

the aftermarket analyst

A PUBLICATION FOCUSED ON MERGERS, ACQUISITIONS AND CORPORATE FINANCE IN THE AUTOMOTIVE AFTERMARKET INDUSTRY

Gross Margin Erosion: What's The End Game?

As we have often mentioned, the flow of capital into the auto aftermarket has continued unabated. The good news is that the availability of capital from private equity groups and lenders has continued to drive up purchase price multiples. The bad news is that the actual value of some deals has leveled off because of an overwhelming problem U.S. manufacturers have been facing: the erosion of their Gross Profit Margins. In order to keep the aftermarket a viable investment vehicle, manufacturers must deal head-on with some of the most pressing external factors currently facing them. These include the following:

Raw Material Price Increases

Commodities are currently experiencing their strongest bull market in more than 20 years. Consequently, raw material price increases are becoming more persistent and severe. Unfortunately, most manufacturers have been unable to pass along these increases in a timely manner because they are being squeezed by more powerful market participants — namely mass retailers and powerful warehouse distributors.

The most obvious way to ensure the success of a price increase is to make products that customers want. This means keeping a laser-like focus on developing proprietary patented products that are in demand by the end user. However fundamental this concept may be, too few manufacturers are actually making a concerted effort to differentiate their products.

Another price-increase survival mechanism growing in popularity is “alternative distribution.” Manufacturers

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Lou Merz to Head Capstone's Detroit Office

Capstone Financial Group has announced that Louis R. Merz has joined the firm as Managing Director of the Company's new Detroit office. Lou will be spearheading that office and be actively involved in the firm's automotive aftermarket transactions, with a special emphasis on hard parts manufacturers, distributors and retailers. He will also be President of Capstone Automotive Consulting, a new division formed to work with aftermarket companies in getting them ready for a liquidity event.

Lou has a distinguished career in the aftermarket industry with international firms such as Delphi Automotive Systems, MascoTech, Moog Automotive and BorgWarner. Lou has also served as Chairman of AAIA and President of the Automotive Sales Council.

Dan Smith, founder and President of Capstone, said, “The knowledge and experience that Lou brings to the Company will certainly broaden our footprint in the auto aftermarket industry. He is one of the few people that truly understands that important link between the OE, Tier 1, and aftermarket supplier. He will help cement Capstone's leading position as investment bankers to the auto aftermarket.”

Smith added, “Over the last few months we have seen a heightened increase in aftermarket companies struggling with operational and financial difficulties. They need help in getting their operations ready for a sale or recapitalization. There's not a human being in the world that knows more about the space than Lou, and we are so pleased to have him initiate our automotive consulting practice.”

Lou may be reached at 248.723.8247 or emailed at lmerz@capfg.com.

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RECENTLY ANNOUNCED AUTOMOTIVE AFTERMARKET TRANSACTIONS

Announce Date	Acquirer/Investor(S)	Target	Target Description	Firm Value (\$mil.)	Rev. FV / Rev.	EBITDA FV / EBITDA
3/10/2006	Illinois Tools Works Inc.	Certain trademarks and patents of CamAir Corp.	Makes drying controls for compressed air products, such as the TS and CT series of desiccant dryers used in body shops, paint facilities and other aftermarket repair installations	—	—	—
3/9/2006	United Components, Inc.	ASC Industries, Inc.	Manufacturer of automotive water pumps and industrial components	154.7	—	—
3/8/2006	American Capital Strategies Ltd.	AAMCO Transmissions Inc.	Transmission repair service shops	—	—	—
3/6/2006	Monro Muffler Brake, Inc.	ProCare Automotive Service Solutions, L.L.C.	Operates 82 retail locations that offer automotive maintenance and repair services	14.0	50.0 0.28x	—
3/1/2006	Black & Decker Corp.	Vector Products Inc.	Designs and markets portable consumer power products including vehicle battery chargers and rechargeable spotlights	160.0	1.07x 150.0	—
3/1/2006	Parts Plus of New Mexico	Pueblo Motive Service	Retailer and distributor of automotive parts and supplies	—	—	—
2/23/2006	The Bosch Group and MANN+HUMMEL	ArvinMeritor's Light Vehicle Aftermarket Purolator filters business	Supplier of filtration products including air, oil, and fuel filters	—	—	—
2/16/2006	GoldenWest Lubricants, Inc.	Prolong Super Lubricants, Inc.	Marketer of patented consumer automotive, commercial, industrial and household products	—	—	—
2/14/2006	Transamerican Auto Parts Company, LLC	Four Wheel Drive Hardware, LLC	Catalog and internet retailer of Jeep aftermarket parts and accessories	—	—	—
2/10/2006	Quantum Fuel Systems Technologies Worldwide, Inc.	Regency Conversions, Inc.	One of the largest vehicle converters in North America, producing approximately 5,000 vehicles annually which are sold through 250 automobile dealerships throughout the continental U.S.	10.9	40.0 0.27x	—
2/3/2006	LLR Partners, Inc.	The Reading Group	Manufacturer and distributor of specialty truck equipment	—	—	—
2/1/2006	LKQ Corporation	Transwheel Corporation	Aluminum alloy wheel refurbishing and distribution business	—	28.5	—
1/24/2006	Harbour Group	Alemite LLC	Designs and manufactures a wide range of lubrication equipment sold into the auto aftermarket and industrial industries	—	—	—
1/23/2006	Hampton Products International Corporation	Keeper Corporation	Manufacturer of automotive cargo management products	—	—	—
1/18/2006	Industrial Enterprises of America, Inc.	Pitt Penn	Supplier of automotive and chemical products	—	—	—
1/18/2006	Kirtland Capital Partners	Crysteel Manufacturing Inc.	Manufacturer of light and medium dump and platform bodies and hoists	—	—	—
1/9/2006	Monomoy Capital Partners LLC	Barjan Products LLC	Largest distributor of nonfood general merchandise, such as automotive accessories, toys, sunglasses, books and videos to truck stops and travel centers in the U.S.	20.0	140.0 0.14x	—
1/6/2006	Investcorp SA	Autodistribution SA	France's largest independent distributor of auto, truck and industrial parts	729.0	—	—
1/4/2006	Harbour Group	Late Great Chevrolet Association, Inc.	Sells a complete line of interior and exterior parts and accessories directly to retail customers through several specialty catalogs and a monthly membership publication, Chevy Times	—	—	—
1/3/2006	LKQ Corporation	Fit-Rite Body Parts	Aftermarket collision automotive replacement parts business	37.0	39.6 0.9x	—
12/30/2005	General Cable Corporation	Beru S.A. de C.V.	Automotive aftermarket assembly and distribution operation	—	—	—
12/21/2005	Capital Partners	Dayton Parts, LLC	Manufacturer and distributor of aftermarket heavy duty truck parts	—	—	—

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are seeking ways around their more powerful and demanding customers by selling directly to car dealers, installers and even consumers. Not only do these efforts generate higher margins, but they produce lower customer concentrations and higher company valuations.

Asian Imports

The phenomenon of cheap Asian imports putting downward pressure on the prices U.S. manufacturers can charge has been well chronicled. This is not going to change unless there is a massive devaluation of the dollar relative to other currencies or the U.S. is successful at implementing tariffs on these goods. However, we saw the difficulty of this in the administration's well intended but ill-fated steel tariffs.

To put it colloquially; if we can't beat 'em, we must join 'em. Again, the ideal answer is to develop proprietary patented products and protect them as well as possible. If you're a manufacturer, accept the fact that your product can probably be made more cheaply in China and focus on your customer type.

"American" Factors

As evidenced by recent bankruptcy filings, the problems facing auto OEMs are affecting every Tier One supplier in the country. Also, these problems are filtering down into the aftermarket because of pricing pressures and lower vehicles sales.

Let's not kid ourselves. Other than sometimes insular management, the biggest problems for the OEMs are healthcare and pension costs (read: labor unions). For example, General Motors spends more on health care than steel. What's wrong with this picture? The short answer is that these costs have been driven through the roof by malpractice suits and the resultant insurance costs that doctors can no longer afford. From the time our courts made McDonald's pay a woman because her coffee was too hot, the picture was clear.

In addition, our litigious society has caused workers comp premiums in California to increase 300% in the

last four years. In South Carolina, some workers comp premiums are 47% of compensation!

The solution: tort reform. Call your congressman and tell him to stop pussyfooting around with reform. The lack of results is driving the American manufacturing base into bankruptcy. Also, call your favorite plaintiff's attorney and his ambulance-chasing buddies and tell them that while their antics are making them superrich, they are putting hundreds of thousands of other Americans out of work.

The other solution: lower union costs. The entitlement mentality of some of America's blue collar workers has come back to bite them. Many think they work for the union, not the company. See how that theory holds up in bankruptcy court.

Only when these problems are resolved will we see a stabilization of the American manufacturing base, particularly that in the automotive aftermarket industry.

Register Early for the 2006 Aftermarket Financial Symposium

The second annual *Aftermarket Financial Symposium* will provide top speakers and presenters who will address key financial issues and trends in outsourcing, mergers and acquisitions, accounting, fringe benefits, technology, risk management, investments, strategic planning, research and bank financing.

The symposium will be held at the Hyatt Regency O'Hare in Chicago on Tuesday, Sept. 26 and Wednesday, Sept. 27. For more information, contact Susan Medick at 301-654-6664 or e-mail susan.medick@aftermarket.org.

About Capstone

Capstone Financial Group is an investment banking firm which assists owners of middle market companies with their financial needs - including mergers and acquisitions, recapitalizations, private placements, divestitures, and other financial advisory services. Capstone is backed by a highly experienced and knowledgeable team of financial professionals with firsthand knowledge of starting, operating, growing, and selling middle market companies. Visit us online at www.capfg.com.

Selected Public Company Capitalization and Operating Figures
(\$ in millions, except per share data)

Company	Enterprise Value				Last Twelve Months (LTM)				
	Price as of 3/26/06	Market Cap	Debt	Cash	Enterprise Value (1)	LTM Date	Revenue	EBITDA	Net Income
Manufacturers									
Tenneco Automotive Inc.	\$21.80	\$940.5	\$1,378.0	\$141.0	\$2,257.4	12/31/05	\$4,441.0	\$390.0	\$59.8
Standard Motor Products, Inc.	9.64	178.1	338.3	14.0	502.3	12/31/05	830.4	36.8	1.5
Aftermarket Technology Corp.	21.43	467.2	90.7	45.5	523.7	12/31/05	442.0	66.7	32.2
R&B, Inc.	10.14	180.0	35.8	2.9	218.5	12/31/05	278.1	35.6	17.1
Proliance International, Inc.	5.95	90.8	50.4	5.2	137.0	9/30/05	309.5	5.2	(7.1)
Milemarker International Inc.	3.51	35.0	4.4	0.2	39.3	12/31/05	24.8	5.5	3.2
Wholesalers & Distributors									
Genuine Parts Company	\$44.41	\$7,679.2	\$500.9	\$188.9	\$8,125.5	12/31/05	\$9,783.1	\$774.6	\$437.4
LKQ Corporation	20.49	1,073.5	47.5	3.6	1,221.0	12/31/05	547.4	61.5	30.9
Keystone Automotive Industries, Inc.	42.13	679.5	21.4	5.6	715.2	12/30/05	600.9	38.3	19.0
The Coast Distribution System, Inc.	7.30	32.3	19.2	0.7	52.6	9/30/05	174.5	8.4	3.8
Retailers									
Autozone, Inc.	\$98.26	\$7,540.8	\$1,779.3	\$81.4	\$9,371.7	2/11/06	\$5,812.5	\$1,120.9	\$565.8
Advance Auto Parts, Inc.	42.00	4,538.2	1,224.4	40.8	5,831.5	12/31/05	4,265.0	529.1	234.7
O'Reilly Automotive, Inc.	35.91	4,037.2	100.8	31.4	4,222.6	12/31/05	2,045.3	309.8	164.3
The Pep Boys - Manny, Moe & Jack	15.90	861.3	534.0	36.5	1,364.5	10/29/05	2,241.8	80.0	(22.6)
CSK Auto Corporation	16.16	708.0	395.1	19.3	1,095.2	10/30/05	1,594.5	121.9	31.3

Selected Public Company Multiples and Operating Statistics

Company	Enterprise Value /					P / E Ratio	Margins		
	Revenue	EBIT	EBITDA	Free Cash Flow (2)	Net Income		Gross Margins	EBITDA Margins	Net Margins
Manufacturers									
Tenneco Automotive Inc.	0.5x	10.6x	5.8x	9.2x	37.7x	15.7	15.3%	8.8%	1.3%
Standard Motor Products, Inc.	0.6x	25.9x	13.7x	18.7x	NM	119.6	22.4%	4.4%	0.2%
Aftermarket Technology Corp.	1.2x	9.8x	7.9x	10.6x	16.3x	14.5	24.1%	15.1%	7.3%
R&B, Inc.	0.8x	7.3x	6.1x	7.7x	12.8x	10.5	35.5%	12.8%	6.1%
Proliance International, Inc.	0.4x	NM	26.3x	NM	NM	NM	17.9%	1.7%	NM
Milemarker International Inc.	1.6x	7.6x	7.2x	7.4x	12.4x	11.0	45.4%	22.0%	12.8%
Mean	0.9x	12.3x	11.2x	10.7x	19.8x	34.3x	26.8%	10.8%	5.6%
Median	0.7x	9.8x	7.5x	9.2x	14.5x	14.5x	23.3%	10.8%	6.1%
Wholesalers & Distributors									
Genuine Parts Company	0.8x	11.5x	10.5x	11.8x	18.6x	17.6	31.3%	7.9%	4.5%
LKQ Corporation	2.2x	23.1x	19.8x	34.6x	39.5x	34.8	47.1%	11.2%	5.6%
Keystone Automotive Industries, Inc.	1.2x	24.5x	18.7x	22.7x	37.6x	35.7	44.4%	6.4%	3.2%
The Coast Distribution System, Inc.	0.3x	6.9x	6.2x	6.7x	13.8x	8.5	18.5%	4.8%	2.2%
Mean	1.1x	16.5x	13.8x	19.0x	27.4x	24.1x	35.3%	7.6%	3.9%
Median	1.0x	17.3x	14.6x	17.2x	28.1x	26.2x	37.9%	7.1%	3.8%
Retailers									
Autozone, Inc.	1.6x	9.4x	8.4x	11.2x	16.6x	13.3	49.2%	19.3%	9.7%
Advance Auto Parts, Inc.	1.4x	14.3x	11.0x	18.6x	24.8x	19.3	47.2%	12.4%	5.5%
O'Reilly Automotive, Inc.	2.1x	16.7x	13.6x	40.4x	25.7x	24.6	43.6%	15.1%	8.0%
The Pep Boys - Manny, Moe & Jack	0.6x	NM	17.1x	NM	NM	NM	24.3%	3.6%	NM
CSK Auto Corporation	0.7x	12.8x	9.0x	12.2x	35.0x	22.6	45.4%	7.6%	2.0%
Mean	1.3x	13.3x	11.8x	20.6x	25.5x	20.0x	42.0%	11.6%	6.3%
Median	1.4x	13.5x	11.0x	15.4x	25.3x	21.0x	45.4%	12.4%	6.8%

(1) Enterprise Value equals market cap, plus debt, minus cash

(2) Free Cash Flow equals EBITDA less capital expenditure

"NM" is not meaningful