdings.

We believe the combination of these actions should allow us to grow profitability over the next five years.



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Our operations are located in geographically diverse markets from New Hampshire to California. The following table sets forth the regions and geographic markets in which we operate, the percentage of new vehicle retail units sold in each region in 2006, and the number of dealerships and franchises in each region:

<b>Region</b>	<b>Geographic Market</b>	<b>Percentage of Our New Vehicle Retail Units Sold During the Twelve Months Ended December 31, 2006</b>	<b>As of December 31, 2006</b>	
			<b>Number of Dealerships</b>	<b>Number of Franchises</b>
Northeast	Massachusetts	12.5%	10	11
	New Hampshire	3.8	3	3
	New Jersey	3.3	6	7
	New York	2.3	4	4
Southeast		21.9	23	25
	Louisiana	5.0	5	8
	Florida	4.5	4	4
	Georgia	3.8	6	8
	Mississippi	0.6	3	3
Central	Alabama	0.3	1	1
		14.2	19	24
	Texas	33.4	35	52
	Oklahoma	10.6	13	20
West	New Mexico	2.1	3	7
	Colorado <sup>(1)</sup>	0.2		
	California	46.3	51	79
Total		100.0%	105	143

(1) We disposed of our only Colorado dealership during 2006.

Each of our local operations has a management structure that promotes and rewards entrepreneurial spirit and the achievement of team goals. The general manager of each dealership, with assistance from the managers of new vehicle sales, used vehicle sales, parts and service, and finance and insurance, is ultimately responsible for the

operation, personnel and financial performance of the dealership. Our dealerships are operated as distinct profit centers, and our general managers have a reasonable degree of empowerment within our organization. Our regional vice presidents are responsible for the overall performance of their regions and for overseeing the dealership general managers.

*New Vehicle Sales*

In 2006, we sold or leased 129,198 new vehicles representing 34 brands in retail transactions at our dealerships. Our retail sales of new vehicles accounted for approximately 28.2% of our gross profit in 2006. In addition to the profit related to the transactions, a typical new vehicle sale or lease creates the following additional profit opportunities for a dealership:

manufacturer rebates and incentives, if any;

the resale of any trade-in purchased by the dealership;

the sale of third-party finance, vehicle service and insurance contracts in connection with the retail sale; and

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the service and repair of the vehicle both during and after the warranty period.

Brand diversity is one of our strengths. The following table sets forth new vehicle sales revenue by brand and the number of new vehicle retail units sold in the year ended, and the number of franchises we owned as of, December 31, 2006:

	<b>New Vehicle Revenues (In thousands)</b>	<b>New Vehicle Unit Sales</b>	<b>Franchises Owned as of December 31, 2006</b>
Toyota	\$ 910,582	37,063	13
Ford	484,757	16,032	14
Nissan	333,459	13,004	12
Lexus	293,066	6,748	3
Honda	255,914	10,817	8
Mercedes-Benz	237,621	4,121	3
BMW	210,281	4,304	6
Chevrolet	201,582	7,184	6
Dodge	186,520	6,363	9
Chrysler	82,925	3,200	10
Acura	77,109	2,293	4
Jeep	76,568	2,814	9
GMC	61,845	1,872	4
Infiniti	54,337	1,406	1
Scion	42,502	2,666	N/A <sup>(1)</sup>
Volvo	39,721	1,134	2
Audi	28,726	637	1
Lincoln	28,514	665	5
Mitsubishi	28,015	1,180	4
Mazda	21,905	1,011	2
Volkswagen	18,542	749	2
Mercury	18,540	679	6
Subaru	14,589	573	1
Pontiac	14,468	659	4
Cadillac	13,228	265	2
Kia	11,337	522	2
Porsche	10,843	147	1
Mini	9,000	361	1
Buick	8,758	318	4
Hyundai	6,762	317	1
Maybach	3,919	9	1
Suzuki	1,396	80	1
Lotus	210	4	1
Hummer	37	1	

Total	\$	3,787,578	129,198	143
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(1) The Scion brand is not considered a separate franchise, but rather is governed by our Toyota franchise agreements. We sell the Scion brand at 12 of our Toyota franchised locations.

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Our mix of domestic, import and luxury franchises is also critical to our success. Over the past two years, we have strategically managed our exposure to the declining domestic market and emphasized the fast growing luxury and import markets, shifting our revenue mix from 41% domestic and 59% luxury and import in 2004 to 30% and 70% in 2006, respectively. Our mix for the year ended December 31, 2006, is set forth below:

	<b>New Vehicle Revenues (In thousands)</b>	<b>New Vehicle Unit Sales</b>	<b>Percentage of Total Units Sold</b>
Import	\$ 1,645,001	67,982	53%
Domestic	1,135,963	39,121	30
Luxury	1,006,614	22,095	17
	<b>\$ 3,787,578</b>	<b>129,198</b>	<b>100%</b>

Some new vehicles we sell are purchased by customers under lease or lease-type financing arrangements with third-party lenders. New vehicle leases generally have shorter terms, bringing the customer back to the market, and our dealerships specifically, sooner than if the purchase was debt financed. In addition, leasing provides our dealerships with a steady supply of late-model, off-lease vehicles to be inventoried as pre-owned vehicles. Generally, these vehicles remain under factory warranty, allowing the dealerships to provide repair services, for the contract term. However, the penetration of finance and insurance product sales on leases tends to be less than in other financing arrangements. We typically do not guarantee residual values on lease transactions.

***Used Vehicle Sales***

We sell used vehicles at each of our franchised dealerships. In 2006, we sold or leased 67,868 used vehicles at our dealerships, and sold 45,706 used vehicles in wholesale markets. Our retail sales of used vehicles accounted for approximately 14.9% of our gross profit in 2006, while losses from the sale of vehicles on wholesale markets reduced our gross profit by approximately 0.3%. Used vehicles sold at retail typically generate higher gross margins on a percentage basis than new vehicles because of our ability to acquire these vehicles at favorable prices due to their limited comparability and the nature of their valuation, which is dependent on a vehicle's age, mileage and condition, among other things. Valuations also vary based on supply and demand factors, the level of new vehicle incentives, the availability of retail financing, and general economic conditions.

Profit from the sale of used vehicles depends primarily on a dealership's ability to obtain a high-quality supply of used vehicles at reasonable prices and to effectively manage that inventory. Our new vehicle operations provide our used vehicle operations with a large supply of generally high-quality trade-ins and off-lease vehicles, the best sources of high-quality used vehicles. Our dealerships supplement their used vehicle inventory from purchases at auctions, including manufacturer-sponsored auctions available only to franchised dealers, and from wholesalers. During 2006, we enhanced our management of used vehicle inventory, focusing on the more profitable retail used vehicle business and deliberately reducing our wholesale used vehicle business. To facilitate, we completed installation of American Auto Exchange's used vehicle management software in all of our dealerships. This internet based software tool enables our managers to make used vehicle inventory decisions based on real time market valuation data, and is an integral part of acquisition integration. It also allows us to leverage our size and local market presence by enabling the sale of used vehicles at a given dealership from our other dealerships in a local market, effectively broadening the demand for



our used vehicle inventory. In addition, this software supports increased oversight of our assets in inventory, allowing us to better control our exposure to used vehicles, the values of which typically decline over time. Each of our dealerships attempts to maintain no more than a 37 days supply of used vehicles.

In addition to active management of the quality and age of our used vehicle inventory, we have attempted to increase the profitability of our used vehicle operations by participating in manufacturer certification programs where available. Manufacturer certified pre-owned vehicles typically sell at a premium compared to other used vehicles and are available only from franchised new vehicle dealerships. Certified pre-owned vehicles are eligible for new vehicle benefits such as new vehicle finance rates and, in some cases, extension of the manufacturer warranty. Our certified pre-owned vehicle sales have increased from 15.8% of total used retail sales in 2005 to 16.9% in 2006.

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***Parts and Service Sales***

We sell replacement parts and provide maintenance and repair services at each of our franchised dealerships and provide collision repair services at the 30 collision centers we operate. Our parts and service business accounted for approximately 37.3% of our gross profit in 2006. We perform both warranty and non-warranty service work at our dealerships, primarily for the vehicle brand(s) sold at a particular dealership. Warranty work accounted for approximately 19.4% of the revenues from our parts and service business in 2006. Our parts and service departments also perform used vehicle reconditioning and new vehicle preparation services for which they realize a profit when a vehicle is sold to a retail customer.

The automotive repair industry is highly fragmented, with a significant number of independent maintenance and repair facilities in addition to those of the franchised dealerships. We believe, however, that the increasing complexity of new vehicles has made it difficult for many independent repair shops to retain the expertise necessary to perform major or technical repairs. We have made investments in obtaining, training and retaining qualified technicians to work in our service and repair facilities and in state of the art repair equipment to be utilized by these technicians. Additionally, manufacturers permit warranty work to be performed only at franchised dealerships, and there is a trend in the automobile industry towards longer new vehicle warranty periods. As a result, we believe an increasing percentage of all repair work will be performed at franchised dealerships that have the sophisticated equipment and skilled personnel necessary to perform repairs and warranty work on today's complex vehicles.

Our strategy to capture an increasing share of the parts and service work performed by franchised dealerships includes the following elements:

*Focus on Customer Relationships; Emphasize Preventative Maintenance.* Our dealerships seek to retain new and used vehicle customers as customers of our parts and service departments. To accomplish this goal, we use systems that track customers' maintenance records and notify owners of vehicles purchased or serviced at our dealerships in advance when their vehicles are due for periodic service. Our use of computer-based customer relationship management tools increases the reach and effectiveness of our marketing efforts, allowing us to target our promotional offerings to areas in which service capacity is under-utilized or profit margins are greatest. We continue to train our service personnel to establish relationships with their service customers to promote a long-term business relationship. Vehicle service contracts sold by our finance and insurance personnel also assist us in the retention of customers after the manufacturer's warranty expires. We believe our parts and service activities are an integral part of the customer service experience, allowing us to create ongoing relationships with our dealerships' customers thereby deepening customer loyalty to the dealership as a whole.

*Sell Vehicle Service Contracts in Conjunction with Vehicle Sales.* Our finance and insurance sales departments attempt to connect new and used vehicle customers with vehicle service contracts and secure repeat customer business for our parts and service departments.

*Efficient Management of Parts Inventory.* Our dealerships' parts departments support their sales and service departments, selling factory-approved parts for the vehicle makes and models sold by a particular dealership. Parts are either used in repairs made in the service department, sold at retail to customers, or sold at wholesale to independent repair shops and other franchised dealerships. Our dealerships employ parts managers who oversee parts inventories and sales. Our dealerships also frequently share parts with each other. Modern day software programs are used to monitor parts inventory to avoid obsolete and unused parts to maximize sales and to take advantage of manufacturer return procedures.

***Finance and Insurance Sales***

Revenues from our finance and insurance operations consist primarily of fees for arranging financing, vehicle service and insurance contracts in connection with the retail purchase of a new or used vehicle. Our finance and insurance business accounted for approximately 20.0% of our gross profit in 2006. We offer a wide variety of third-party finance, vehicle service and insurance products in a convenient manner and at competitive prices. To increase transparency to our customers, we offer all of our products on menus that display pricing and other information, allowing customers to choose the products that suit their needs.

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*Financing.* We arrange third-party purchase and lease financing for our customers. In return, we receive a fee from the third-party finance company upon completion of the financing. These third-party finance companies include manufacturers' captive finance companies, selected commercial banks and a variety of other third-parties, including credit unions and regional auto finance companies. The fees we receive are subject to chargeback, or repayment to the finance company, if a customer defaults or prepays the retail installment contract, typically during some limited time period at the beginning of the contract term. We have negotiated incentive programs with some finance companies pursuant to which we receive additional fees upon reaching a certain volume of business. We do not own a finance company, and, generally, do not retain substantial credit risk after a customer has received financing, though we do retain limited credit risk in some circumstances.

*Extended Warranty, Vehicle Service and Insurance Products.* We offer our customers a variety of vehicle warranty and extended protection products in connection with purchases of new and used vehicles, including:

extended warranties;

maintenance, or vehicle service, products and programs;

guaranteed asset protection, or GAP, insurance, which covers the shortfall between a customer's contract balance and insurance payoff in the event of a total vehicle loss;

credit life and accident and disability insurance; and

lease wear and tear insurance.

The products our dealerships currently offer are generally underwritten and administered by independent third parties, including the vehicle manufacturers' captive finance subsidiaries. Under our arrangements with the providers of these products, we either sell these products on a straight commission basis, or we sell the product, recognize commission and participate in future underwriting profit, if any, pursuant to a retrospective commission arrangement. These commissions may be subject to chargeback, in full or in part, if the contract is terminated prior to its scheduled maturity. We own a company that reinsures a portion of the third-party credit life and accident and disability insurance policies we sell.

***New and Used Vehicle Inventory Financing***

Our dealerships finance their inventory purchases through the floorplan portion of our revolving credit facility and separate floorplan arrangements with Ford Motor Credit Company and DaimlerChrysler Services North America. We renewed our revolving credit facility in December 2005 for a five-year term. The facility provides \$750.0 million in floorplan financing capacity that we use to finance our used vehicle inventory and all new vehicle inventory other than new vehicles produced by Ford, DaimlerChrysler and their affiliates. During 2006, we had separate floorplan arrangements with Ford Motor Credit Company and DaimlerChrysler Services North America. Each provided \$300 million of floorplan financing capacity. We use the funds available under these arrangements exclusively to finance our inventories of new vehicles produced by the lenders' respective manufacturer affiliates. The DaimlerChrysler Facility was initially set to mature on December 16, 2006; however, we reached an agreement with DaimlerChrysler, extending the maturity date to February 28, 2007. We do not anticipate renewing this facility past its maturity date, and plan to use borrowings under the Credit Facility to pay off the balance at that time. The Ford Facility was also initially set to mature in December 2006; however, we reached an agreement with Ford to extend the maturity date of this facility to December 2007. Most manufacturers also offer interest assistance to offset floorplan interest charges incurred in connection with inventory purchases.

**Acquisition and Divestiture Program**

We pursue an acquisition and divestiture program focused on the following objectives:

enhancing brand and geographic diversity with a focus on import and luxury brands;

creating economies of scale;

delivering a targeted return on investment; and

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eliminating underperforming dealerships.

We have grown our business primarily through acquisitions. From January 1, 2002 through December 31, 2006, we:

purchased 66 franchises with expected annual revenues, estimated at the time of acquisition, of approximately \$3.0 billion;

disposed of 28 franchises with annual revenues of approximately \$391.4 million; and

were granted 10 new franchises by vehicle manufacturers.

**Acquisition strategy.** We seek to acquire large, profitable, well-established dealerships that are leaders in their markets to:

expand into geographic areas we do not currently serve;

expand our brand, product and service offerings in our existing markets;

capitalize on economies of scale in our existing markets; and/or

increase operating efficiency and cost savings in areas such as advertising, purchasing, data processing, personnel utilization and the cost of floorplan financing.

We typically pursue dealerships with superior operational management personnel whom we seek to retain. By retaining existing management personnel who have experience and in-depth knowledge of their local market, we seek to avoid the risks involved with employing and training new and untested personnel.

We continue to focus on the acquisition of dealerships or groups of dealerships that offer opportunities for higher returns, particularly import and luxury brands, and will enhance the geographic diversity of our operations in regions with attractive long-term economic prospects. In 2006, we continued disposing of under-performing dealerships and expect this process to continue throughout 2007 as we rationalize our dealership portfolio to increase the overall profitability of our operations.

**Recent Acquisitions.** In 2006, we acquired 13 franchises, 12 import and one domestic, with expected annual revenues of approximately \$725.5 million. The new franchises included (i) a Toyota/Scion franchise and a Nissan franchise in the Los Angeles metro market, (ii) a Honda, Kia and two Nissan franchises in Alabama and Mississippi, (iii) a BMW, Honda and two Acura franchises in New Jersey, (iv) a Toyota and Lexus franchises in Manchester, New Hampshire and (v) a Buick franchise in Oklahoma City that is operated out of an existing Pontiac-GMC dealership. In addition, during 2006 Suzuki granted us a dealership in the Los Angeles area.

**Divestiture Strategy.** We continually review our capital investments in dealership operations for disposition opportunities, based upon a number of criteria, including:

the rate of return over a period of time;

location of the dealership in relation to existing markets and our ability to leverage our cost structure; and

the dealership franchise brand.

While it is our desire to only acquire profitable, well-established dealerships, at times we must acquire stores that do not fit our investment profile as a part of a particular dealership group. We acquire such dealerships with the understanding that we may need to divest ourselves of them in the near or immediate future. The costs associated with such divestiture are included in our analysis of whether we acquire all dealerships in the same acquisition. Additionally, we may acquire a dealership whose profitability is marginal, but which we believe can be increased through various factors such as (i) change in management, (ii) increase or improvement in facility operations, (iii) relocation of facility based on demographic changes, or (iv) reduction in costs and sales training. If, after a period of time, a dealership's profitability does not respond in a positive nature, management will make the decision to sell the dealership to a third party, or, in the rare case, surrender the dealership back to the manufacturer. Management constantly monitors the performance of all of its stores, and routinely assesses the need for divestiture.

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**Recent Dispositions.** During 2006, we sold 13 franchises with annual revenues of approximately \$197.8 million. In connection with divestitures, we are sometimes required to incur additional charges associated with lease terminations, or accounting charges related to the impairment of assets. For 2007, we have estimated charges related to divestitures to be between \$5 million and \$10 million.

**Outlook.** Our acquisition target for 2007 is to complete acquisitions of dealerships that have at least \$600 million in estimated aggregated annual revenues. In this regard, during January 2007, we acquired BMW, Mini and Volkswagen franchises with total expected annual revenues of \$123.1 million. Also in early 2007, we disposed of two Ford franchises and a Chrysler franchise with annual revenues of \$48.2 million. Based on market conditions, franchise performance and our overall strategy, we continue to anticipate disposing of franchises and/or underlying dealerships from time to time.

## **Competition**

We operate in a highly competitive industry. In each of our markets, consumers have a number of choices in deciding where to purchase a new or used vehicle and where to have a vehicle serviced. According to industry sources, there are approximately 21,500 franchised automobile dealerships and approximately 45,000 independent used vehicle dealers in the retail automotive industry.

Our competitive success depends, in part, on national and regional automobile-buying trends, local and regional economic factors and other regional competitive pressures. Conditions and competitive pressures affecting the markets in which we operate, or in any new markets we enter, could adversely affect us, although the retail automobile industry as a whole might not be affected. Some of our competitors may have greater financial, marketing and personnel resources, and lower overhead and sales costs than we do. We cannot guarantee that our strategy will be more effective than the strategies of our competitors.

**New and Used Vehicles.** In the new vehicle market, our dealerships compete with other franchised dealerships in their market areas, as well as auto brokers, leasing companies, and Internet companies that provide referrals to, or broker vehicle sales with, other dealerships or customers. We are subject to competition from dealers that sell the same brands of new vehicles that we sell and from dealers that sell other brands of new vehicles that we do not sell in a particular market. Our new vehicle dealer competitors also have franchise agreements with the various vehicle manufacturers and, as such, generally have access to new vehicles on the same terms as we do. We do not have any cost advantage in purchasing new vehicles from vehicle manufacturers, and our franchise agreements do not grant us the exclusive right to sell a manufacturer's product within a given geographic area. In the used vehicle market, our dealerships compete with other franchised dealers, large multi-location used vehicle retailers, local independent used vehicle dealers, automobile rental agencies and private parties for the supply and resale of used vehicles. We believe the principal competitive factors in the automotive retailing business are location, on-site management, the suitability of a franchise to the market in which it is located, service, price and selection.

**Parts and Service.** In the parts and service market, our dealerships compete with other franchised dealers to perform warranty repairs and with other automobile dealers, franchised and independent service center chains, and independent repair shops for non-warranty repair and maintenance business. We believe the principal competitive factors in the parts and service business are the quality of customer service, the use of factory-approved replacement parts, familiarity with a manufacturer's brands and models, convenience, the competence of technicians, location, and price. A number of regional or national chains offer selected parts and services at prices that may be lower than ours.

**Finance and Insurance.** In addition to competition for vehicle sales and service, we face competition in arranging financing for our customers' vehicle purchases from a broad range of financial institutions. Many financial institutions



now offer finance and insurance products over the Internet, which may reduce our profits from the sale of these products. We believe the principal competitive factors in the finance and insurance business are convenience, interest rates, product availability and flexibility in contract length.

**Acquisitions.** We compete with other national dealer groups and individual investors for acquisitions. Increased competition, especially in certain of the luxury and foreign brands, may raise the cost of acquisitions. We

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cannot guarantee that there will be sufficient opportunities to complete desired acquisitions, nor are we able to guarantee that we will be able to complete acquisitions on terms acceptable to us.

**Financing Arrangements**

As of December 31, 2006, our total outstanding indebtedness and lease and other obligations were approximately \$1,841.8 million, including the following:

\$437.3 million under the floorplan portion of our revolving credit facility;

\$477.6 million of future commitments under various operating leases;

\$281.3 million in 2 1/4% under our convertible senior notes due 2036;

\$135.2 million in 8 1/4% senior subordinated notes due 2013;

\$133.0 million under our Ford Motor Credit Company floorplan facility;

\$131.8 million under our DaimlerChrysler Services North America floorplan facility;

\$23.2 million under floorplan notes payable to various manufacturer affiliates for rental vehicles;

\$12.9 million of various notes payable;

\$18.1 million of letters of credit, to collateralize certain obligations, issued under the acquisition portion of our revolving credit facility; and

\$191.4 million of other short- and long-term purchase commitments.

As of December 31, 2006, we had the following approximate amounts available for additional borrowings under our various credit facilities:

\$312.7 million under the floorplan portion of our revolving credit facility;

\$181.9 million under the acquisition portion of our revolving credit facility;

\$167.0 million under our Ford Motor Credit Company floorplan facility; and

\$168.2 million available for additional borrowings under the DaimlerChrysler Services North America floorplan facility.

In addition, the indenture relating to our senior subordinated notes and other debt instruments allow us to incur additional indebtedness and enter into additional operating leases.

**Stock Repurchase Program**

In March 2006, our Board of Directors authorized us to repurchase up to \$42.0 million of our common stock, subject to management's judgment and the restrictions of our various debt agreements. In June 2006, this authorization was replaced with a \$50.0 million authorization concurrent with the issuance of the 2.25% Notes. In conjunction with the

issuance of the 2.25% Notes, we repurchased 933,800 shares of our common stock at an average price of \$53.54 per share, exhausting the entire \$50.0 million authorization.

In addition, under separate authorization, in March 2006, the Company's Board of Directors authorized the repurchase of a number of shares equivalent to the shares issued pursuant to the Company's employee stock purchase plan on a quarterly basis. Pursuant to this authorization, a total of 86,000 shares were repurchased during 2006, at an average price of \$53.33 per share, or approximately \$4.6 million. Approximately \$2.7 million of the funds for such repurchases came from employee contributions during the period.

Future repurchases are subject to the discretion of our Board of Directors after considering our results of operations, financial condition, cash flows, capital requirements, outlook for our business, general business conditions and other factors.

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**Dividends**

During 2006, our Board of Directors approved four quarterly cash dividends totaling \$0.55 per share. On February 20, 2007, our Board of Directors approved a dividend of \$0.14 per share for shareholders of record on March 6, 2007, that will be paid on March 15, 2007. We intend to pay dividends in the future based on cash flows, covenant compliance, tax laws and other factors. See Note 9 to our consolidated financial statements for a description of restrictions on the payment of dividends.

**Relationships and Agreements with our Manufacturers**

Each of our dealerships operates under a franchise agreement with a vehicle manufacturer (or authorized distributor). The franchise agreements grant the franchised automobile dealership a non-exclusive right to sell the manufacturer's or distributor's brand of vehicles and offer related parts and service within a specified market area. These franchise agreements grant our dealerships the right to use the manufacturer's or distributor's trademarks in connection with their operations, and impose numerous operational requirements and restrictions relating to, among other things:

- inventory levels;
- working capital levels;
- the sales process;
- minimum sales performance requirements;
- customer satisfaction standards;
- marketing and branding;
- facilities and signage;
- personnel;
- changes in management; and
- monthly financial reporting.

Our dealerships' franchise agreements are for various terms, ranging from one year to indefinite, and in most cases manufacturers have renewed such franchises upon expiration so long as the dealership is in compliance with the terms of the agreement. We generally expect our franchise agreements to survive for the foreseeable future and, when the agreements do not have indefinite terms, anticipate routine renewals of the agreements without substantial cost or modification. Each of our franchise agreements may be terminated or not renewed by the manufacturer for a variety of reasons, including manufacturer inability to produce vehicles attractive to our consumers, unapproved changes of ownership or management and performance deficiencies in such areas as sales volume, sales effectiveness and customer satisfaction. However, in general, the states in which we operate have automotive dealership franchise laws that provide that, notwithstanding the terms of any franchise agreement, it is unlawful for a manufacturer to terminate or not renew a franchise unless "good cause" exists. It generally is difficult for a manufacturer to terminate, or not renew, a franchise under these laws, which were designed to protect dealers. While historically in the automotive retail industry, dealership franchise agreements were rarely involuntarily terminated or not renewed by the manufacturer,

recent difficult economic times of certain manufacturers have led to reconsideration by some manufacturers of the scope of their respective dealership networks. From time to time, certain manufacturers assert sales and customer satisfaction performance deficiencies under the terms of our framework and franchise agreements at a limited number of our dealerships. We generally work with these manufacturers to address the asserted performance issues.

Our dealership service departments perform vehicle repairs and service for customers under manufacturer warranties. We are reimbursed for such service directly from the manufacturer. Some manufacturers offer rebates to new vehicle customers that we are required, under specific program rules, to adequately document, support and typically are responsible for collecting. In addition, some manufacturers provide us with incentives to sell certain models and levels of inventory over designated periods of time. Under the terms of our dealership franchise

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agreements, the respective manufacturers are able to perform warranty, incentive and rebate audits and charge us back for unsupported or non-qualifying warranty repairs, rebates or incentives.

In addition to the individual dealership franchise agreements discussed above, we have entered into framework agreements with most major vehicle manufacturers and distributors. These agreements impose a number of restrictions on our operations, including on our ability to make acquisitions and obtain financing, and on our management and change of control provisions related to the ownership of our common stock. For a discussion of these restrictions and the risks related to our relationships with vehicle manufacturers, please read Risk Factors.

The following table sets forth the percentage of our new vehicle retail unit sales attributable to the manufacturers that accounted for approximately 10% or more of our new vehicle retail unit sales:

<b>Manufacturer</b>	<b>Percentage of New Vehicle Retail Units Sold during the Twelve Months Ended December 31, 2006</b>
Toyota/Lexus	36.0%
Ford	15.1%
DaimlerChrysler	12.8%
Nissan/Infiniti	11.2%
Honda/Acura	10.1%

**Governmental Regulations*****Automotive and Other Laws and Regulations***

We operate in a highly regulated industry. A number of state and federal laws and regulations affect our business. In every state in which we operate, we must obtain various licenses in order to operate our businesses, including dealer, sales and finance, and insurance licenses issued by state regulatory authorities. Numerous laws and regulations govern our conduct of business, including those relating to our sales, operations, financing, insurance, advertising and employment practices. These laws and regulations include state franchise laws and regulations, consumer protection laws, and other extensive laws and regulations applicable to new and used motor vehicle dealers, as well as a variety of other laws and regulations. These laws also include federal and state wage-hour, anti-discrimination and other employment practices laws.

Our financing activities with customers are subject to federal truth-in-lending, consumer leasing and equal credit opportunity laws and regulations, as well as state and local motor vehicle finance laws, installment finance laws, usury laws and other installment sales laws and regulations. Some states regulate finance fees and charges that may be paid as a result of vehicle sales. Claims arising out of actual or alleged violations of law may be asserted against us, or our dealerships, by individuals or governmental entities and may expose us to significant damages or other penalties, including revocation or suspension of our licenses to conduct dealership operations and fines.

Our operations are subject to the National Traffic and Motor Vehicle Safety Act, Federal Motor Vehicle Safety Standards promulgated by the United States Department of Transportation and the rules and regulations of various state motor vehicle regulatory agencies. The imported automobiles we purchase are subject to United States customs

duties, and in the ordinary course of our business we may, from time to time, be subject to claims for duties, penalties, liquidated damages or other charges.

Our operations are subject to consumer protection laws known as Lemon Laws. These laws typically require a manufacturer or dealer to replace a new vehicle or accept it for a full refund within one year after initial purchase if the vehicle does not conform to the manufacturer's express warranties and the dealer or manufacturer, after a reasonable number of attempts, is unable to correct or repair the defect. Federal laws require various written disclosures to be provided on new vehicles, including mileage and pricing information. We are aware that several states are considering enacting consumer bill-of-rights statutes to provide further protection to the consumer which could affect our profitability in such states.

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### ***Environmental, Health and Safety Laws and Regulations***

Our operations involve the use, handling, storage and contracting for recycling and/or disposal of materials such as motor oil and filters, transmission fluids, antifreeze, refrigerants, paints, thinners, batteries, cleaning products, lubricants, degreasing agents, tires and fuel. Consequently, our business is subject to a complex variety of federal, state and local requirements that regulate the environment and public health and safety.

Most of our dealerships utilize aboveground storage tanks, and to a lesser extent underground storage tanks, primarily for petroleum-based products. Storage tanks are subject to periodic testing, containment, upgrading and removal under the Resource Conservation and Recovery Act and its state law counterparts. Clean-up or other remedial action may be necessary in the event of leaks or other discharges from storage tanks or other sources. In addition, water quality protection programs under the federal Water Pollution Control Act (commonly known as the Clean Water Act), the Safe Drinking Water Act and comparable state and local programs govern certain discharges from some of our operations. Similarly, certain air emissions from operations such as auto body painting may be subject to the federal Clean Air Act and related state and local laws. Certain health and safety standards promulgated by the Occupational Safety and Health Administration of the United States Department of Labor and related state agencies also apply.

Some of our dealerships are parties to proceedings under the Comprehensive Environmental Response, Compensation, and Liability Act, or CERCLA, typically in connection with materials that were sent to former recycling, treatment and/or disposal facilities owned and operated by independent businesses. The remediation or clean-up of facilities where the release of a regulated hazardous substance occurred is required under CERCLA and other laws.

We generally obtain environmental studies on dealerships to be acquired and, as necessary, implement environmental management or remedial activities to reduce the risk of noncompliance with environmental laws and regulations. Nevertheless, we currently own or lease, and in connection with our acquisition program will in the future own or lease, properties that in some instances have been used for auto retailing and servicing for many years. These laws apply regardless of whether we lease or purchase the land and facilities. Although we have utilized operating and disposal practices that were standard in the industry at the time, it is possible that environmentally sensitive materials such as new and used motor oil, transmission fluids, antifreeze, lubricants, solvents and motor fuels may have been spilled or released on or under the properties owned or leased by us or on or under other locations where such materials were taken for disposal. Further, we believe that structures found on some of these properties may contain suspect asbestos-containing materials, albeit in an undisturbed condition. In addition, many of these properties have been operated by third parties whose use, handling and disposal of such environmentally sensitive materials were not under our control.

We incur significant costs to comply with applicable environmental, health and safety laws and regulations in the ordinary course of our business. We do not anticipate, however, that the costs of such compliance will have a material adverse effect on our business, results of operations, cash flows or financial condition, although such outcome is possible given the nature of our operations and the extensive environmental, public health and safety regulatory framework. Finally, we generally obtain environmental studies on dealerships to be disposed of for the purpose of determining our ongoing liability after the sale, if any.

### **Insurance and Bonding**

Our operations expose us to the risk of various liabilities, including:

claims by employees, customers or other third parties for personal injury or property damage resulting from our operations; and



finances and civil and criminal penalties resulting from alleged violations of federal and state laws or regulatory requirements.

The automotive retailing business is also subject to substantial risk of property loss as a result of the significant concentration of property values at dealership locations. Under self-insurance programs, we retain various levels of aggregate loss limits, per claim deductibles and claims handling expenses as part of our various insurance programs,

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including property and casualty and employee medical benefits. In certain cases, we insure costs in excess of our retained risk per claim under various contracts with third-party insurance carriers. Actuarial estimates for the portion of claims not covered by insurance are based on historical claims experience, adjusted for current trends and changes in claims-handling procedures. Risk retention levels may change in the future as a result of changes in the insurance market or other factors affecting the economics of our insurance programs. Although we have, subject to certain limitations and exclusions, substantial insurance, we cannot assure that we will not be exposed to uninsured or underinsured losses that could have a material adverse effect on our business, financial condition, results of operations or cash flows.

We make provisions for retained losses and deductibles by reflecting charges to expense based upon periodic evaluations of the estimated ultimate liabilities on reported and unreported claims. The insurance companies that underwrite our insurance require that we secure certain of our obligations for self-insured exposures with collateral. Our collateral requirements are set by the insurance companies and, to date, have been satisfied by posting surety bonds, letters of credit and/or cash deposits. Our collateral requirements may change from time to time based on, among other things, our total insured exposure and the related self-insured retention assumed under the policies.

## **Employees**

As of December 31, 2006, we employed approximately 8,785 people, of whom approximately:

1,251 were employed in managerial positions;

2,483 were employed in non-managerial vehicle sales department positions;

4,091 were employed in non-managerial parts and service department positions; and

960 were employed in administrative support positions.

We believe our relationships with our employees are favorable. Seventy-eight of our employees in one region are represented by a labor union. Because of our dependence on vehicle manufacturers, we may be affected by labor strikes, work slowdowns and walkouts at vehicle manufacturing facilities. Additionally, labor strikes, work slowdowns and walkouts at businesses participating in the distribution of manufacturers' products may also affect us.

## **Seasonality**

We generally experience higher volumes of vehicle sales and service in the second and third calendar quarters of each year. This seasonality is generally attributable to consumer buying trends and the timing of manufacturer new vehicle model introductions. In addition, in some regions of the United States, vehicle purchases decline during the winter months. As a result, our revenues, cash flows and operating income are typically lower in the first and fourth quarters and higher in the second and third quarters. Other factors unrelated to seasonality, such as changes in economic condition and manufacturer incentive programs, may exaggerate seasonal or cause counter-seasonal fluctuations in our revenues and operating income.

## **Executive Officers**

Our executive officers serve at the pleasure of our Board of Directors and are subject to annual appointment by our Board of Directors at its first meeting following each annual meeting of stockholders.

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The following table sets forth certain information as of the date of this Annual Report on Form 10-K regarding our current executive officers:

<b>Name</b>	<b>Age</b>	<b>Position</b>
Earl J. Hesterberg	53	President and Chief Executive Officer
John C. Rickel	45	Senior Vice President and Chief Financial Officer
Randy L. Callison	53	Senior Vice President, Operations and Corporate Development
Darryl M. Burman	48	Vice President, General Counsel and Corporate Secretary

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***Earl J. Hesterberg***

Mr. Hesterberg has served as our President and Chief Executive Officer and as a director since April 9, 2005. Prior to joining us, Mr. Hesterberg served as Group Vice President, North America Marketing, Sales and Service for Ford Motor Company since October 2004. From July 1999 to September 2004, he served as Vice President, Marketing, Sales and Service for Ford of Europe. Mr. Hesterberg has also served as President and Chief Executive Officer of Gulf States Toyota, and held various senior sales, marketing, general management, and parts and service positions with Nissan Motor Corporation in U.S.A. and Nissan Europe.

***John C. Rickel***

Mr. Rickel was appointed Senior Vice President and Chief Financial Officer in December 2005. From 1984 until joining us, Mr. Rickel held a number of executive and managerial positions of increasing responsibility with Ford Motor Company. He most recently served as controller of Ford Americas, where he was responsible for the financial management of Ford's western hemisphere automotive operations. Immediately prior to that, he was chief financial officer of Ford Europe, where he oversaw all accounting, financial planning, information services, tax and investor relations activities. From 2002 to 2004, Mr. Rickel was chairman of the board of Ford Russia and a member of the board and the audit committee of Ford Otosan, a publicly traded automotive company located in Turkey and owned 41% by Ford Motor Company. Mr. Rickel received his BSBA in 1982 and MBA in 1984 from the Ohio State University.

***Randy L. Callison***

Mr. Callison has served as Senior Vice President, Operations and Corporate Development since May 2006 and as our Vice President, Operations and Corporate Development from January 2006 until May 2006. From August 1998 until January 2006, Mr. Callison served as Vice President, Corporate Development. Mr. Callison has been involved as a key member of our acquisition team and has been largely responsible for building our dealership network since joining us in 1997. Prior to joining us, Mr. Callison served for a number of years as a general manager for a Nissan/Oldsmobile dealership and subsequently as chief financial officer for the Mossy Companies, a large Houston-based automotive retailer.

Mr. Callison began his automotive career as a dealership controller after spending nine years with Arthur Andersen as a CPA in its audit practice, where his client list included Houston-area automotive dealerships.

***Darryl M. Burman***

Mr. Burman was appointed Vice President, General Counsel and Corporate Secretary in December 2006. Prior to joining us, Mr. Burman was a partner and head of the corporate and securities practice in the Houston office of Epstein Becker Green Wickliff & Hall, P.C. From September 1995 until September 2005, Mr. Burman served as the head of the corporate and securities practice of Fant & Burman, L.L.P. in Houston, Texas. Mr. Burman graduated from the University of South Florida in 1980 and received his J.D. from South Texas College of Law in 1983.

**Certifications**

We will timely provide the annual certification of our Chief Executive Officer to the New York stock Exchange. We filed last year's certification in March 2006. In addition, our Chief Executive Officer and Chief Financial Officer each have signed and filed the certifications under Section 302 of the Sarbanes-Oxley Act of 2002 with this Annual Report on Form 10-K.

**Item 1A. Risk Factors**

*Our business and the automotive retail industry in general are susceptible to adverse economic conditions, including changes in consumer confidence, fuel prices and credit availability, which could have a material adverse effect on our business, revenues and profitability.*

We believe the automotive retail industry is influenced by general economic conditions and particularly by consumer confidence, the level of personal discretionary spending, interest rates, fuel prices, unemployment rates

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and credit availability. Historically, unit sales of motor vehicles, particularly new vehicles, have been cyclical, fluctuating with general economic cycles. During economic downturns, retail new vehicle sales typically experience periods of decline characterized by oversupply and weak demand. Although incentive programs initiated by manufacturers in late 2001 abated these historical trends, the automotive retail industry may experience sustained periods of decline in vehicle sales in the future. Any decline or change of this type could have a material adverse effect on our business, revenues, cash flows and profitability.

Fuel prices during 2006 reached historically high levels. Fuel prices may continue to affect consumer preferences in connection with the purchase of our vehicles. Consumers may be less likely to purchase larger, more expensive vehicles, such as sports utility vehicles or luxury automobiles and more likely to purchase smaller, less expensive vehicles. Further increases in fuel prices could have a material adverse effect on our business, revenues, cash flows and profitability.

In addition, local economic, competitive and other conditions affect the performance of our dealerships. Our revenues, cash flows and profitability depend substantially on general economic conditions and spending habits in those regions of the United States where we maintain most of our operations.

***If we fail to obtain a desirable mix of popular new vehicles from manufacturers our profitability can be affected.***

We depend on the manufacturers to provide us with a desirable mix of new vehicles. The most popular vehicles usually produce the highest profit margins and are frequently difficult to obtain from the manufacturers. If we cannot obtain sufficient quantities of the most popular models, our profitability may be adversely affected. Sales of less desirable models may reduce our profit margins. Several manufacturers generally allocate their vehicles among their franchised dealerships based on the sales history of each dealership. If our dealerships experience prolonged sales slumps, these manufacturers may cut back their allotments of popular vehicles to our dealerships and new vehicle sales and profits may decline. Similarly, the delivery of vehicles, particularly newer, more popular vehicles, from manufacturers at a time later than scheduled could lead to reduced sales during those periods.

***If we fail to obtain renewals of one or more of our franchise agreements on favorable terms or substantial franchises are terminated, our operations may be significantly impaired.***

Each of our dealerships operates under a franchise agreement with one of our manufacturers (or authorized distributors). Without a franchise agreement, we cannot obtain new vehicles from a manufacturer. As a result, we are significantly dependent on our relationships with these manufacturers, which exercise a great degree of influence over our operations through the franchise agreements. Each of our franchise agreements may be terminated or not renewed by the manufacturer for a variety of reasons, including any unapproved changes of ownership or management and other material breaches of the franchise agreements. Manufacturers may also have a right of first refusal if we seek to sell dealerships. We cannot guarantee all of our franchise agreements will be renewed or that the terms of the renewals will be as favorable to us as our current agreements. In addition, actions taken by manufacturers to exploit their bargaining position in negotiating the terms of renewals of franchise agreements or otherwise could also have a material adverse effect on our revenues and profitability. Our results of operations may be materially and adversely affected to the extent that our franchise rights become compromised or our operations restricted due to the terms of our franchise agreements or if we lose substantial franchises.

Our franchise agreements do not give us the exclusive right to sell a manufacturer's product within a given geographic area. As a result, a manufacturer may grant another dealer a franchise to start a new dealership near one of our locations, or an existing dealership may move its dealership to a location that would directly compete against us. The location of new dealerships near our existing dealerships could materially adversely affect our operations and reduce the profitability of our existing dealerships.

***Our success depends upon the continued viability and overall success of a limited number of manufacturers.***

We are subject to a concentration of risk in the event of financial distress, including potential bankruptcy, of a major vehicle manufacturer. Toyota/Lexus, Ford, DaimlerChrysler, Nissan/Infiniti, Honda/Acura and General

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Motors dealerships represented approximately 93.1% of our total new vehicle retail units sold in 2006. In particular, sales of Ford and General Motors new vehicles represented 23.1% of our new vehicle unit sales in 2006.

In the event of a bankruptcy by a vehicle manufacturer, among other things: (1) the manufacturer could attempt to terminate all or certain of our franchises, and we may not receive adequate compensation for them, (2) we may not be able to collect some or all of our significant receivables that are due from such manufacturer and we may be subject to preference claims relating to payments made by such manufacturer prior to bankruptcy, (3) we may not be able to obtain financing for our new vehicle inventory, or arrange financing for our customers for their vehicle purchases and leases, with such manufacturer's captive finance subsidiary, which may cause us to finance our new vehicle inventory, and arrange financing for our customers, with alternate finance sources on less favorable terms, and (4) consumer demand for such manufacturer's products could be materially adversely affected.

These events may result in a partial or complete write-down of our goodwill and/or intangible franchise rights with respect to any terminated franchises and cause us to incur impairment charges related to operating leases and/or receivables due from such manufacturers. In addition, vehicle manufacturers may be adversely impacted by economic downturns or recessions, significant declines in the sales of their new vehicles, increases in interest rates, declines in their credit ratings, labor strikes or similar disruptions (including within their major suppliers), supply shortages or rising raw material costs, rising employee benefit costs, adverse publicity that may reduce consumer demand for their products (including due to bankruptcy), product defects, vehicle recall campaigns, litigation, poor product mix or unappealing vehicle design, or other adverse events. These and other risks could materially adversely affect any manufacturer and impact its ability to profitably design, market, produce or distribute new vehicles, which in turn could materially adversely affect our business, results of operations, financial condition, stockholders' equity, cash flows and prospects.

***Manufacturers' restrictions on acquisitions may limit our future growth.***

We must obtain the consent of the manufacturer prior to the acquisition of any of its dealership franchises. Delays in obtaining, or failing to obtain, manufacturer approvals for dealership acquisitions could adversely affect our acquisition program. Obtaining the consent of a manufacturer for the acquisition of a dealership could take a significant amount of time or might be rejected entirely. In determining whether to approve an acquisition, manufacturers may consider many factors, including the moral character and business experience of the dealership principals and the financial condition, ownership structure, customer satisfaction index scores and other performance measures of our dealerships.

Our manufacturers attempt to measure customers' satisfaction with automobile dealerships through systems generally known as the customer satisfaction index or CSI. Manufacturers may use these performance indicators, as well as sales performance numbers, as conditions for certain payments and as factors in evaluating applications for additional acquisitions. The manufacturers have modified the components of their CSI scores from time to time in the past, and they may replace them with different systems at any time. From time to time, we have not met all of the manufacturers' requirements to make acquisitions. To date, there have been no acquisition opportunities which have been denied by any manufacturer. However, we cannot assure you that all of our proposed future acquisitions will be approved. In the event this was to occur, this could materially adversely affect our acquisition strategy.

In addition, a manufacturer may limit the number of its dealerships that we may own or the number that we may own in a particular geographic area. If we reach a limitation imposed by a manufacturer for a particular geographic market, we will be unable to make additional acquisitions of that manufacturer's franchises in that market, which could limit our ability to grow in that geographic area. In addition, geographic limitations imposed by manufacturers could restrict our ability to make geographic acquisitions involving markets that overlap with those we already serve.



We may acquire only four primary Lexus dealerships or six outlets nationally, including only two Lexus dealerships in any one of the four Lexus geographic areas. We own three primary Lexus dealership franchises. Also, we own the maximum number of Toyota dealerships we are currently permitted to own in the Gulf States region, which is comprised of Texas, Oklahoma, Louisiana, Mississippi and Arkansas, and in the Boston region, which is comprised of Maine, Massachusetts, New Hampshire, Rhode Island and Vermont. Currently, Ford is emphasizing increased sales performance from all of its franchised dealers, including our Ford dealerships. As such, Ford has

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requested that we focus on the performance of owned dealerships as opposed to acquiring additional Ford dealerships. We intend to comply with this request.

***Manufacturers' restrictions could negatively impact our ability to obtain certain types of financings.***

Provisions in our agreements with our manufacturers may, in the future, restrict our ability to obtain certain types of financing. A number of our manufacturers prohibit pledging the stock of their franchised dealerships. For example, our agreement with GM contains provisions prohibiting pledging the stock of our GM franchised dealerships. Our agreement with Ford permits us to pledge our Ford franchised dealerships' stock and assets, but only for Ford dealership-related debt. Moreover, our Ford agreement permits our Ford franchised dealerships to guarantee, and to use Ford franchised dealership assets to secure, our debt, but only for Ford dealership-related debt. Ford waived that requirement with respect to our March 1999 and August 2003 senior subordinated notes offerings and the subsidiary guarantees of those notes. Certain of our manufacturers require us to meet certain financial ratios. Our failure to comply with these ratios gives the manufacturers the right to reject proposed acquisitions, and may give them the right to purchase their franchises for fair value.

***Certain restrictions relating to our management and ownership of our common stock could deter prospective acquirers from acquiring control of us and adversely affect our ability to engage in equity offerings.***

As a condition to granting their consent to our previous acquisitions and our initial public offering, some of our manufacturers have imposed other restrictions on us. These restrictions prohibit, among other things:

any one person, who in the opinion of the manufacturer is unqualified to own its franchised dealership or has interests incompatible with the manufacturer, from acquiring more than a specified percentage of our common stock (ranging from 20% to 50% depending on the particular manufacturer's restrictions) and this trigger level can fall to as low as 5% if another vehicle manufacturer is the entity acquiring the ownership interest or voting rights;

certain material changes in our business or extraordinary corporate transactions such as a merger or sale of a material amount of our assets;

the removal of a dealership general manager without the consent of the manufacturer; and

a change in control of our Board of Directors or a change in management.

Our manufacturers may also impose additional similar restrictions on us in the future. Actions by our stockholders or prospective stockholders that would violate any of the above restrictions are generally outside our control. If we are unable to comply with or renegotiate these restrictions, we may be forced to terminate or sell one or more franchises, which could have a material adverse effect on us. These restrictions may prevent or deter prospective acquirers from acquiring control of us and, therefore, may adversely impact the value of our common stock. These restrictions also may impede our ability to acquire dealership groups, to raise required capital or to issue our stock as consideration for future acquisitions.

***If manufacturers discontinue or change sales incentives, warranties and other promotional programs, our results of operations may be materially adversely affected.***

We depend on our manufacturers for sales incentives, warranties and other programs that are intended to promote dealership sales or support dealership profitability. Manufacturers historically have made many changes to their incentive programs during each year. Some of the key incentive programs include:

customer rebates;

dealer incentives on new vehicles;

below-market financing on new vehicles and special leasing terms;

warranties on new and used vehicles; and

sponsorship of used vehicle sales by authorized new vehicle dealers.

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A discontinuation or change in our manufacturers' incentive programs could adversely affect our business. Moreover, some manufacturers use a dealership's CSI scores as a factor governing participation in incentive programs. Failure to comply with the CSI standards could adversely affect our participation in dealership incentive programs, which could have a material adverse effect on us.

***Growth in our revenues and earnings will be impacted by our ability to acquire and successfully integrate and operate dealerships.***

Growth in our revenues and earnings depends substantially on our ability to acquire and successfully integrate and operate dealerships. We cannot guarantee that we will be able to identify and acquire dealerships in the future. In addition, we cannot guarantee that any acquisitions will be successful or on terms and conditions consistent with past acquisitions. Restrictions by our manufacturers, as well as covenants contained in our debt instruments, may directly or indirectly limit our ability to acquire additional dealerships. In addition, increased competition for acquisitions may develop, which could result in fewer acquisition opportunities available to us and/or higher acquisition prices. Some of our competitors may have greater financial resources than us.

We will continue to need substantial capital in order to acquire additional automobile dealerships. In the past, we have financed these acquisitions with a combination of cash flow from operations, proceeds from borrowings under our credit facility, bond issuances, stock offerings, and the issuance of our common stock to the sellers of the acquired dealerships.

We currently intend to finance future acquisitions by using cash and, in rare situations, issuing shares of our common stock as partial consideration for acquired dealerships. The use of common stock as consideration for acquisitions will depend on three factors: (1) the market value of our common stock at the time of the acquisition, (2) the willingness of potential acquisition candidates to accept common stock as part of the consideration for the sale of their businesses, and (3) our determination of what is in our best interests. If potential acquisition candidates are unwilling to accept our common stock, we will rely solely on available cash or proceeds from debt or equity financings, which could adversely affect our acquisition program. Accordingly, our ability to make acquisitions could be adversely affected if the price of our common stock is depressed.

In addition, managing and integrating additional dealerships into our existing mix of dealerships may result in substantial costs, diversion of our management's attention, delays, or other operational or financial problems. Acquisitions involve a number of special risks, including: