

the aftermarket analyst

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

The China Syndrome: Why U.S. Manufacturers Can't Compete In the Current Market Environment

In last month's article on gross margin erosion, we discussed various factors affecting the profitability of U.S. manufacturing enterprises including the impact of low-cost Asian importers. In this article, we will illuminate more fully the challenge posed by Asian manufacturers and why the status quo makes it nearly impossible for their U.S. counterparts to effectively compete.

The most compelling evidence of this is the fact that Asian manufacturers are usually quite happy with a 5 percent gross profit margin. Worse still, American manufacturers have to earn a 20 percent gross profit margin just to break even with their Asian competitors. Consider, for example, that Asian manufacturers:

- have income taxes (e.g., those in Hong Kong) generally estimated at 20 percent, but really only pay about 17 percent if they pay at all.
- don't pay freight.
- don't pay advertising allowances.
- have little need for R&D expenses because many just copy U.S. products.
- don't pay sales commissions. Customers come to them.
- have no bad debts because they are paid via letter of credit.
- don't give accounts receivables terms of 90 to 180 days.
- rarely have to take back returns and defective products.

So, the breakeven analysis is as follows:

Asian gross profit	5%
U.S. income taxes	4%
Freight	2%
Advertising allowances	2%
R&D	1%
Sales commissions	3%
Bad debts	1%
Terms	1%
Returns	<u>1%</u>
U.S. gross profit	20%

As if the above weren't bad enough, also consider the following business costs:

Labor Rates. Hong Kong's reported labor rates average about \$1 per hour (but are really more in the 50¢ per hour range) vs. a U.S. starting range of say \$10.00 per hour plus benefits. Vietnam currently has a labor rate approximately ½ that of China, with Malaysia not far behind. Also, Asian companies don't pay for vacation time, workers' comp insurance, medical benefits or unemployment insurance.

Buildings. As opposed to U.S. buildings which have requirements mandated by OSHA, many overseas buildings are concrete block or corrugated steel and have no heating, air conditioning or sprinkler systems. The net result equates to construction costs which may only be 20 percent of those in the U.S.

Machinery. Asian machine costs are 50 percent to 60

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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
4/27/2006	B&M Racing and Performance Products	McLeod Industries	Manufactures and distributes a full line of clutch assemblies, flywheels, hydraulic throw-out bearings, bellhousings and rail shifters	—	—	—
4/5/2006	MSD Performance Inc.	Edge Products	Manufacturer of diesel performance modules and controllers	—	—	—
3/31/2006	GPX International Tire Corporation	Maine Industrial Tires Limited	Manufacturer of solid rubber tires for the lift truck, aerial platform, off-the-road and ground support vehicle industries	—	—	—
3/24/2006	Centric Parts	StopTech LLC	Manufacturer of balanced brake system upgrades for street performance and track day cars	—	—	—
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	—	—	—

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percent less than in the U.S. because they have no required labor approvals, no safety requirements, no serious pollution controls, no hydroelectric approvals, and they do not need to be automated since labor is cheap.

Raw materials. For years, the far east has been the dumping ground for excess raw materials. These items are sold at pricing never seen in North America. Now, producers are buying their way into the largest potential market on the planet at low costs to establish themselves, while U.S. manufacturers pay inflated prices.

R&D. In the U.S., a company pays \$150,000 per year for an engineer with a doctorate degree. Low-cost countries can pay \$25,000 for an engineer to simply copy products developed by U.S. competitors.

Patents. U.S. companies pay a fortune to get a patent, only to have it ignored by Asian producers.

Tooling costs. These are totally a function of the labor rates discussed above. Material costs are not an issue.

Other expenses. Asian manufacturers don't generally partake in stock lifts, special orders, trade shows, anniversary specials, extended terms on a new warehouse, or a merchandise manager's grand idea discount.

Though nobody wants to hear it, the above items are the new way of life. Wealthy Asian owners are educating their children in U.S. schools so these kids can sell their products over here with the above advantages. As Walter Cronkite said, ". . . and that's the way it is."

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 4/21/06	Market Cap	Debt	Cash	Enterprise Value (1)	LTM Date	Revenue	EBITDA	Net Income
Manufacturers									
Tenneco Automotive Inc.	\$26.73	\$1,153.2	\$1,378.0	\$141.0	\$2,493.0	12/31/05	\$4,441.0	\$390.0	\$59.8
Aftermarket Technology Corp.	25.02	545.5	90.7	45.5	606.6	12/31/05	442.0	66.7	32.2
Directed Electronics, Inc.	16.68	413.2	171.8	12.2	572.8	12/31/05	304.6	29.0	(2.6)
Standard Motor Products, Inc.	8.25	152.4	338.3	14.0	476.7	12/31/05	830.4	36.8	1.5
R&B, Inc.	10.16	180.3	35.8	2.9	218.9	12/31/05	278.1	35.6	17.1
Proliance International, Inc.	5.40	82.4	41.9	4.6	120.5	12/31/05	296.8	(12.4)	(25.4)
Milemarker International Inc.	3.50	34.9	4.4	0.2	39.2	12/31/05	24.8	5.5	3.2
Wholesalers & Distributors									
Genuine Parts Company	\$44.49	\$7,693.1	\$500.9	\$188.9	\$8,139.8	12/31/05	\$9,783.1	\$774.6	\$437.4
LKQ Corporation	21.54	1,128.5	47.5	3.6	1,283.9	12/31/05	547.4	61.5	30.9
Keystone Automotive Industries, Inc.	41.19	664.3	21.4	5.6	699.3	12/30/05	600.9	38.3	19.0
The Coast Distribution System, Inc.	7.32	32.4	19.9	1.7	52.3	12/31/05	176.3	8.5	3.8
Retailers									
Autozone, Inc.	\$95.19	\$7,305.2	\$1,779.3	\$81.4	\$9,124.3	2/11/06	\$5,812.5	\$1,120.9	\$565.8
Advance Auto Parts, Inc.	38.92	4,205.4	1,224.4	40.8	5,479.6	12/31/05	4,265.0	529.1	234.7
O'Reilly Automotive, Inc.	35.11	3,947.3	100.8	31.4	4,127.2	12/31/05	2,045.3	309.8	164.3
The Pep Boys - Manny, Moe & Jack	15.05	816.2	587.5	48.3	1,359.4	1/28/06	2,235.2	68.7	(35.8)
CSK Auto Corporation	12.90	565.2	395.1	19.3	946.3	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.	0.6x	11.7x	6.4x	10.1x	41.7x	19.3	15.3%	8.8%	1.3%
Aftermarket Technology Corp.	1.4x	11.4x	9.1x	12.3x	18.8x	17.0	24.1%	15.1%	7.3%
Directed Electronics, Inc.	1.9x	24.3x	19.8x	21.0x	NM	NM	33.0%	9.5%	NM
Standard Motor Products, Inc.	0.6x	24.5x	13.0x	17.8x	NM	102.4	22.4%	4.4%	0.2%
R&B, Inc.	0.8x	7.4x	6.2x	7.7x	12.8x	10.6	35.5%	12.8%	6.1%
Proliance International, Inc.	0.4x	NM	NM	NM	NM	NM	16.6%	NM	NM
Milemarker International Inc.	1.6x	7.6x	7.2x	7.4x	12.3x	11.0	45.4%	22.0%	12.8%
Mean	1.0x	14.5x	10.3x	12.7x	21.4x	32.0x	27.5%	12.1%	5.6%
Median	0.8x	11.6x	8.1x	11.2x	15.8x	17.0x	24.1%	11.2%	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	2.3x	24.3x	20.9x	36.4x	41.6x	36.5	47.1%	11.2%	5.6%
Keystone Automotive Industries, Inc.	1.2x	23.9x	18.2x	22.2x	36.7x	34.9	44.4%	6.4%	3.2%
The Coast Distribution System, Inc.	0.3x	6.8x	6.2x	7.3x	13.9x	8.6	18.5%	4.8%	2.1%
Mean	1.2x	16.6x	14.0x	19.4x	27.7x	24.4x	35.3%	7.6%	3.9%
Median	1.0x	17.7x	14.4x	17.0x	27.7x	26.2x	37.9%	7.1%	3.8%
Retailers									
Autozone, Inc.	1.6x	9.2x	8.1x	10.9x	16.1x	12.9	49.2%	19.3%	9.7%
Advance Auto Parts, Inc.	1.3x	13.4x	10.4x	17.5x	23.3x	17.9	47.2%	12.4%	5.5%
O'Reilly Automotive, Inc.	2.0x	16.3x	13.3x	39.5x	25.1x	24.0	43.6%	15.1%	8.0%
The Pep Boys - Manny, Moe & Jack	0.6x	NM	19.8x	NM	NM	NM	22.9%	3.1%	NM
CSK Auto Corporation	0.6x	11.1x	7.8x	10.5x	30.2x	18.1	45.4%	7.6%	2.0%
Mean	1.2x	12.5x	11.9x	19.6x	23.7x	18.2x	41.7%	11.5%	6.3%
Median	1.3x	12.2x	10.4x	14.2x	24.2x	18.0x	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