LITHIA MOTORS INC
Form 10-K
March 07, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Fiscal Year Ended: December 31, 2010

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number: 001-14733

LITHIA MOTORS, INC.

(Exact name of registrant as specified in its charter)

Oregon	**93-0572810**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
360 E. Jackson Street, Medford, Oregon	**97501**
(Address of principal executive offices)	**(Zip Code)**

541-776-6899

(Registrant s telephone number including area code)

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

Title of each class	**Name of each exchange on which registered**
Class A common stock, without par value	**New York Stock Exchange**

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

(Title of Class)

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

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act: ¨

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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 incorporated by reference in Part III of this Form 10-K, or any amendment to this Form 10-K. x

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was approximately $137,435,000 computed by reference to the last sales price ($6.18) as reported by the New York Stock Exchange for the Registrant s Class A common stock, as of the last business day of the Registrant s most recently completed second fiscal quarter (June 30, 2010).

The number of shares outstanding of the Registrant s common stock as of March 7, 2011 was: Class A: 22,571,272 shares and Class B: 3,762,231 shares.

Documents Incorporated by Reference

The Registrant has incorporated into Part III of Form 10-K, by reference, portions of its Proxy Statement for its 2011 Annual Meeting of Shareholders.

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LITHIA MOTORS, INC.

2010 FORM 10-K ANNUAL REPORT

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PART I

Item 1. Business

Forward Looking Statements

Certain statements under the sections entitled Risk Factors, Management s Discussion and Analysis of Financial Condition and Results of Operations and Business and elsewhere in this Form 10-K constitute forward-looking statements. Generally, you can identify forward-looking statements by terms such as may, will, should, expect, plan, intend, forecast, anticipate, believe, estimate, predict, potenti negative of these terms or other comparable terminology. The forward-looking statements contained in this Form 10-K involve known and unknown risks, uncertainties and situations that may cause our actual results, level of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by these statements. Some of the important factors that could cause actual results to differ from our expectations are discussed in Item 1A. to this Form 10-K.

While we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements. You should not place undue reliance on these forward-looking statements.

Overview

We are a leading operator of automotive franchises and a retailer of new and used vehicles and services. As of March 7, 2011, we offered 26(1) brands of new vehicles and all brands of used vehicles in 82(2) stores in the United States and online at Lithia.com. We sell new and used cars and light trucks, replacement parts; provide vehicle maintenance, warranty, paint and repair services and arrange related financing, service contracts, protection products and credit insurance.

Our dealerships are primarily located in mid-size regional markets throughout the Western and Midwestern regions of the United States. The majority of our franchises are in single-point locations, enabling brand exclusivity with no other dealership with the same franchise in the market.

The following tables set forth information about our stores that were part of operations as of December 31, 2010:

State	Number of Stores	Percent of 2010 Revenue
Texas	14	25%
Oregon	16	15
California	11	11
Washington	7	10
Alaska	7	10
Montana	7	8
Iowa	7	7
Idaho	6	6
Nevada	4	4
North Dakota	3	2
Colorado	1	1
New Mexico	1	1
Total	84	100%

(1) Added a Fiat franchise in March 2011.

(2) Operations were ceased at one store in Idaho in January 2011 and one store in Oregon in March 2011.

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Business Strategy and Operations

Our mission is to be the preferred provider of cars and trucks and related services in North America. We strive for diversification in our products and services, brands and geographic locations to insulate us from market risk and to maintain profitability. We have developed a centralized support structure to reduce store level administrative functions. This allows store personnel to focus on providing a positive customer experience. With our management information systems, our emphasis on standardized operating practices and administrative functions performed centrally in Medford, Oregon, we seek to gain economies of scale from our dealership network.

To reduce our dependence on any one manufacturer and our susceptibility to changing consumer preferences, we offer a variety of luxury, import and domestic new vehicle brands and models. Encompassing economy and luxury cars, sports utility vehicles, crossovers, minivans and light trucks, we believe our brand mix is well-suited to what people want in the markets we serve. For example, in the rural, agricultural markets, as opposed to metropolitan markets, we believe more consumers prefer trucks or SUVs, and a larger percentage of customers choose domestic vehicles.

We have centralized many administrative functions to streamline store level operations. Accounts payable, accounts receivable, credit and collections, accounting and taxes, information technology, legal, human resources, human development, treasury, cash management, advertising and marketing are all centralized at our corporate headquarters. The reduction of administrative functions at our stores allows our local managers to focus on customer-facing opportunities to generate increased revenues and gross profit. Our operations are supported by our dedicated training and personnel development program, which shares best practices across our dealership network and seeks to develop our store management talent.

Operations are structured to promote an entrepreneurial environment at the dealership level. Each store s general manager, with assistance from regional and corporate management, is ultimately responsible for dealership operations, personnel, store culture and financial performance.

During 2010, we focused on the following key areas to achieve our mission:

- increasing revenues in all business lines;
- capturing a greater percentage of overall new vehicle sales in our local markets;
- selling lower-priced used vehicles to reach additional customers;
- reducing exposure to Chrysler through risk management and acquisition of other franchises;
- reducing the amount of non-operating assets by divesting closed facilities and vacant land;
- utilizing prudent cash management, including investing capital to produce accretive returns; and
- reducing our exposure to pending debt maturities by renewing and extending debt instruments.

We believe our cost structure is aligned with current industry sales levels. Through initiatives started in the second quarter of 2008, we have successfully established a cost structure which can be leveraged as vehicle sales levels improve. Our selling, general and administrative expense as a percentage of gross profit has improved to 78.8% in 2010 compared to 86.2% in 2008. In periods of higher revenue, for example the third quarter of 2010, our selling, general and administrative expense as a percentage of gross profit was as low as 73.8%. We believe we are well positioned to improve our selling, general and administrative expense leverage as vehicle sales levels continue to improve.

We continuously evaluate our portfolio of franchises, divesting stores that are not expected to meet our financial return requirements while selectively acquiring attractive stores in our target markets. In the past three years, we generated $72.7 million in cash by divesting stores that did not meet our financial return expectations. Additionally, in 2010, we spent $23.7 million in cash on acquisitions which increase revenue and diversify our portfolio.

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New Vehicles

In 2010, we sold 33,701 new vehicles, generating 22.9% of our gross profit for the year. New vehicle sales also have the potential to create incremental profit opportunities through manufacturer incentives, resale of trade-in vehicles, sale of third-party financing, vehicle service and insurance contracts, and future service and repair work.

In 2010, we represented 25 domestic and imported brands ranging from economy to luxury cars, sport utility vehicles, crossovers, minivans and light trucks.

Manufacturer	Percent of 2010 Total Revenue	Percent of 2010 New Vehicle Revenue	Percent of 2010 New Vehicle Gross Profit
Chrysler, Jeep, Dodge	15.0%	29.9%	30.6%
GMC, Chevrolet, Cadillac, Buick	8.7	17.3	18.0
Toyota, Scion	5.9	11.8	11.5
BMW	4.5	9.0	7.5
Honda, Acura	3.5	7.0	7.5
Ford, Lincoln	3.0	6.0	4.9
Subaru	2.2	4.4	3.7
Hyundai	2.0	4.0	5.5
Volkswagen, Audi	1.6	3.2	3.2
Nissan	1.3	2.7	2.9
Mercedes	1.1	2.2	2.1
Kia	0.7	1.5	1.4
Porsche	0.4	0.7	0.9
Mazda	0.2	0.3	0.3
Suzuki	*	*	*
Saab	*	*	*
Total	50.1%	100.0%	100.0%

* Less than 0.1%

We purchase our new car inventory directly from manufacturers, who generally allocate new vehicles to stores based on availability, monthly sales and market area. Accordingly, we rely on the manufacturers to provide us with vehicles that meet consumer demand at suitable locations, with appropriate quantities and prices. However, high demand vehicles are often in short supply. We exchange vehicles with other automotive retailers and between our own stores to accommodate customer demand and to balance inventory.

Used Vehicles

At each new vehicle store, we also sell used vehicles. We have certain stores that sell only used vehicles. In 2010, retail used vehicle sales generated 21.5% of our gross profit.

Our used vehicle operations give us an opportunity to:

generate sales to customers financially unable or unwilling to purchase a new vehicle;

- increase new and used vehicle sales by aggressively pursuing customer trade-ins; and

- increase finance and insurance revenues and service and parts sales.

Our longer-term strategy is to maintain a ratio of one retail used vehicle sale to one retail new vehicle sale. For the past two years, we have been able to maintain this ratio. We achieve this through offering three categories of used vehicles: manufacturer certified used vehicles; late model, lower mileage vehicles; and value autos. We offer manufacturer certified used vehicles at most of our franchised dealerships. These vehicles undergo additional reconditioning and receive an extended factory-provided

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warranty. Late model, lower mileage vehicles are highly reconditioned and offer a Lithia certified warranty. Value autos are older, higher mileage vehicles that undergo a safety check and a lesser degree of reconditioning. Value autos are offered to customers who require a less expensive vehicle with lower monthly payments.

We acquire our used vehicles through customer trade-ins and at closed auctions. We also purchase vehicles directly from customers visiting our stores, private parties advertising through local newspapers, competing dealers and online.

In addition, as a complement to our ongoing used vehicle operation at each store, and in response to customer demand, we use personnel in our support services group to identify and communicate the optimal mix of used vehicles that are most attractive to our markets. We conduct our own internal used vehicle auctions, and often centrally manage the sale of used vehicles at public auctions at the corporate level.

We wholesale used vehicles that are in poor condition, are aged in our inventory, or are not suitable for our stocking plan. In 2010, we increased the number of late-model used vehicles we wholesaled based on our sales experience with similar cars and as we shifted our mix to increase the number of value autos in inventory.

Vehicle Financing

We believe that arranging financing is an important part of our ability to sell vehicles and related products and services. Our sales personnel and finance and insurance managers receive training in securing customer financing and possess extensive knowledge of available financing alternatives. We attempt to arrange financing for every vehicle we sell and we offer customers financing on a same day basis, giving us an advantage, particularly over smaller competitors who do not generate enough sales to attract our breadth of finance sources.

We earn a commission on each finance, service and insurance contract we write and subsequently sell to a third-party. We normally arrange financing for customers by selling the contracts to outside sources on a non-recourse basis to avoid the risk of default.

We were able to arrange financing on 72% of the vehicles we sold during 2010, compared to 68% in 2009. Our presence in multiple markets and changes in technology surrounding the credit application process have allowed us to utilize a larger network of lenders across a broader geographic area. Additionally, credit markets improved throughout 2010, as the asset-backed securities market for automotive paper improved and banks increased the volume of automotive loans initiated. Sub-prime customers, who comprised approximately 8% of the financing we completed in 2010, continue to experience constraints in obtaining automotive financing. While the market for sub-prime customers improved in 2010, we believe vehicle sales will increase as these customers are able to obtain loans at more attractive terms.

Service Contracts and Other Products

Our finance and insurance managers also market third-party extended warranty contracts, insurance contracts and vehicle and theft protection products to our new and used vehicle buyers. These products and services yield higher profit margins than vehicle sales and contribute significantly to our profitability. Extended warranty contracts for new vehicles provide additional coverage beyond the duration or scope of the manufacturer s warranty. We also sell service contracts to used vehicle buyers, which provide coverage for certain major repairs. We believe the sale of extended warranties and service contracts increase our service and parts business as well, linking future repair work to our locations.

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When customers finance an automobile purchase, we offer them guaranteed auto protection (gap) coverage that provides protection from loss incurred by the difference in the amount owed and the amount received under a comprehensive insurance claim. We receive a commission on each gap policy sold.

We offer a lifetime lube, oil and filter (LOF) service, which, in 2010, was purchased by 34% of our total new and used vehicle buyers. This service helps us retain customers by building customer loyalty and it provides opportunities for selling additional routine maintenance items and generating repeat service and parts business. In 2010, we sold approximately $51 of additional maintenance on each lifetime LOF service we performed.

Service, Body and Parts

In 2010, our service, body and parts operations generated 37% of our gross profit. Our service, body and parts operations are an integral part of establishing customer loyalty and contribute significantly to our overall revenue and profits. We provide parts and service primarily for the new vehicle brands sold by our stores, but we also service most makes and models.

The service and parts business provides important repeat revenues to our stores. We market our parts and service products by notifying owners when their vehicles are due for periodic service. This encourages preventive maintenance rather than post-breakdown repairs. The number of customers who purchase our lifetime LOF service helps to improve customer loyalty and provides opportunities for repeat parts and service business.

Revenues from the service and parts departments are particularly important during economic downturns, as owners tend to repair their existing vehicles rather than buy new vehicles during such periods. This partially mitigates the effects of a drop in new vehicle sales that may occur in a recessionary economic environment.

Our service, body and parts operations provide us an opportunity to build the Lithia Automotive brand independent of new vehicle franchises. We have branded our service processes as Assured Service. Assured Service provides customer benefits such as same day service, upfront price guarantees and a three-year/50,000 mile warranty on repairs. We have also launched Assured Automotive Products on various commodity items such as tires, filters and batteries. These store branded parts provide improved margins as we procure in bulk directly from the manufacturer.

The number of vehicles in operation has been declining over the past several years as the extended challenging economic environment has curtailed vehicle purchases. We believe that this presents a challenge to our service, body and parts business in the foreseeable future as there are fewer vehicles requiring service. We expect this impact to be more severe for domestic brands, as, over time, there will be fewer domestic vehicles in service due to their decline in overall market share over the past few years from the levels seen historically.

To counteract the impact of fewer units in operation, we have increased marketing efforts and lowered prices on routine maintenance items. We have also focused on offering more commodity products, such as wiper blades and tires, with the goal of being a full service provider for all of our customers vehicle needs. We believe offering one-stop shopping will be an important point of differentiation, particularly to take advantage of additional sales opportunities with customers purchasing a lifetime LOF service. These return customers provide an opportunity to offer more diversified services, and will help to offset the impact from the decline in the number of vehicles in operation.

In 2010, the expected decline in service revenues was partially offset as we serviced a greater percentage of older vehicles than we have historically. We believe this is due to the efforts outlined above as well as our customers keeping their vehicles for longer periods of time, providing us with opportunities to service their vehicles deeper into the ownership cycle.

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In 2010, we added collision centers to stores in Iowa and Oregon. We believe body shops provide an attractive opportunity to grow our business, and we continue to evaluate potential locations to expand. We currently operate 15 collision repair centers: four in Texas; three in Oregon; two each in Idaho and Iowa; and one each in Alaska, Washington, Montana and Nevada.

Marketing

We market ourselves as Lithia Auto Stores-Serving our Communities since 1946. In most markets, except where prohibited by franchise requirements, our stores are identified as Lithia Auto Stores.

We emphasize customer satisfaction and we realize that customer retention is critical to our success. We want our customers experiences to be satisfying so that they refer us to their families and friends. We utilize an owner marketing strategy, consisting of email, traditional mail and phone contact, to maintain regular communication and solicit feedback.

To increase awareness and traffic at our stores, we employ a combination of traditional and digital media to reach potential customers. Total advertising expense, net of manufacturer credits, was $27.1 million in 2010, $18.4 million in 2009 and $17.6 million in 2008. In 2010, approximately 65% of those funds were spent in traditional media and 35% were spent in digital and owner communications. In all of our communications, we seek to differentiate ourselves from competitors by conveying price, selection and finance benefits unique to Lithia.

Certain advertising and marketing expenditures are offset by manufacturer co-op programs. Advertising credits not tied to specific vehicles are earned as requests for reimbursement are submitted to manufacturers for qualifying advertising expenditures. These reimbursements are recognized as a reduction of advertising expense upon manufacturer confirmation of submitted expenditures. Manufacturer cooperative advertising credits were $2.7 million in 2010, $3.8 million in 2009 and $4.3 million in 2008.

Many people now shop online before visiting our stores. We maintain websites for all of our stores and a corporate site (Lithia.com) dedicated to generating customer leads for our stores. Today, our websites enable our customers to:

- locate our stores and identify the new vehicle brands sold at each store;
- search new and pre-owned vehicle inventory;
- view current pricing and specials;
- obtain Kelley Blue Book values;
- submit credit applications;
- shop for and order manufacturers vehicle parts;
- schedule service appointments;
- pay for service; and
- provide feedback about their Lithia experience.

We also have mobile versions of our websites in anticipation of greater adoption of mobile technology.

We post our inventory on major new and used vehicle listing services (cars.com, autotrader.com, kbb.com, ebay, craigslist, etc.) to reach online shoppers. We also employ search engine optimization, search engine marketing and online display advertising to reach more online prospects.

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Social influence marketing represents a very cost-effective method to enhance our corporate reputation and increase vehicle sales and service. We are deploying tools and training to our employees in ways that will help us listen to our customers and create more ambassadors for Lithia.

Franchise Agreements

Each of our stores operate under a separate agreement (Franchise Agreement) with the manufacturer of the new vehicle brand it sells.

Typical automobile Franchise Agreements specify the locations within a designated market area at which the store may sell vehicles and related products and perform certain approved services. The designation of such areas and the allocation of new vehicles among stores are at the discretion of the manufacturer. Franchise Agreements do not, however, guarantee exclusivity within a specified territory.

A Franchise Agreement may impose requirements on the store with respect to:

- facilities and equipment;
- inventories of vehicles and parts;
- minimum working capital;
- training of personnel; and
- performance standards for market share and customer satisfaction.

Each manufacturer closely monitors compliance with these requirements and requires each store to submit monthly financial statements. Franchise Agreements also grant a store the right to use and display manufacturers trademarks, service marks and designs in the manner approved by each manufacturer.

We have determined the useful life of a Franchise Agreement is indefinite, even though certain Franchise Agreements are renewed after one to five years. In our experience, agreements are routinely renewed without substantial cost and there are legal remedies to help prevent termination. Certain Franchise Agreements, including those with Ford and Chrysler, have no termination date. In addition, state franchise laws protect franchised automotive retailers. Under certain laws, a manufacturer may not terminate or fail to renew a franchise without good cause or prevent any reasonable changes in the capital structure or financing of a store.

The typical Franchise Agreement provides for early termination or non-renewal by the manufacturer upon:

- a change of management or ownership without manufacturer consent;
- insolvency or bankruptcy of the dealer;
- death or incapacity of the dealer/manager;
- conviction of a dealer/manager or owner of certain crimes;

- misrepresentation of certain sales or inventory information by the store, dealer/manager or owner to the manufacturer;
- failure to adequately operate the store;
- failure to maintain any license, permit or authorization required for the conduct of business;
- poor market share; or
- low customer satisfaction index scores.

Agreements generally provide for prior written notice before a franchise can be terminated under most circumstances. We also sign master framework agreements with most manufacturers that impose additional requirements on our stores. See Item 1A. Risk Factors.

Competition

The retail automotive business is highly competitive. Currently, there are approximately 18,000 dealers in the United States, many of whom are independent operators managed by individuals, families or small retail groups. We compete primarily with other automotive retailers, both publicly and privately-held.

Vehicle manufacturers have designated specific marketing and sales areas within which only one dealer of a vehicle brand may operate. In addition, our Franchise Agreements typically limit our ability to acquire multiple dealerships of a given brand within a particular market area. Certain state franchise laws also restrict us from relocating our dealerships, or establishing new dealerships of a particular brand, within any area that is served by another dealer with the same brand. Accordingly, to the extent that a market has multiple dealers of a particular brand, as certain markets we are in do, we are subject to significant intra-brand competition.

We are larger and have more financial resources than most private automotive retailers with which we currently compete in the majority of our regional markets. We compete directly with retailers with similar or greater resources in our metropolitan markets in Seattle, Washington and Concord, California. If we enter other metropolitan markets, we may face competitors that are larger or have access to greater financial resources. We do not have any cost advantage in purchasing new vehicles from manufacturers. We rely on advertising and merchandising, pricing, our customer guarantees and sales model, our sales expertise, service reputation and the location of our stores to sell new vehicles.

Regulation

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, privacy laws, escheatment laws, anti-money laundering 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 numerous federal, state and local laws and regulations. Claims arising out of actual or alleged violations of law may be asserted against us or our stores by individuals, a class of individuals, or governmental entities. These claims may expose us to significant damages or other penalties, including revocation or suspension of our licenses to conduct store 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.

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 stores 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

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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 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.

Certain stores 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 requi