MATTHEWS
A COMMERCIAL REAL ESTATE PUBLICATION AT THE INTERSECTION OF INNOVATION AND INFORMATION
Acquisitions, consolidation, and activist investors have shaken up the playing field in the Retail Auto Repair Industry. Wall Street is getting into the action amongst the national incumbents, as everyone has quickly realized that there is a huge opportunity to profit from the consolidation and expansion in the Auto Repair Industry. Most of the large incumbents such as Pep Boys, Firestone, TBC Corporation, Goodyear, and Monro Muffler have significantly slowed approval of new Greenfield development projects in favor of the acquisition potential of thousands of smaller operators who are ripe for the picking.

The appetite for acquisition, as opposed to Greenfield development, have left some of their preferred developers twiddling their thumbs waiting for projects to be approved. The top players in the market are not holding anything back in terms of swallowing up smaller operators in an effort to accelerate their expansion strategies. Auto Repair tenants have quickly realized that retrofitting sites is much quicker and cost effective than approving new developments in which they must pay high rents and wait a year or more for development.

This has led to a slowdown in the inventory available for net leased investors and a slight compression in cap rates. The good news is, we believe this acquisition mode to be in the 3rd or 4th quarter. As the premium acquisition targets dwindle, operators will either settle for lower quality acquisitions or more likely, revert back to relying on Greenfield development to accomplish their aggressive expansion plans.

Like much of the broader net leased retail market, we are experiencing the stabilization of cap rates for the top Auto Repair and Service operators. Cap rates have dropped slightly in the last year, approximately 25 BPS on average. Investors still perceive auto service as a hedge against e-commerce as service-based retailers are less likely to be impacted. With that being said, Firestone, Goodyear, and a number of new startups are fighting for e-commerce market share.

Pep Boys who was taken Private by Carl Icahn is aggressively increasing their nationwide footprint. Bridgestone (after losing the bidding war for Pep Boys,) announced an aggressive expansion of their own. Monro Muffler continues to lead the pack in largest annual increase in store count. Goodyear is vacating an increasing amount of locations (presumably focusing on their e-commerce platform.) Midas and Just Brakes plan to add tires into their mix of services, while Jiffy Lube seems to have some tricks up its sleeve and some big plans as well.
Pep Boys has been busy backfilling vacant Goodyear stores and also has some acquisition plans of its own. Most analysts projected that the reason for Icahn acquisition of Pep Boys was primarily due to the synergies with his Auto Plus brand. In fact, Icahn appears to have gone in a different direction as we have observed a greater degree of focus on expanding the auto service platform. We believe he has even sold off some of the auto parts operations at select 2 Georgia locations that recently were retrofitted from an 18,000 SF Pep Boys to a 2-Tenant building with both Pep Boys and Advance Auto Parts (AAP). Pep Boys retains the service side of the building and has sublet or sold the parts business to AAP in a number of stores in Georgia. We predict more of these arrangements to continue popping up and if successful, Icahn could be viewing Advance Auto as his exit strategy.

After losing out on the Pep Boys acquisition and an immediate increase of approximately 7,500 service bays in 800 new locations, Firestone announced an aggressive 3-year expansion plan to increase its footprint 30% with the addition of approximately 800 new retail outlets. Firestone plans to open 40-50 new stores a year, with the difference being made up through acquisitions. Goodyear has been exploring alternative business plans for its retail locations by creating new beautiful buildings with a large construction footprint, making them very expensive to lease. Goodyear’s total store count has experienced a net loss each year in the past 4 years, steadily declining from 1,400 to 1,100 stores in 2015. TBC Corporation is in the process of rebranding all their locations outside of Florida to NTB and is also aggressively expanding both its corporate operations and franchise brands through new development and acquisition.

### NEW STORE OPENINGS

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Pep Boys</th>
<th>Advance Auto Parts</th>
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<td>20</td>
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### TOTAL TRANSACTIONS

Since most of the national tenants have significantly limited their Greenfield expansion in favor of acquisitions, the market for newly developed auto service locations has slowed. As the last approved projects are finalized, there is not a lot left in the pipeline. However, we do anticipate Auto Service tenants to begin picking up steam with their approval for new projects, which will be about 18 months out from completion. Thus, a majority of the recent sales have been retrofits of existing sites with a refurbished look or resales with a shorter term remaining on the lease on behalf of private landlords. In addition, tenants such as Firestone have shifted to an in-house development model in favor of owning their own real estate while Pep Boys, TBC Corporation, Goodyear and Jiffy Lube still prefer to lease.
AVERAGE CAP RATES

The Auto Service Industry like the broader retail sector, has seen a stabilization of cap rates across the board. The market is no longer experiencing a year over year 50 basis point drop in cap rates that we experienced between 2011-2014. Overall, we are seeing cap rates for new construction roughly 75-100 basis points lower than the industry as a whole.

Year to date, the average cap rate for a new development Pep Boys property is 6.25%, while new development Bridgestone’s, Goodyears, and TBC Corporate properties are trading on average at a 5.75% cap rate. On average, with 5 years remaining on the lease term, Pep Boys trade at a 7.75% cap rate, Bridgestone is closer to 7.25%, Goodyear’s are at 8% and TBC Corp’s are 7.50%. The difference in yields more than likely stems from Pep Boys struggling financial performance reported before being taken private, reporting significant losses in the years prior to being taken private. Jiffy Lube cap rates are more variable due to the fact that it is a primarily franchise based organization, however the new development properties that come with a strong guarantee trade on average for 5.75-6.00% range where smaller operators trade about 100 basis points higher.

* BARS REPRESENT AVERAGE CAP RATES
* LINES REPRESENT AVG CAP RATES FOR NEW CONSTRUCTION

Data source: Costar & Real Capital Analytics
*All 2016 data is year to date
The outlook for the auto service segment remains strong. Many private equity firms, hedge funds, and incumbent tenants all continue to heavily invest because they recognize the huge opportunity in the retail auto service market. This alone will bode well for real estate as it seems all of the national tenants have very lofty expansion plans.

All of the national tenants (except Goodyear) have had a net increase in store count year over year and continue to grow same-store sales. The main catalysts that have the potential to derail the optimistic outlook for the industry are primarily related to 3 factors:

- **Newer Vehicles and Service Packages** - With the cash for clunkers program, many customers chose to purchase a new car instead of keeping their old car, which is subject to more repairs. Additionally, many dealerships offer service packages with the purchase of a new vehicle which reduces the demand for 3rd party auto servicers.

- **More Efficient Vehicles** - Cars are more efficient and need less maintenance and repair. This has been one of the largest impacts on Jiffy Lubes bottom line as they are primarily a Lube based business model. Vehicles used to need oil changes every 3,000 miles, but now with more efficient vehicles this has been stretched to 4,500 and even 6,000 miles.

- **Rise of E-commerce** – While the auto service industry has additional barriers to entry than say, office supply stores, there are a number of start-ups that are testing out the waters for Tire and Service delivery. In addition, both Goodyear and Firestone are investing heavily into their Ecommerce platforms.

The biggest opportunity in the marketplace is in the new acquisition targets, retrofitting of existing locations, and finding viable locations. The outlook for demand continues to remain strong as Auto Service investments generally offer higher cap rate returns and more favorable increases than other retailers that have moved to a flat rental rate model.

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**AVERAGE RENTS**

While TBC Corporation and Pep Boys are strategically keeping occupancy costs low with healthy rent structures in the $20/SF range, Firestone and Goodyear seem to be sparing no expense in their new developments. It is not uncommon for a newly developed Firestone property to be paying $30+/SF or a newly developed Goodyear paying close to $40/SF. Jiffy Lube rents range dramatically with the average paying around $100,000 per year on only 2,500 SF. Although, some reach as high as $180,000 and can be as low as $24,000 annually. Jiffy Lube and Goodyear also have been the most aggressive when it comes to lease negotiations in seeking rental reductions. Both tenants have substantial leverage as they know Auto Service sites are notoriously difficult to backfill. This aspect paired with the fact that they are generally paying higher than market rents to begin with, Landlords do not have many alternatives.

**FUTURE OUTLOOK**

The outlook for the auto service segment remains strong. Many private equity firms, hedge funds, and incumbent tenants all continue to heavily invest because they recognize the huge opportunity in the retail auto service market. This alone will bode well for real estate as it seems all of the national tenants have very lofty expansion plans. All of the national tenants (except Goodyear) have had a net increase in store count year over year and continue to grow same-store sales.

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