GROUP 1 AUTOMOTIVE INC
Form 10-K
February 27, 2007

Table of Contents

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

FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2006

o **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:

Title of each class	Name of exchange on which registered
Common stock, par value $0.01 per share	**New York Stock Exchange**

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 þ No o

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 o No þ

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 þ No o

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. o

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 þ Accelerated filer o Non-accelerated filer o

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

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.

TABLE OF CONTENTS

Table of Contents

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 ou 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;

Table of Contents

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.

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 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.

Table of Contents

Dealership Operations

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:

Region	Geographic Market	Percentage of Our New Vehicle Retail Units Sold During the Twelve Months Ended December 31, 2006	As of December 31, 2006 Number of Dealerships	Number of Franchises
Northeast	Massachusetts	12.5%	10	11
	New Hampshire	3.8	3	3
	New Jersey	3.3	6	7
	New York	2.3	4	4
		21.9	23	25
Southeast	Louisiana	5.0	5	8
	Florida	4.5	4	4
	Georgia	3.8	6	8
	Mississippi	0.6	3	3
	Alabama	0.3	1	1
		14.2	19	24
Central	Texas	33.4	35	52
	Oklahoma	10.6	13	20
	New Mexico	2.1	3	7
	Colorado(1)	0.2		
		46.3	51	79
West	California	17.6	12	15
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

Table of Contents

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:

	New Vehicle Revenues (In thousands)	New Vehicle Unit Sales	Franchises Owned as of December 31, 2006
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(1)
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

(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.

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:

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

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.

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.

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

Table of Contents

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.

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 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 21/4% under our convertible senior notes due 2036;

$135.2 million in 81/4% 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.

Table of Contents

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

Table of Contents

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:

Manufacturer	Percentage of New Vehicle Retail Units Sold during the Twelve Months Ended December 31, 2006
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.

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 fines 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, 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.

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

Name	Age	Position
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

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 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

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 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.

Table of Contents

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:

- incurring significantly higher capital expenditures and operating expenses;
- failing to integrate the operations and personnel of the acquired dealerships;
- entering new markets with which we are not familiar;
- incurring undiscovered liabilities at acquired dealerships, in the case of stock acquisitions;
- disrupting our ongoing business;
- failing to retain key personnel of the acquired dealerships;
- impairing relationships with employees, manufacturers and customers; and

incorrectly valuing acquired entities,

some or all of which could have a material adverse effect on our business, financial condition, cash flows and results of operations. Although we conduct what we believe to be a prudent level of investigation regarding the operating condition of the businesses we purchase in light of the circumstances of each transaction, an unavoidable level of risk remains regarding the actual operating condition of these businesses.

If state dealer laws are repealed or weakened, our dealerships will be more susceptible to termination, non-renewal or renegotiation of their franchise agreements.

State dealer laws generally provide that a manufacturer may not terminate or refuse to renew a franchise agreement unless it has first provided the dealer with written notice setting forth good cause and stating the grounds for termination or nonrenewal. Some state dealer laws allow dealers to file protests or petitions or attempt to comply with the manufacturer s criteria within the notice period to avoid the termination or nonrenewal. Though unsuccessful to date, manufacturers lobbying efforts may lead to the repeal or revision of state dealer laws. If dealer laws are repealed in the states in which we operate, manufacturers may be able to terminate our franchises without providing advance notice, an opportunity to cure or a showing of good cause. Without the protection of state dealer laws, it may also be more difficult for our dealers to renew their franchise agreements upon expiration.

In addition, these state dealer laws restrict the ability of automobile manufacturers to directly enter the retail market in the future. If manufacturers obtain the ability to directly retail vehicles and do so in our markets, such competition could have a material adverse effect on us.

If we lose key personnel or are unable to attract additional qualified personnel, our business could be adversely affected because we rely on the industry knowledge and relationships of our key personnel.

We believe our success depends to a significant extent upon the efforts and abilities of our executive officers, senior management and key employees, including our regional vice presidents. Additionally, our business is dependent upon our ability to continue to attract and retain qualified personnel, including the management of acquired dealerships. The market for qualified employees in the industry and in the regions in which we operate, particularly for general managers and sales and service personnel, is highly competitive and may subject us to increased labor costs during periods of low unemployment. We do not have employment agreements with most of our dealership general managers and other key dealership personnel.

The unexpected or unanticipated loss of the services of one or more members of our senior management team could have a material adverse effect on us and materially impair the efficiency and productivity of our operations. We do not have key man insurance for any of our executive officers or key personnel. In addition, the loss of any of our key employees or the failure to attract qualified managers could have a material adverse effect on our business and may materially impact the ability of our dealerships to conduct their operations in accordance with our national standards.

The impairment of our goodwill, our indefinite-lived intangibles and our other long-lived assets has had, and may have in the future, a material adverse effect on our reported results of operations.

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, we assess goodwill and other indefinite-lived intangibles for impairment on an annual basis, or more frequently when events or circumstances indicate that an impairment may have occurred. Based on the organization and management of our business during 2006, we determined that each region qualified as reporting units for the purpose of assessing goodwill for impairment.

To determine the fair value of our reporting units in assessing the carrying value of our goodwill for impairment, we use a discounted cash flow approach. Included in this analysis are assumptions regarding revenue growth rates, future gross margin estimates, future selling, general and administrative expense rates and our weighted average cost of capital. We also must estimate residual values at the end of the forecast period and future capital expenditure requirements. Each of these assumptions requires us to use our knowledge of (a) our industry, (b) our recent transactions, and (c) reasonable performance expectations for our operations. If any one of the above assumptions changes, in some cases insignificantly, or fails to materialize, the resulting decline in our estimated fair value could result in a material impairment charge to the goodwill associated with the applicable reporting unit, especially with respect to those operations acquired prior to July 1, 2001.

We are required to evaluate the carrying value of our indefinite-lived, intangible franchise rights at a dealership level. To test the carrying value of each individual intangible franchise right for impairment, we also use a discounted cash flow based approach. Included in this analysis are assumptions, at a dealership level, regarding revenue growth rates, future gross margin estimates and future selling, general and administrative expense rates. Using our weighted average cost of capital, estimated residual values at the end of the forecast period and future capital expenditure requirements, we calculate the fair value of each dealership s franchise rights after considering estimated values for tangible assets, working capital and workforce. If any one of the above assumptions changes, in some cases insignificantly, or fails to materialize, the resulting decline in our estimated fair value could result in a material impairment charge to the intangible franchise right associated with the applicable dealership.

We assess the carrying value of our other long-lived assets, in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, when events or circumstances indicate that an impairment may have occurred.

Changes in interest rates could adversely impact our profitability.

All of the borrowings under our various credit facilities bear interest based on a floating rate. Therefore, our interest expense will rise with increases in interest rates. Rising interest rates may also have the effect of depressing demand in the interest rate sensitive aspects of our business, particularly new and used vehicle sales, because many of our customers finance their vehicle purchases. As a result, rising interest rates may have the effect of simultaneously increasing our costs and reducing our revenues. We receive credit assistance from certain automobile manufacturers, which is reflected as a reduction in cost of sales on our statements of operations, and we have entered into derivative transactions to convert a portion of our variable rate debt to fixed rates to partially mitigate this risk. Please see Quantitative and Qualitative Disclosures about Market Risk for a discussion regarding our interest rate sensitivity.

A decline of available financing in the sub-prime lending market has, and may continue to, adversely affect our sales of used vehicles.

A significant portion of vehicle buyers, particularly in the used car market, finance their purchases of automobiles. Sub-prime finance companies have historically provided financing for consumers who, for a variety of reasons including poor credit histories and lack of a down payment, do not have access to more traditional finance sources. Our recent experience suggests that sub-prime finance companies have tightened their credit standards and may continue to apply these higher standards in the future. This has adversely affected our used vehicle sales. If sub-prime finance companies continue to apply these higher standards, if there is any further tightening of credit standards used by sub-prime finance companies, or if there is any additional decline in the overall availability of credit in the sub-prime lending market, the ability of these consumers to purchase vehicles could be limited, which could have a material adverse effect on our used car business, revenues, cash flows and profitability.

Our insurance does not fully cover all of our operational risks, and changes in the cost of insurance or the availability of insurance could materially increase our insurance costs or result in a decrease in our insurance coverage.

The operation of automobile dealerships is subject to compliance with a wide range of laws and regulations and is subject to a broad variety of risks. While we have insurance on our real property, comprehensive coverage for our vehicle inventory, general liability insurance, workers compensation insurance, employee dishonesty coverage, employment practices liability insurance, pollution coverage and errors and omissions insurance in connection with vehicle sales and financing activities, we are self-insured for a portion of our potential liabilities. In certain instances, our insurance may not fully cover an insured loss depending on the magnitude and nature of the claim. Additionally, changes in the cost of insurance or the availability of insurance in the future could substantially increase our costs to maintain our current level of coverage or could cause us to reduce our insurance coverage and increase the portion of our risks that we self-insure.

Substantial competition in automotive sales and services may adversely affect our profitability due to our need to lower prices to sustain sales and profitability.

The automotive retail industry is highly competitive. Depending on the geographic market, we compete with:

franchised automotive dealerships in our markets that sell the same or similar makes of new and used vehicles that we offer, occasionally at lower prices than we do;

other national or regional affiliated groups of franchised dealerships;

private market buyers and sellers of used vehicles;

Internet-based vehicle brokers that sell vehicles obtained from franchised dealers directly to consumers;

service center chain stores; and

independent service and repair shops.

We also compete with regional and national vehicle rental companies that sell their used rental vehicles. In addition, automobile manufacturers may directly enter the retail market in the future, which could have a material adverse effect on us. As we seek to acquire dealerships in new markets, we may face significant competition as we strive to gain market share. Some of our competitors may have greater financial, marketing and personnel resources and lower overhead and sales costs than we have. We do not have any cost advantage in purchasing new vehicles from vehicle manufacturers and typically rely on advertising, merchandising, sales expertise, service reputation and dealership location in order to sell new vehicles. Our franchise agreements do not grant us the exclusive right to sell a manufacturer s product within a given geographic area. Our revenues and profitability may be materially and adversely affected if competing dealerships expand their market share or are awarded additional franchises by manufacturers that supply our dealerships.

In addition to competition for vehicle sales, our dealerships compete with franchised dealerships to perform warranty repairs and with other automotive dealers, franchised and independent service center chains and independent garages for non-warranty repair and routine maintenance business. Our dealerships compete with other automotive dealers, service stores and auto parts retailers in their parts operations. We believe that the principal competitive factors in service and parts sales 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 our dealerships prices. We also compete with a broad range of financial institutions in arranging financing for our customers vehicle purchases.

Some automobile manufacturers have in the past acquired, and may in the future attempt to acquire, automotive dealerships in certain states. Our revenues and profitability could be materially adversely affected by the efforts of manufacturers to enter the retail arena.

In addition, the Internet is becoming a significant part of the advertising and sales process in our industry. We believe that customers are using the Internet as part of the sales process to compare pricing for cars and related finance and insurance services, which may reduce gross profit margins for new and used cars and profits for related finance and insurance services. Some Web sites offer vehicles for sale over the Internet without the benefit of having a dealership franchise, although they must currently source their vehicles from a franchised dealer. If Internet new vehicle sales are allowed to be conducted without the involvement of franchised dealers, or if dealerships are able to effectively use the Internet to sell outside of their markets, our business could be materially adversely affected. We would also be materially adversely affected to the extent that Internet companies acquire dealerships or align themselves with our competitors dealerships.

Please see Business Competition for more discussion of competition in our industry.

We are subject to substantial regulation which may adversely affect our profitability and significantly increase our costs in the future.

A number of state and federal laws and regulations affect our business. We are also subject to laws and regulations relating to business corporations generally. Any failure to comply with these laws and regulations may result in the assessment of administrative, civil, or criminal penalties, the imposition of remedial obligations or the issuance of injunctions limiting or prohibiting our operations. In every state in which we operate, we must obtain various licenses in order to operate our businesses, including dealer, sales, finance and insurance-related licenses issued by state authorities. These laws also regulate our conduct of business, including our advertising, operating, financing, employment and sales practices. Other laws and regulations include state franchise laws and regulations and other extensive laws and regulations applicable to new and used motor vehicle dealers, as well as federal and state wage-hour, anti-discrimination and other employment practices laws. Furthermore, some states have initiated consumer bill of rights statutes which involve increases in our costs associated with the sale of vehicles, or decreases in some of our profit centers.

Table of Contents

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, insurance 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 also subject to the National Traffic and Motor Vehicle Safety Act, the Magnusson-Moss Warranty Act, Federal Motor Vehicle Safety Standards promulgated by the United States Department of Transportation and various state motor vehicle regulatory agencies. The imported automobiles we purchase are subject to U.S. 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.

Possible penalties for violation of any of these laws or regulations include revocation or suspension of our licenses and civil or criminal fines and penalties. In addition, many laws may give customers a private cause of action. Violation of these laws, the cost of compliance with these laws, or changes in these laws could result in adverse financial consequences to us.

Our automotive dealerships are subject to federal, state and local environmental regulations that may result in claims and liabilities, which could be material.

We are subject to a wide range of federal, state and local environmental laws and regulations, including those governing discharges into the air and water, the operation and removal of underground and aboveground storage tanks, the use, handling, storage and disposal of hazardous substances and other materials, and the investigation and remediation of contamination. As with automotive dealerships generally, and service, parts and body shop operations in particular, our business involves the use, storage, handling and contracting for recycling or disposal of hazardous materials or wastes and other environmentally sensitive materials. Operations involving the management of hazardous and non-hazardous materials are subject to requirements of the federal Resource Conservation and Recovery Act, or RCRA, and comparable state statutes. 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 RCRA 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. We may also have liability in connection with materials that were sent to third-party recycling, treatment, and/or disposal facilities under the Comprehensive Environmental Response, Compensation and Liability Act, and comparable state statutes, which impose liability for investigation and remediation of contamination without regard to fault or the legality of the conduct that contributed to the contamination. Similar to many of our competitors, we have incurred and will continue to incur, capital and operating expenditures and other costs in complying with such laws and regulations.

Soil and groundwater contamination is known to exist at some of our current or former properties. Further, environmental laws and regulations are complex and subject to change. In addition, in connection with our acquisitions, it is possible that we will assume or become subject to new or unforeseen environmental costs or liabilities, some of which may be material. In connection with our dispositions, or prior dispositions made by companies we acquire, we may retain exposure for environmental costs and liabilities, some of which may be material. We may be required to make material additional expenditures to comply with existing or future laws or regulations, or as a result of the future discovery of environmental conditions. Please see Business Governmental Regulations Environmental, Health and Safety Laws and Regulations for a discussion of the effect of such regulations on us.

Our indebtedness and lease obligations could materially adversely affect our financial health, limit our ability to finance future acquisitions and capital expenditures, and prevent us from fulfilling our financial obligations.

Our indebtedness and lease obligations could have important consequences to us, including the following:

- our ability to obtain additional financing for acquisitions, capital expenditures, working capital or general corporate purposes may be impaired in the future;
- a substantial portion of our current cash flow from operations must be dedicated to the payment of principal on our indebtedness, thereby reducing the funds available to us for our operations and other purposes;
- some of our borrowings are and will continue to be at variable rates of interest, which exposes us to the risk of increasing interest rates; and
- we may be substantially more leveraged than some of our competitors, which may place us at a relative competitive disadvantage and make us more vulnerable to changing market conditions and regulations.

In addition, our debt instruments contain numerous covenants that limit our discretion with respect to business matters, including mergers or acquisitions, paying dividends, repurchasing our common stock, incurring additional debt or disposing of assets. A breach of any of these covenants could result in a default under the applicable agreement or indenture. In addition, a default under one agreement or indenture could result in a default and acceleration of our repayment obligations under the other agreements or indentures under the cross default provisions in those agreements or indentures. If a default or cross default were to occur, we may not be able to pay our debts or borrow sufficient funds to refinance them. Even if new financing were available, it may not be on terms acceptable to us. As a result of this risk, we could be forced to take actions that we otherwise would not take, or not take actions that we otherwise might take, in order to comply with the covenants in these agreements and indentures.

Our stockholder rights plan and our certificate of incorporation and bylaws contain provisions that make a takeover of Group 1 difficult.

Our stockholder rights plan and certain provisions of our certificate of incorporation and bylaws could make it more difficult for a third party to acquire control of Group 1, even if such change of control would be beneficial to our stockholders. These include provisions:

- providing for a board of directors with staggered, three-year terms, permitting the removal of a director from office only for cause;
- allowing only the Board of Directors to set the number of directors;
- requiring super-majority or class voting to affect certain amendments to our certificate of incorporation and bylaws;
- limiting the persons who may call special stockholders meetings;
- limiting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to the board of directors or for proposing matters that can be acted upon at stockholders meetings; and

allowing our Board of Directors to issue shares of preferred stock without stockholder approval.

Certain of our franchise agreements prohibit the acquisition of more than a specified percentage of our common stock without the consent of the relevant manufacturer. These terms of our franchise agreements could also make it more difficult for a third party to acquire control of Group 1.

We can issue preferred stock without stockholder approval, which could materially adversely affect the rights of common stockholders.

Our restated certificate of incorporation authorizes us to issue blank check preferred stock, the designation, number, voting powers, preferences, and rights of which may be fixed or altered from time to time by our board of directors. Accordingly, the board of directors has the authority, without stockholder approval, to issue preferred stock with rights that could materially adversely affect the voting power or other rights of the common stock holders or the market value of the common stock.

Internet Web Site and Availability of Public Filings

Our Internet address is www.group1auto.com. We make the following information available free of charge on our Internet Web site:

- Annual Report on Form 10-K;
- Quarterly Reports on Form 10-Q;
- Current Reports on Form 8-K;
- Amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934;
- Our Corporate Governance Guidelines;
- The charters for our Audit, Compensation, Finance/Risk Management and Nominating/Governance Committees;
- Our Code of Conduct for Directors, Officers and Employees; and
- Our Code of Ethics for our Chief Executive Officer, Chief Financial Officer and Controller.

We make our SEC filings available on our Web site as soon as reasonably practicable after we electronically file such material with, or furnish such material to, the SEC. We make our SEC filings available via a link to our filings on the SEC Web site. The above information is available in print to anyone who requests it.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We use a number of facilities to conduct our dealership operations. Each of our dealerships may include facilities for (1) new and used vehicle sales, (2) vehicle service operations, (3) retail and wholesale parts operations, (4) collision service operations, (5) storage and (6) general office use. In the past we tried to structure our operations so as to avoid the ownership of real property. In connection with our acquisitions, we generally sought to lease rather than acquire the facilities on which the acquired dealerships were located. We generally entered into lease agreements with respect to such facilities that have 30-year total terms with 15-year initial terms and three five-year option periods, at our option. As a result, we lease the majority of our facilities under long-term operating leases. See Note 13 to our consolidated financial statements.

During 2006, we actively pursued our revised business strategy of acquiring real estate on which our existing dealerships are currently located, or improved or unimproved property where we intend to relocate our existing or future dealerships. To date, we have acquired our real estate by utilizing our existing cash reserves. We have decided to pursue our preferred business model of having one of our subsidiaries, Group 1 Realty, Inc., act as the landlord of our dealership operations. To that end, we acquired approximately $89.5 million of real estate in conjunction with our dealership acquisitions and existing facility improvement and expansion actions in 2006, as well as, through the selective exercise of lease buy-out options. With these acquisitions, we now own $117.4 million in real estate holdings. We are currently negotiating a stand-alone credit facility for the purpose of acquiring real estate and not deplete our capital resources that are customarily used for acquisition of desired dealerships. However, there can be no guaranty that we will ultimately enter into such credit facility.

Item 3. Legal Proceedings

From time to time, our dealerships are named in claims involving the manufacture of automobiles, contractual disputes and other matters arising in the ordinary course of business.

The Texas Automobile Dealers Association (TADA) and certain new vehicle dealerships in Texas that are members of the TADA, including a number of our Texas dealership subsidiaries, were named in two state court class action lawsuits and one federal court class action lawsuit. The three actions alleged that since January 1994, Texas dealers deceived customers with respect to a vehicle inventory tax and violated federal antitrust laws. In April 2002, the state court in which two of the actions were pending certified classes of consumers and the Texas Court of Appeals affirmed the trial court s order of class certifications in October 2002. The defendants requested that the Texas Supreme Court review that decision, and the Court declined that request on March 26, 2004. The defendants petitioned the Texas Supreme Court to reconsider its denial, and that petition was denied on September 10, 2004. In the federal antitrust action, in March 2003, the federal district court also certified a class of consumers. Defendants appealed the district court s certification to the Fifth Circuit Court of Appeals, which on October 5, 2004, reversed the class certification order and remanded the case back to the federal district court for further proceedings. In February 2005, the plaintiffs in the federal action sought a writ of certiorari to the United States Supreme Court in order to obtain review of the Fifth Circuit s order, which request the Court denied. In June 2005, the Company s Texas dealerships and certain other defendants in the lawsuits entered settlements with the plaintiffs in each of the cases. The settlement of the state court actions was approved by the state court in August 2006. The court dismissed the state court actions in October 2006. As a result of that settlement, the state court certified a settlement class of certain Texas automobile purchasers. Dealers participating in the settlement, including all of our Texas dealership subsidiaries, agreed to issue certificates for discounts off future vehicle purchases, refund cash in some circumstances, pay attorneys fees, and make certain disclosures regarding inventory tax charges when itemizing such charges on customer invoices. In addition, participating dealers have funded certain costs of the settlement, including costs associated with notice of the settlement to the class members. The federal action did not involve the certification of any additional classes. The federal court action was dismissed December 29, 2006. The Company paid the remaining expenses of its portion of the settlements in December 2006, which were approximately $1.1 million.

On August 29, 2005, our Dodge dealership in Metairie, Louisiana, suffered severe damage due to Hurricane Katrina and subsequent flooding. The dealership facility was leased. Pursuant to its terms, we terminated the lease based on damages suffered at the facility. The lessor disputed the termination as wrongful and instituted arbitration proceedings. The lessor demanded damages for alleged wrongful termination and other items related to alleged breaches of the lease agreement. In June 2006, we paid a total of $4.5 million in full and final settlement of all claims associated with the termination of the lease and in lieu of any further payments under the terms of the lease. At the time the lease was terminated, payments remaining due under the lease over the initial term thereof (155 months at the time of termination) totaled $16.3 million. The $4.5 million charge is reflected as a component of selling, general and administrative expenses in the accompanying consolidated statements of operations.

In addition to the foregoing matters, due to the nature of the automotive retailing business, we may be involved in legal proceedings or suffer losses that could have a material adverse effect on our business. In the normal course of business, we are required to respond to customer, employee and other third-party complaints. In addition, the manufacturers of the vehicles we sell and service have audit rights allowing them to review the validity of amounts claimed for incentive-, rebate-or warranty-related items and charge back the Company for amounts determined to be invalid rewards under the manufacturers programs, subject to the Company s right to appeal any such decision. In August 2006, one of the Company s manufacturers notified the Company of the results of a recently completed incentive and rebate-related audit at one of the Company s dealerships, in which the manufacturer had assessed a $3.1 million claim against the Company for chargeback of alleged non-qualifying incentive and rebate awards. The Company believes that it has meritorious defenses against this claim that it will pursue under the manufacturer s appeals process.

Other than as noted above, there are currently no legal or other proceedings pending against or involving us that, in our opinion, based on current known facts and circumstances, are expected to have a material adverse effect on our financial position or results of operations.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Table of Contents

PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The common stock is listed on the New York Stock Exchange under the symbol GPI. There were 73 holders of record of our common stock as of February 23, 2007.

The following table presents the quarterly high and low sales prices for our common stock, as reported on the New York Stock Exchange Composite Tape under the symbol GPI and dividends paid per common share for 2005 and 2006.

	High	Low	Dividends Paid
2005:			
First Quarter	$ 31.78	$ 25.65	$
Second Quarter	27.55	24.04	
Third Quarter	32.98	24.05	
Fourth Quarter	32.94	25.87	
2006:			
First Quarter	$ 50.17	$ 30.94	$ 0.13
Second Quarter	63.97	47.54	0.14
Third Quarter	61.73	43.27	0.14
Fourth Quarter	58.68	47.80	0.14

In February 2007, our Board of Directors declared a dividend of $0.14 per common share. We expect these dividend payments on our outstanding common stock and common stock equivalents to total approximately $3.4 million in the first quarter of 2007. The payment of any future dividend is 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.

Provisions of our credit facilities and our senior subordinated notes require us to maintain certain financial ratios and limit the amount of disbursements we may make outside the ordinary course of business. These include limitations on the payment of cash dividends and on stock repurchases, which are limited to a percentage of cumulative net income. As of December 31, 2006, our credit facility, the most restrictive agreement with respect to such limits, limited future dividends and stock repurchases to $45.6 million. This amount will increase or decrease in future periods by adding to the current limitation the sum of 50% of our consolidated net income, if positive, and 100% of equity issuances, less actual dividends or stock repurchases completed in each quarterly period. Our revolving credit facility matures in 2010 and our 8.25% senior subordinated notes mature in 2013.

Purchases of Equity Securities by the Issuer

No shares of our common stock were repurchased during the three months ended December 31, 2006. See Business Stock Repurchase Program for more information.

Securities Authorized by Issuance under Equity Compensation Plans

See Part III, Item 12, Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

Sales of Unregistered Securities

None.

Table of Contents

Item 6. Selected Financial Data

The following selected historical financial data as of December 31, 2006, 2005, 2004, 2003, and 2002, and for the five years in the period ended December 31, 2006, have been derived from our audited financial statements, subject to certain reclassifications to make prior years conform to the current year presentation. This selected financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related notes included elsewhere in this Annual Report on Form 10-K.

We have accounted for all of our dealership acquisitions using the purchase method of accounting and, as a result, we do not include in our financial statements the results of operations of these dealerships prior to the date we acquired them. As a result of the effects of our acquisitions and other potential factors in the future, the historical financial information described in the selected financial data is not necessarily indicative of the results of operations and financial position of Group 1 in the future or the results of operations and financial position that would have resulted had such acquisitions occurred at the beginning of the periods presented in the selected financial data.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(In thousands, except per share amounts)				
Income Statement Data:					
Revenues	$ 6,083,484	$ 5,969,590	$ 5,435,033	$ 4,518,560	$ 4,214,364
Cost of sales	5,118,684	5,037,184	4,603,267	3,795,149	3,562,069
Gross profit	964,800	932,406	831,766	723,411	652,295
Selling, general and administrative expenses	739,765	741,471	672,210	561,078	503,336
Depreciation and amortization	18,138	18,927	15,836	12,510	10,137
Asset impairments	2,241	7,607	44,711		
Income from operations	204,656	164,401	99,009	149,823	138,822
Other income and (expense):					
Floorplan interest expense	(46,682)	(37,997)	(25,349)	(21,571)	(20,187)
Other interest expense, net	(18,783)	(18,122)	(19,299)	(15,191)	(10,578)
Loss on redemption of senior subordinated notes	(488)		(6,381)		(1,173)
Other income (expense), net	645	125	(28)	11	398
Income before income taxes	139,348	108,407	47,952	113,072	107,282
Provision for income taxes	50,958	38,138	20,171	36,946	40,217
Income before cumulative effect of a change in accounting principle	88,390	70,269	27,781	76,126	67,065
Cumulative effect of a change in accounting principle, net of tax		(16,038)			

Net Income	$ 88,390	$ 54,231	$ 27,781	$ 76,126	$ 67,065
Earnings per share:					
Basic:					
Income before cumulative effect of a change in accounting principle	$ 3.66	$ 2.94	$ 1.22	$ 3.38	$ 2.93
Net Income	$ 3.66	$ 2.27	$ 1.22	$ 3.38	$ 2.93
Diluted:					
Income before cumulative effect of a change in accounting principle	$ 3.62	$ 2.90	$ 1.18	$ 3.26	$ 2.80
Net Income	$ 3.62	$ 2.24	$ 1.18	$ 3.26	$ 2.80
Dividends per share	$ 0.55	$	$	$	$
Weighted average shares outstanding:					
Basic	24,146	23,866	22,808	22,524	22,875
Diluted	24,446	24,229	23,494	23,346	23,968

Table of Contents

	December 31, 2006	2005	2004 (In thousands)	2003	2002
Balance Sheet Data:					
Working capital	$ 237,054	$ 137,196	$ 155,453	$ 275,582	$ 95,704
Inventories	830,628	756,838	877,575	671,279	622,205
Total assets	2,113,955	1,833,618	1,947,220	1,502,445	1,437,590
Floorplan notes payable credit facility	437,288	407,396	632,593	297,848	642,588
Floorplan notes payable manufacturer affiliates	287,978	316,189	215,667	195,720	9,950
Acquisition line			84,000		
Long-term debt, including current portion	429,493	158,860	157,801	231,088	82,847
Stockholders equity	692,840	626,793	567,174	518,109	443,417
Long-term debt to capitalization(1)	38%	20%	30%	31%	16%

(1) Includes long-term debt and acquisition line

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operation

You should read the following discussion in conjunction with Part I, including the matters set forth in the Risk Factors section of this Form 10-K, and our Consolidated Financial Statements and notes thereto included elsewhere in this Annual Report on Form 10-K.

Overview

We are a leading operator in the $1.0 trillion automotive retail industry. As of December 31, 2006, we owned and operated 143 franchises at 105 dealership locations and 30 collision centers. 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, the Company reorganized its operations and as of December 31, 2006, the retail network consisted of the following four regions (with the number of dealerships they comprised): (i) the Northeast (23 dealerships in Massachusetts, New Hampshire, New Jersey and New York), (ii) the Southeast (19 dealerships in Alabama, Florida, Georgia, Louisiana and Mississippi), (iii) the Central (51 dealerships in New Mexico, Oklahoma and Texas), and (iv) the 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.

During 2006, as throughout our nine-year history, we grew our business primarily through acquisitions. We typically seek to acquire large, profitable, well-established and well-managed dealerships that are leaders in their respective market areas. Over the past five years, we have acquired 66 dealership franchises with annual revenues of approximately $3.0 billion, disposed of or terminated 28 dealership franchises with annual revenues of approximately $391.4 million, and been granted ten new dealership franchises by the manufacturers. Each acquisition has been accounted for as a purchase and the corresponding results of operations of these dealerships are included in our financial statements from the date of acquisition. In the following discussion and analysis, we report certain performance measures of our newly acquired dealerships separately from those of our existing dealerships.

Our operating results reflect the combined performance of each of our interrelated business activities, which include the sale of new vehicles, used vehicles, finance and insurance products, and parts, service and collision repair services. Historically, each of these activities has been directly or indirectly impacted by a variety of supply/demand factors, including vehicle inventories, consumer confidence, discretionary spending, availability and affordability of consumer credit, manufacturer incentives, weather patterns, fuel prices and interest rates. For example, during periods of sustained economic downturn or significant supply/demand imbalances, new vehicle sales may be negatively impacted as consumers tend to shift their purchases to used vehicles. Some consumers may even delay their purchasing decisions altogether, electing instead to repair their existing vehicles. In such cases, however, we believe the impact on our overall business is mitigated by our ability to offer other products and services, such as used vehicles and parts, service and collision repair services.

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.

For the years ended December 31, 2006, 2005 and 2004, we realized net income of $88.4 million, $54.2 million and $27.8 million, respectively, and diluted earnings per share of $3.62, $2.24 and $1.18, respectively. The following factors impacted our financial condition and results of operations in 2006, 2005 and 2004, and may cause our reported financial data not to be indicative of our future financial condition and operating results.

Year Ended December 31, 2006:

Asset Impairments: In conjunction with our annual impairment assessment of goodwill and indefinite-lived intangible assets, we determined the carrying value of indefinite-lived intangible franchise rights associated with two of our domestic franchises to be impaired. Accordingly, we recognized a $1.4 million pretax impairment charge in the fourth quarter of 2006. In addition, during the fourth quarter of 2006, we entered into an agreement to sell one of our Ford dealership franchises and, as a result, identified the carrying value of certain fixed assets associated with the dealership to be impaired. In connection therewith, we recorded a pretax impairment charge of $0.8 million.

Hurricanes Katrina and Rita Insurance Settlements and New Orleans Recovery: We settled all building, content and vehicle damage and business interruption insurance claims with our insurance carriers in 2006. As a result, we recognized an additional $6.4 million of business interruption proceeds related to covered payroll and fixed cost expenditures incurred during 2006, as a reduction of selling, general and administrative expenses in the consolidated statements of operations.

Lease Terminations: On March 30, 2006, we announced that the Dealer Services Group of Automatic Data Processing Inc. (ADP) would become the sole dealership management system provider for our existing stores. We converted a number of our stores from other systems to ADP in 2006 and settled the lease termination agreement with one of our other system providers for all stores converted as of December 31, 2006.

In June 2006, as a result of the significant damage sustained at our Dodge store on the East Bank of New Orleans during Hurricane Katrina, we terminated our franchise with DaimlerChrylser, dealership operations at this store and the associated facilities lease agreement. As a result of the lease termination, we recognized a $4.5 million charge.

Dealership Disposals: We disposed of 13 franchises during 2006, resulting in an aggregate gain on sale of $5.8 million.

Severance Costs: In conjunction with our management realignment from platform to regional structures, we entered into severance agreements with several employees. In aggregate, these severance costs amounted to

$3.5 million in 2006.

Stock Based Compensation: We provide compensation benefits to employees and non-employee directors pursuant to our 1996 Stock Option Plan, as amended, and 1998 Employee Stock Purchase Plan, as amended. Historically, we utilized stock options to provide long-term incentive to these individuals. However, beginning in March 2005, we began utilizing restricted stock awards or, at the recipient s election, phantom stock awards, in lieu of stock options. Any future grants of either stock options or restricted stock awards are subject to the discretion of our board of directors.

As a result of adopting FASB Statement No. 123(R), Share-Based Payment, on January 1, 2006, we recognized $1.8 million of additional stock-based compensation expense related to stock options and $1.1 million related to the Purchase Plan during the year ended December 31, 2006. Our income before income taxes and net income for the year ended December 31, 2006, were therefore $2.9 million and $2.8 million lower than if we had continued to account for stock-based compensation under APB 25. Basic and diluted earnings per share were both $0.11 lower for the year ended December 31, 2006, than if we had continued to account for the stock-based compensation under APB 25.

Year Ended December 31, 2005:

Hurricanes Katrina and Rita: On August 29, 2005, Hurricane Katrina struck the Gulf Coast of the United States, including New Orleans, Louisiana. At that time, we operated six dealerships in the New Orleans area consisting of nine franchises. Two of the dealerships were located in the heavily flooded East Bank of New Orleans and nearby Metairie areas, while the other four are located on the West Bank of New Orleans, where flood-related damage was less severe. The East Bank stores suffered significant damage and were ultimately closed in 2006 and the respective franchises terminated. The West Bank stores reopened approximately two weeks after the storm.

On September 24, 2005, Hurricane Rita came ashore along the Texas/Louisiana border, near Houston and Beaumont, Texas. The Company operates two dealerships in Beaumont, Texas, consisting of eleven franchises and nine dealerships in the Houston area consisting of seven franchises. As a result of the evacuation by many residents of Houston, and the aftermath of the storm in Beaumont, all of these dealerships were closed several days before and after the storm. All of these dealerships have since resumed normal operations.

At the time of the incidents, we estimated the damage sustained at our New Orleans-area and Beaumont dealership facilities and our inventory of new and used vehicles at those locations to be approximately $23.4 million. After we applied the terms of our underlying property and casualty insurance policies, we recorded an insurance recovery receivable totaling $19.2 million and reduced the above-noted estimated loss to $4.2 million. This loss is included in selling, general and administrative expenses in the consolidated statements of operations. The receivable was established based on our determination, given our experience with these type claims and discussions to date with our insurance carriers, that it is probable that recovery will occur for the amount of these losses and the cost to repair our leased facilities in excess of insurance policy deductibles. We made the determination of whether recovery was probable in accordance with the requirements of SFAS No. 5, Accounting for Contingencies, which defines probable as being likely to occur. During the fourth quarter, we received total payments on these receivables of $14.6 million.

We maintain business interruption insurance coverage under which our insurance providers advanced a total of $5.0 million, subject to final audit under the policies and also subject to settlement adjustments. During the fourth quarter of 2005, we recorded approximately $1.4 million of these proceeds, related to covered payroll and fixed cost expenditures since August 29, 2005, as a reduction to the above-noted loss accrual. Final audits and settlement adjustments were made during 2006, resulting in an additional $2.8 million in insurance proceeds received. We recorded the remaining $6.4 million of business interruption insurance proceeds in 2006 as a reduction of selling, general and administrative expenses.

Cumulative Effect of a Change in Accounting Principle: For some of our dealerships, our adoption of EITF D-108, Use of the Residual Method to Value Acquired Assets Other Than Goodwill, resulted in intangible franchise rights having carrying values that were in excess of their fair values. This required us to write-off the excess value of $16.0 million, net of deferred taxes of $10.2 million, or $0.66 per diluted share, as the cumulative effect of a change in accounting principle in the first quarter of 2005.

Asset Impairments: In connection with the preparation and review of our third-quarter interim financial statements, we determined that recent events and circumstances in New Orleans indicated that an impairment of goodwill, intangible franchise rights and/or other long-lived assets may have occurred in the three months ended September 30, 2005. Therefore, we performed interim impairment assessments of these assets. As a result of these assessments, we determined that the carrying value of the intangible franchise right associated with our Dodge franchise in New Orleans was impaired and recorded a pretax charge of $1.3 million during the third quarter of 2005.

Due to the then pending disposals of two of our California franchises, a Kia and a Nissan franchise, we tested the respective asset groups for impairment during the third quarter of 2005. These tests resulted in impairments of long-lived assets totaling $3.7 million.

During our annual review of the fair value of our goodwill and indefinite-lived intangible assets at December 31, 2005, we determined that the fair value of indefinite-lived intangible franchise rights related to three of our franchises, primarily a Pontiac/GMC franchise in the South Central region, did not exceed their carrying value and impairment charges were required. Accordingly, we recorded a $2.6 million pretax impairment charge during the fourth quarter of 2005.

Year Ended December 31, 2004:

Impairment of Goodwill and Long-Lived Assets: As a result of the further deterioration of our Atlanta platform s financial results, we concluded that the carrying amount of the reporting unit exceeded its fair value as of September 30, 2004. Accordingly, in the third quarter of 2004, we recorded a total pretax charge of $41.4 million related to the impairment of the carrying value of its goodwill and certain long-lived assets.

Loss on Redemption of Senior Subordinated Notes: In March 2004, we completed the redemption of all of our outstanding 107/8% senior subordinated notes and incurred a $6.4 million pretax charge.

Impairment of Indefinite-Lived Intangible Asset: During our annual assessment of the carrying value of our goodwill and indefinite-lived intangible assets in connection with our year-end financial statement preparation process, we determined that the carrying value of one of our Mitsubishi franchises in the California region was in excess of its fair market value. Accordingly, we recorded a pretax charge of $3.3 million.

These items, and other variances between the periods presented, are covered in the following discussion.

Table of Contents

Key Performance Indicators

The following table highlights certain of the key performance indicators we use to manage our business:

Consolidated Statistical Data

	For the Year Ended December 31,		
	2006	2005	2004
Unit Sales			
Retail Sales			
New Vehicle	129,198	126,108	117,971
Used Vehicle	67,868	68,286	66,336
Total Retail Sales	197,066	194,394	184,307
Wholesale Sales	45,706	50,489	49,372
Total Vehicle Sales	242,772	244,883	233,679
Gross Margin			
New Vehicle Retail Sales	7.2%	7.1%	7.1%
Adjusted Used Vehicle Total(1)	12.6%	12.3%	11.3%
Parts and Service Sales	54.4%	54.3%	54.8%
Total Gross Margin	15.9%	15.6%	15.3%
SG&A(2) as a % of Gross Profit	76.7%	79.5%	80.8%
Operating Margin	3.4%	2.8%	1.8%
Pretax Margin	2.3%	1.8%	0.9%
Finance and Insurance Revenues per Retail Unit Sold	$ 977	$ 957	$ 938

(1) We monitor a statistic we call adjusted used vehicle gross margin which equals total used vehicle gross profit, which includes the total net profit or loss from the wholesale sale of used vehicles, divided by retail used vehicle sales revenues. The net profit or loss on wholesale used vehicle sales are included in this number, as these transactions facilitate retail used vehicle sales and management of inventory levels.

(2) Selling, general and administrative expenses.

The following discussion briefly highlights certain of the results and trends occurring within our business. Throughout the following discussion, references are made to same store results and variances, which are discussed in more detail in the **Results of Operations** section that follows.

Since 2004, our retail unit sales have increased as the impact of our acquisitions were offset by slight declines in same store unit sales. While our new vehicle retail sales have increased each year, our used vehicle retail sales increased from 2004 to 2005, but declined slightly from 2005 to 2006. We experienced a decline in same store new vehicle retail sales from 2004 to 2005 and from 2005 to 2006 as production in our domestic brands weakened, consistent with their overall national performance. The domestic downturn was offset by improvements in our year-over-year same store import and luxury brands results and, on a consolidated basis, was further compensated each year by substantial increases in new vehicle retail sales as a result of acquisitions. The decline in our same store used vehicle retail sales from 2004 to 2005 was offset by a substantial escalation in used vehicle retail sales from acquisitions. Conversely, from 2005 to 2006, the decline in same store used vehicle retail sales was only partially counterbalanced by the results from our transactions. Our same store used vehicle retail sales have declined from 2004 to 2006, as we have taken intentional steps toward better managing our used vehicle inventory and becoming more critical of the used vehicles we purchase and retain for resale, resulting in better overall performance of our used vehicle business.

Despite the decline in same store new vehicle retail sales over the past three years, we have maintained our new vehicle gross margin at 7.1% for the twelve months ended December 31, 2004 and 2005, with a slight increase to 7.2% in 2006. At the same time, we have improved our same store gross profit per new retail unit sold to $2,023 per unit in 2005 as compared to $2,007 per unit in 2004, and to $2,126 per unit in 2006 as compared to $2,088 per unit in 2005. In addition, our consolidated gross profit per new retail unit sold has risen from $2,007 per unit in 2004, to $2,073 per unit in 2005 and $2,105 per unit in 2006. Our same store gross profit per retail unit sold was up slightly in 2005, as we experienced a strong contribution from the full-year impact of franchises, primarily luxury and import, acquired in 2004. In 2006, we benefited from higher gross profits per retail units sold, primarily attributable to our domestic and import brands.

Our used vehicle results are directly affected by the level of manufacturer incentives on new vehicles, the number and quality of trade-ins and lease turn-ins and the availability of consumer credit. Over the last three years, we have seen a decline in same store retail sales of used vehicle units, partially offset by the benefit received from acquisitions. During this same time period, however, we have seen pricing begin to stabilize, we have initiated efforts to better manage our used vehicle inventory and taken deliberate action to maximize our retail used vehicle profits. As a result, our same store retail and consolidated wholesale volumes have declined from 2004 to 2006, but adjusted used vehicle total margin has increased from 11.3% in 2004, to 12.3% in 2005 and 12.6% in 2006.

Our consolidated parts and service gross margin decreased slightly from 54.8% in 2004, to 54.3% in 2005, and remained relatively flat from 2005 to 2006. Our same store parts and service gross margin mirrored our consolidated results. A shift from 2004 to 2005 in our business mix of lower margin wholesale parts business and higher margin customer pay and warranty-related service business caused our overall parts and service gross margin to decline in 2005. As manufacturer quality issues were resolved in 2005 and our warranty-related service business declined, we intensified our focus on customer pay (non-warranty) service and maintained our gross margin between 2005 and 2006. Our same store gross profit rose 3.2% from 2004 to 2005, and 1.5% from 2005 to 2006, as our overall level of sales activity increased.

Overall, our consolidated gross margin has steadily improved from 15.3% in 2004 to 15.6% in 2005 and 15.9% in 2006.

Our consolidated finance and insurance revenues per retail unit sold have continued to increase from $938 per retail unit sold in 2004 to $957 in 2005, and $977 in 2006, reflecting improvements in our penetration rates and the partial dilutive effect of our acquisitions during those periods. Our same store finance and insurance revenues per unit sold paralleled our consolidated results, increasing from $939 per retail unit sold in 2004 as compared to $971 in 2005, and from $960 in 2005 as compared to $986 in 2006.

During the past three years, our consolidated selling, general and administrative expenses (SG&A) as a percentage of gross profit, have continued to decline from 80.8% during 2004, to 79.5% in 2005 and 76.7% in 2006. The decrease in SG&A as a percentage of gross profit from 2005 to 2006 was the combined result of the increases in gross profit noted above and personnel-related cost reduction initiatives implemented in late 2005 and early 2006. These reductions were partially offset by the 2006 adoption of SFAS 123(R), Share-Based Payment, resulting in compensation expense being recognized related to stock option and employee stock purchase grants. The decline in SG&A as a percentage of gross profit from 2004 to 2005 came primarily from reductions in advertising costs. Our same store results in SG&A as a percentage of gross profit emulated the consolidated results, as the 2004 ratio of 80.7% declined to 79.4% when compared to 2005, and from 78.4% to 77.3% when comparing 2005 to 2006.

The combination of the above factors, together with the reduction in the level of impairment charges recorded in 2006 and 2005, as compared to 2004, partially offset by an increase in our floorplan interest expense over the three-year period, contributed to a net improvement in our operating margin to 3.4% in 2006 and 2.8% in 2005, as compared to 1.8% in 2004, and in our pretax margin to 2.3% in 2006 and 1.8% in 2005, as compared to 0.9% in 2004. Our floorplan interest expense increased primarily as a result of rising interest rates.

We believe that our continued growth depends on, among other things, our ability to successfully acquire and integrate new dealerships, while at the same time achieving optimum performance from our diverse franchise mix, attracting and retaining high-caliber employees and reinvesting as needed to maintain top-quality facilities. During 2007, we expect to spend approximately $80.0 million to construct new facilities and upgrade or expand existing facilities, although we expect to finance some of this construction with a new mortgage facility as well as with funds from sell and lease back transactions. In addition, we expect to complete acquisitions of dealerships with at least $600 million in expected aggregate annual revenues.

Table of Contents

Critical Accounting Policies and Accounting Estimates

Our consolidated financial statements are impacted by the accounting policies we use and the estimates and assumptions we make during their preparation. The following is a discussion of our critical accounting policies and critical accounting estimates.

Critical Accounting Policies

We have identified below what we believe to be the most pervasive accounting policies that are of particular importance to the portrayal of our financial position, results of operations and cash flows. See Note 2 to our Consolidated Financial Statements for further discussion of all our significant accounting policies.

Inventories. We carry our new, used and demonstrator vehicle inventories, as well as our parts and accessories inventories, at the lower of cost or market in our consolidated balance sheets. Vehicle inventory cost consists of the amount paid to acquire the inventory, plus reconditioning cost, cost of equipment added and transportation. Additionally, we receive interest assistance from some of our manufacturers. This assistance is accounted for as a vehicle purchase price discount and is reflected as a reduction to the inventory cost on our balance sheets and as a reduction to cost of sales in our statements of operation as the vehicles are sold. As the market value of our inventory typically declines over time, we establish reserves based on our historical loss experience and market trends. These reserves are charged to cost of sales and reduce the carrying value of our inventory on hand. Used vehicles are complex to value as there is no standardized source for determining exact values and each vehicle and each market in which we operate is unique. As a result, the value of each used vehicle taken at trade-in, or purchased at auction, is determined based on industry data, primarily accessed via our used vehicle management software and the industry expertise of the responsible used vehicle manager. Our valuation risk is mitigated, somewhat, by how quickly we turn this inventory. At December 31, 2006, our used vehicle days supply was 31 days.

Retail Finance, Insurance and Vehicle Service Contract Revenues Recognition. We arrange financing for customers through various institutions and receive financing fees based on the difference between the loan rates charged to customers and predetermined financing rates set by the financing institution. In addition, we receive fees from the sale of insurance and vehicle service contracts to customers. Further, through agreements that we have with certain vehicle service contract administrators, we earn volume incentive rebates and interest income on reserves, as well as participate in the underwriting profits of the products.

We may be charged back for unearned financing, insurance contract or vehicle service contract fees in the event of early termination of the contracts by customers. Revenues from these fees are recorded at the time of the sale of the vehicles and a reserve for future amounts which might be charged back is established based on our historical chargeback results and the termination provisions of the applicable contracts. While our chargeback results vary depending on the type of contract sold, a 10% change in the historical chargeback results used in determining our estimates of future amounts which might be charged back would have changed our reserve at December 31, 2006, by approximately $1.3 million.

Critical Accounting Estimates

The preparation of our financial statements in conformity with generally accepted accounting principals requires management to make certain estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities, the disclosures of contingent assets and liabilities at the balance sheet date and the amounts of revenues and expenses recognized during the reporting period. We analyze our estimates based on our historical experience and various other assumptions that we believe to be reasonable under the circumstances. However, actual results could differ from such estimates. The following is a discussion of our critical accounting estimates.

Goodwill. Goodwill represents the excess, at the date of acquisition, of the purchase price of businesses acquired over the fair value of the net tangible and intangible assets acquired. In June 2001, the Financial Accounting Standards Board, or FASB, issued SFAS No. 141, Business Combinations. Prior to our adoption of SFAS No. 141 on January 1, 2002, we recorded purchase prices in excess of the net tangible assets acquired as goodwill and did not separately record any intangible assets apart from goodwill as all were amortized over similar

Table of Contents

lives. During 2001, the FASB also issued SFAS No. 142, Goodwill and Other Intangible Assets, which changed the treatment of goodwill to:

- no longer permit the amortization of goodwill and indefinite-lived intangible assets;
- require goodwill and intangible assets, of which franchise rights are our most significant, to be recorded separately; and
- require, at least annually, an assessment for impairment of goodwill by reporting unit using a fair-value based, two-step test.

We perform the annual impairment assessment at the end of each calendar year, or more frequently if events or circumstances at a reporting unit occur that would more likely than not reduce the fair value of the reporting unit below its carrying value. Based on the organization and management of our business prior to 2006, each of our groups of dealerships formerly referred to as platforms qualified as reporting units for the purpose of assessing goodwill for impairment. However, with our reorganization into four regions in 2006, and the corresponding changes in our management, operational and reporting structure we determined that goodwill should be evaluated at a regional level.

To determine the fair value of our reporting units, we use a discounted cash flow approach. Included in this analysis are assumptions regarding revenue growth rates, future gross margins, future selling, general and administrative expenses and an estimated weighted average cost of capital. We also must estimate residual values at the end of the forecast period and future capital expenditure requirements. Each of these assumptions requires us to use our knowledge of (1) our industry, (2) our recent transactions and (3) reasonable performance expectations for our operations. If any one of the above assumptions change, in some cases insignificantly, or fails to materialize, the resulting decline in our estimated fair value could result in a material impairment charge to the goodwill associated with the reporting unit(s), especially with respect to those operations acquired prior to July 1, 2001.

Intangible Franchise Rights. Our only significant identifiable intangible assets, other than goodwill, are rights under our franchise agreements with manufacturers. Our dealerships franchise agreements are for various terms, ranging from one year to an indefinite period. We expect these franchise agreements to continue indefinitely and, when these agreements do not have indefinite terms, we believe that renewal of these agreements can be obtained without substantial cost. As such, we believe that our franchise agreements will contribute to cash flows for an indefinite period. Therefore, we do not amortize the carrying amount of our franchise rights. Franchise rights acquired in acquisitions prior to July 1, 2001, were not separately recorded, but were recorded and amortized as part of goodwill and remain a part of goodwill at December 31, 2006 and 2005, in the accompanying consolidated balance sheets. Like goodwill, and in accordance with SFAS No. 142, we test our franchise rights for impairment annually, or more frequently if events or circumstances indicate possible impairment, using a fair-value method.

At the September 2004 meeting of the Emerging Issues Task Force (EITF), the SEC staff issued Staff Announcement No. D-108, Use of the Residual Method to Value Acquired Assets Other Than Goodwill, which states that for business combinations after September 29, 2004, the residual method should no longer be used to value intangible assets other than goodwill. Rather, a direct value method should be used to determine the fair value of all intangible assets other than goodwill required to be recognized under SFAS No. 141, Business Combinations. Additionally, registrants who have applied a residual method to the valuation of intangible assets for purposes of impairment testing under SFAS No. 142, shall perform an impairment test using a direct value method on all intangible assets that were previously valued using a residual method by no later than the beginning of their first fiscal year beginning after December 15, 2004.

To test the carrying value of each individual franchise right for impairment under EITF D-108, we use a discounted cash flow based approach. Included in this analysis are assumptions, at a dealership level, regarding the cash flows directly attributable to the franchise right, revenue growth rates, future gross margins and future selling, general and administrative expenses. Using an estimated weighted average cost of capital, estimated residual values at the end of the forecast period and future capital expenditure requirements, we calculate the fair value of each dealership s franchise rights after considering estimated values for tangible assets, working capital and workforce.

Table of Contents

For some of our dealerships, the adoption of the annual impairment provisions as of January 1, 2005, resulted in a fair value that was less than the carrying value of their intangible franchise rights. As a result, a non-cash charge of $16.0 million, net of deferred taxes of $10.2 million, was recorded as a cumulative effect of a change in accounting principle in accordance with the transitional rules of EITF D-108 in the first quarter of 2005.

If any one of the above assumptions change, including in some cases insignificantly, or fails to materialize, the resulting decline in our intangible franchise rights estimated fair value could result in a material impairment charge to the intangible franchise right associated with the applicable dealership. For example, if our assumptions regarding the future interest rates used in our estimated weighted average cost of capital increased by 100 basis points, and all other assumptions remain constant, the resulting non-cash charge would be approximately $3.4 million.

Self-Insured Property and Casualty Reserves. We are self-insured for a portion of the claims related to our property and casualty insurance programs, requiring us to make estimates regarding expected losses to be incurred.

As a result of recent significant increases in the self insured portion of our worker s compensation and general liability insurance programs, we engaged a third-party actuary to conduct a study of these exposures for all open policy years. Based on the results of this study, we recorded a $1.4 million reduction to our estimated workers compensation and general liability accruals during the third quarter of 2005. We update this actuarial study on an annual basis and make the appropriate adjustments to our accrual. Actuarial estimates for the portion of claims not covered by insurance are based on our historical claims experience adjusted for loss trending and loss development factors. Changes in the frequency or severity of claims from historical levels could influence our reserve for claims and our financial position, results of operations and cash flows. A 10% change in the historical loss history used in determining our estimate of future losses would have changed our reserve for these losses at December 31, 2006, by $3.1 million.

For workers compensation and general liability insurance policy years ended prior to October 31, 2005, this component of our insurance program included aggregate retention (stop loss) limits in addition to a per claim deductible limit. Due to our historical experience in both claims frequency and severity, the likelihood of breaching the aggregate retention limits described above was deemed remote, and as such, we elected not to purchase this stop loss coverage for the policy years beginning November 1, 2006 and 2005. Our exposure per claim under the 2005/2006 and 2006/2007 plans is limited to $1.0 million per occurrence, with unlimited exposure on the number of claims up to $1.0 million that we may incur.

Our maximum potential exposure under all of our self-insured property and casualty plans with aggregate retention limits originally totaled $47.2 million, before consideration of amounts previously paid or accruals we have recorded related to our loss projections. After consideration of these amounts, our remaining potential loss exposure under these plans totals approximately $17.5 million at December 31, 2006.

Fair Value of Assets Acquired and Liabilities Assumed. We estimate the values of assets acquired and liabilities assumed in business combinations, which involves the use of various assumptions. The most significant assumptions, and those requiring the most judgment, involve the estimated fair values of property and equipment and intangible franchise rights, with the remaining attributable to goodwill, if any.

Results of Operations

The Same Store amounts presented below include the results of dealerships for the identical months in each period presented in the comparison, commencing with the first full month in which the dealership was owned by us and, in the case of dispositions, ending with the last full month it was owned by us. Same Store results also include the activities of the corporate office.

For example, for a dealership acquired in June 2005, the results from this dealership will appear in our Same Store comparison beginning in 2006 for the period July 2006 through December 2006, when comparing to July 2005 through December 2005 results.

The following table summarizes our combined Same Store results for the twelve months ended December 31, 2006 as compared to 2005 and the twelve months ended December 31, 2005 compared to 2004. Depending on the periods being compared, the stores included in Same Store will vary. For this reason, the 2005 Same Store results that are compared to 2006 differ from those used in the comparison to 2004.

Total Same Store Data
(dollars in thousands, except per unit amounts)

	For the Year Ended December 31,					
	2006	% Change	2005	2005	% Change	2004
Revenues						
New vehicle retail	$ 3,542,274	(1.0)%	$ 3,578,174	$ 3,339,754	(0.2)%	$ 3,344,855
Used vehicle retail	1,058,082	2.0%	1,037,638	997,393	1.0%	987,542
Used vehicle wholesale	309,502	(15.8)%	367,412	352,880	(1.6)%	358,596
Parts and Service	635,423	1.9%	623,654	589,093	4.3%	564,683
Finance, insurance and other	182,206	0.9%	180,582	175,610	1.6%	172,812
Total revenues	5,727,487	(1.0)%	5,787,460	5,454,730	0.5%	5,428,488
Cost of Sales						
New vehicle retail	3,287,339	(1.1)%	3,322,394	3,103,799	(0.1)%	3,108,407
Used vehicle retail	920,967	1.6%	906,404	870,263	0.4%	867,118
Used vehicle wholesale	312,881	(15.6)%	370,533	356,866	(2.7)%	366,827
Parts and Service	290,765	2.4%	284,055	269,453	5.6%	255,045
Total cost of sales	4,811,952	(1.5)%	4,883,386	4,600,381	0.1%	4,597,397
Gross profit	$ 915,535	1.3%	$ 904,074	$ 854,349	2.8%	$ 831,091
Selling, general and administrative expenses	$ 708,059	(0.1)%	$ 708,814	$ 678,527	1.1%	$ 671,038
Depreciation and amortization expenses	$ 17,442	(3.9)%	$ 18,157	$ 17,708	12.3%	$ 15,773
Floorplan interest expense	$ 43,947	21.9%	$ 36,062	$ 34,860	37.8%	$ 25,301
Gross Margin						
New Vehicle Retail	7.2%		7.1%	7.1%		7.1%
Used Vehicle	9.8%		9.1%	9.1%		8.3%
Parts and Service	54.2%		54.5%	54.3%		54.8%
Total Gross Margin	16.0%		15.6%			

At December 31, 2012, the Company had $28.1 million in unrecognized tax benefits, the recognition of which would have an effect of $25.0 million on the current provision for income taxes. Included in the balance of unrecognized tax benefits at December 31, 2012, was $7.0 million related to tax positions for which it is reasonably possible that the total amounts could significantly change during the next twelve months. This amount represents a decrease in unrecognized tax benefits comprised of items related to federal audits of partnership investments, assessed state income tax audits, state settlement negotiations currently in progress and expiring statutes in federal and foreign jurisdictions.

The Company classifies all income tax related interest and penalties as income tax expense. At December 31, 2012, the Company had accrued $6.2 million for the potential payment of income tax interest and penalties.

There were no significant changes to any of the balances of unrecognized tax benefits at December 31, 2012 during the first nine months of 2013.

12

On January 2, 2013, the American Taxpayer Relief Act (ATRA) was enacted which retroactively reinstated and extended the Federal Research and Development Tax Credit from January 1, 2012 to December 31, 2013. As a result, the Company recognized a $2.0 million discrete tax benefit during the first quarter of 2013. The other provisions of the Act will have a negligible impact on the Company's effective tax rate in 2013.
During the third quarter of 2013, the Company completed the acquisition of the U.S./Canada business of Consorcio Comex, S.A. de C.V. The Company has engaged an independent valuation firm to value the assets of the acquired business. Once this process is completed, the Company will determine if any tax attributes are required to be recorded.
The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The IRS completed an examination of the Company's U.S. income tax returns for the 2008 and 2009 tax years in the third quarter of 2013. The audit adjustments had a negligible impact on the Company's 2013 effective tax rate. The Company has fully resolved all IRS issues relating to the matters challenging the ESOP related federal income tax deductions claimed by the Company. During the third quarter of 2013, the Company made a final interest payment of $2.0 million related to the 2008 ESOP adjustment which had been disclosed in prior years. The Company expects that the IRS will commence an examination of the 2010 and 2011 tax years during the fourth quarter of 2013.
As of September 30, 2013, the Company is subject to non-U.S. income tax examinations for the tax years of 2006 through 2012. In addition, the Company is subject to state and local income tax examinations for the tax years 2002 through 2012.
NOTE 12—NET INCOME PER COMMON SHARE

(Thousands of dollars except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Basic				
Average common shares outstanding	100,460,185	101,525,658	101,362,328	101,680,883
Net income	$262,966	$234,953	$636,438	$562,982
Less net income allocated to unvested restricted shares	(1,700)	(1,965)	(3,978)	(4,654)
Net income allocated to common shares	$261,266	$232,988	$632,460	$558,328
Basic net income per common share	$2.60	$2.29	$6.24	$5.49
Diluted				
Average common shares outstanding	100,460,185	101,525,658	101,362,328	101,680,883
Stock options and other contingently issuable shares (1)	2,162,329	2,493,662	2,189,214	2,287,241
Average common shares outstanding assuming dilution	102,622,514	104,019,320	103,551,542	103,968,124
Net income	$262,966	$234,953	$636,438	$562,982
Less net income allocated to unvested restricted shares assuming dilution	(1,667)	(1,922)	(3,902)	(4,555)
Net income allocated to common shares assuming dilution	$261,299	$233,031	$632,536	$558,427
Diluted net income per common share	$2.55	$2.24	$6.11	$5.37

(1) Stock options and other contingently issuable shares excluded 16,609 shares for the three and nine months ended September 30, 2013. There were no options excluded due to their anti-dilutive effect for the three months ended September 30, 2012. Stock options and other contingently issuable shares excluded 10,924 shares for the nine months ended September 30, 2012.

The Company has two classes of participating securities: common shares and restricted shares, representing 99% and 1% of outstanding shares, respectively. The restricted shares are shares of unvested restricted stock granted under the Company's restricted stock award program. Unvested restricted shares granted prior to April 21, 2010 received non-forfeitable dividends. Accordingly, the shares are considered a participating security and the two-class method of calculating basic and diluted earnings per share is required. Effective April 21, 2010, the restricted stock award program was revised and dividends on performance-based restricted shares granted after this date are deferred and payment is contingent upon the awards vesting. Only the time-based restricted shares, which continue to receive non-forfeitable dividends, are considered a participating security. Basic and diluted earnings per share are calculated using the two-class method in accordance with the Earnings Per Share Topic of the ASC.

NOTE 13—REPORTABLE SEGMENT INFORMATION

The Company reports segment information in the same way that management internally organizes its business for assessing performance and making decisions regarding allocation of resources in accordance with the Segment Disclosures Topic of the ASC. The Company has determined that it has four reportable operating segments: Paint Stores Group, Consumer Group, Global Finishes Group and Latin America Coatings Group (individually, a "Reportable Segment" and collectively, the "Reportable Segments").

(Thousands of dollars)	Three Months Ended September 30, 2013					
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	$1,763,404	$366,845	$507,284	$ 208,645	$ 1,239	$2,847,417
Intersegment transfers		689,319	2,437	9,170	(700,926)	
Total net sales and intersegment transfers	$1,763,404	$1,056,164	$509,721	$ 217,815	$ (699,687)	$2,847,417
Segment profit	$359,352	$73,065 (1)	$44,536	$ (983)		$475,970
Interest expense					$ (15,394)	(15,394)
Administrative expenses and other					(73,114)	(73,114)
Income before income taxes	$359,352	$73,065	$44,536	$ (983)	$ (88,508)	$387,462
	Three Months Ended September 30, 2012					
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	$1,553,461	$348,001	$491,816	$ 208,726	$ 1,222	$2,603,226
Intersegment transfers		644,400	853	13,686	(658,939)	
Total net sales and intersegment transfers	$1,553,461	$992,401	$492,669	$ 222,412	$ (657,717)	$2,603,226
Segment profit	$300,563	$57,054 (1)	$36,415	$ 21,931		$415,963
Interest expense					$ (10,358)	(10,358)
Administrative expenses and other					(62,607)	(62,607)
Income before income taxes	$300,563	$57,054	$36,415	$ 21,931	$ (72,965)	$342,998

(1) Segment profit includes $8,340 and $6,908 of mark-up on intersegment transfers realized as a result of external sales by the Paint Stores Group during the third quarter of 2013 and 2012, respectively.

14

	Nine Months Ended September 30, 2013					
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	$4,537,849	$1,069,085	$1,507,626	$ 610,271	$ 3,643	$7,728,474
Intersegment transfers		1,855,226	7,469	29,081	(1,891,776)	
Total net sales and intersegment transfers	$4,537,849	$2,924,311	$1,515,095	$ 639,352	$ (1,888,133)	$7,728,474
Segment profit	$822,037	$206,079 (2)	$132,929	$ 20,712		$1,181,757
Interest expense					$ (45,774)	(45,774)
Administrative expenses and other					(199,253)	(199,253)
Income before income taxes	$822,037	$206,079	$132,929	$ 20,712	$ (245,027)	$936,730

	Nine Months Ended September 30, 2012					
	Paint Stores Group	Consumer Group	Global Finishes Group	Latin America Coatings Group	Administrative	Consolidated Totals
Net external sales	$4,164,648	$1,066,123	$1,473,584	$ 604,600	$ 3,637	$7,312,592
Intersegment transfers		1,803,175	5,118	36,310	(1,844,603)	
Total net sales and intersegment transfers	$4,164,648	$2,869,298	$1,478,702	$ 640,910	$ (1,840,966)	$7,312,592
Segment profit	$680,257	$193,117 (2)	$113,084	$ 51,099		$1,037,557
Interest expense					$ (30,925)	(30,925)
Administrative expenses and other					(193,516)	(193,516)
Income before income taxes	$680,257	$193,117	$113,084	$ 51,099	$ (224,441)	$813,116

(2) Segment profit includes $22,618 and $21,552 of mark-up on intersegment transfers realized as a result of external sales by the Paint Stores Group during the first nine months of 2013 and 2012, respectively.

In the reportable segment financial information, Segment profit was total net sales and intersegment transfers less operating costs and expenses. Domestic intersegment transfers were accounted for at the approximate fully absorbed manufactured cost, based on normal capacity volumes, plus customary distribution costs. International intersegment transfers were accounted for at values comparable to normal unaffiliated customer sales. The Administrative segment includes the administrative expenses of the Company’s corporate headquarters site. Also included in the Administrative segment was interest expense, interest and investment income, certain expenses related to closed facilities and environmental-related matters, and other expenses which were not directly associated with the Reportable Segments. The Administrative segment did not include any significant foreign operations. Also included in the Administrative segment was a real estate management unit that is responsible for the ownership, management and leasing of non-retail properties held primarily for use by the Company, including the Company’s headquarters site, and disposal of idle facilities. Sales of this segment represented external leasing revenue of excess headquarters space or leasing of facilities no longer used by the Company in its primary businesses. Gains and losses from the sale of property were not a significant operating factor in determining the performance of the Administrative segment.

Net external sales and segment profit of all consolidated foreign subsidiaries were $523.7 million and $18.2 million, respectively, for the third quarter of 2013, and $497.6 million and $37.7 million, respectively, for the third quarter of 2012. Net external sales and segment profit of these subsidiaries were $1.572 billion and $50.2 million, respectively, for the first nine months of 2013, and $1.491 billion and $105.0 million, respectively, for the first nine months of 2012. Long-lived assets of these subsidiaries totaled $679.9 million and $648.8 million at September 30, 2013 and September 30, 2012, respectively. Domestic operations accounted for the remaining net external sales, segment profits and long-lived assets. No single geographic area outside the United States was significant relative to consolidated net external sales, income before taxes, or consolidated long-lived assets.

Export sales and sales to any individual customer were each less than 10 percent of consolidated sales to unaffiliated customers during all periods presented.

NOTE 14—ACQUISITIONS

On November 9, 2012, the Company entered into a definitive Stock Purchase Agreement to purchase all of the issued and outstanding shares of Consorcio Comex, S.A. de C.V. (Comex) for an aggregate purchase price of approximately $2.34 billion, including assumed debt. However, on July 17, 2013, the Federal Competition Commission of Mexico (Commission) informed the Company that the acquisition of Comex was not authorized. The Company appealed the Commission's decision. On September 16, 2013, the Stock Purchase Agreement was amended and restated to extend the date by which the agreement can be terminated by either party to March 31, 2014. Additionally, the Stock Purchase Agreement was amended to reflect a revised purchase price of approximately $2.25 billion. On October 29, 2013, the Commission informed the Company that the Company's appeal relating to its pending acquisition of Comex's Mexico business was denied and the acquisition is not authorized. The Company is currently reviewing the Commission's decision and is considering all options, including whether to refile with the Commission. Comex is a leader in the paint and coatings market in Mexico with headquarters in Mexico City. Also on September 16, 2013, the Company entered into a new definitive Stock Purchase Agreement and completed the acquisition of Comex's U.S./Canada business. The Company has engaged an independent valuation firm to value the assets of the acquired business. Once this process is completed, the Company will record any necessary adjustments. The U.S./Canada business of Comex focuses on the manufacture and sale of paint and paint related products through retail service centers under various proprietary brands. The acquisition of the U.S./Canada business of Comex strengthens the ability of the Paint Stores Group and Consumer Group to serve customers in key geographic markets.

Effective December 18, 2012, the Company acquired Jiangsu Pulanna Coating Co., Ltd. (Pulanna). Headquartered in Changzhou, China, Pulanna is a leading automotive refinishes coatings manufacturer in China. The acquisition strengthens the Global Finishes Group's established presence in China and its ability to serve automotive customers around the world.

Effective June 1, 2012, the Company acquired Geocel Holdings Corporation. Geocel manufactures innovative caulks, sealants, and adhesives specially designed for tough construction and repair applications in commercial, residential, industrial and transport non-automotive markets. Geocel has operations in both the United States and United Kingdom. The acquisition strengthens the Consumer Group’s sealant and adhesive market position.

The completed acquisitions above have been accounted for as purchases and their results of operations have been included in the consolidated financial statements since the date of acquisition. The Pulanna and Geocel acquisitions resulted in the recognition of goodwill and intangible assets.

The following unaudited pro-forma summary presents consolidated financial information as if the U.S./Canada business of Comex, Pulanna and Geocel had been acquired as of the beginning of each period presented. The pro-forma consolidated financial information does not necessarily reflect the actual results that would have occurred had the acquisitions taken place on January 1, 2012 or of future results of operations of these acquisitions under ownership and operation of the Company.

(Thousands of dollars except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net sales	$2,959,162	$2,753,280	$8,083,123	$7,874,576
Net income	257,149	229,297	609,651	524,639
Net income per common share:				
Basic	$2.53	$2.24	$5.96	$5.12
Diluted	$2.47	$2.19	$5.83	$5.01

NOTE 15—FAIR VALUE MEASUREMENTS

The Fair Value Measurements and Disclosures Topic of the ASC applies to the Company’s financial and non-financial assets and liabilities. The guidance applies when other standards require or permit the fair value measurement of assets and liabilities. It does not expand the use of fair value measurements. The Company did not have any fair value measurements for its non-financial assets and liabilities during the third quarter. The following table presents the Company’s financial assets and liabilities that are measured at fair value on a recurring basis, categorized using the fair value hierarchy:

(Thousands of dollars)

	Fair Value at September 30, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Deferred compensation plan asset (1)	$20,456	$3,294	$17,162	
Liabilities:				
Deferred compensation plan liability (2)	$25,800	$25,800		

(1) The deferred compensation plan asset consists of the investment funds maintained for the future payments under the Company's executive deferred compensation plan, which is structured as a rabbi trust. The investments are marketable securities accounted for under the Debt and Equity Securities Topic of the ASC. The level 1 investments are valued using quoted market prices multiplied by the number of shares. The level 2 investments are valued based on vendor or broker models. The cost basis of the investment funds is $20,420.

(2) The deferred compensation plan liability is the Company's liability under its executive deferred compensation plan. The liability represents the fair value of the participant shadow accounts, and the value is based on quoted market prices.

NOTE 16—DEBT

The table below summarizes the carrying amount and fair value of the Company's publicly traded debt and non-publicly traded debt in accordance with the Fair Value Measurements and Disclosures Topic of the ASC. The fair values of the Company's publicly traded debt are based on quoted market prices. The fair values of the Company's non-traded debt are estimated using discounted cash flow analyses, based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. The Company's publicly traded debt and non-traded debt are classified as level 1 and level 2, respectively, in the fair value hierarchy.

(Thousands of dollars)	September 30, 2013		September 30, 2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Publicly traded debt	$1,630,269	$1,631,266	$632,460	$693,681
Non-traded debt	4,105	3,903	6,824	6,607

On March 18, 2013, Sherwin-Williams Canada, Inc., a wholly owned subsidiary of the Company, increased the aggregate amount of its existing credit facility to CAD 150.0 million. The credit facility is being used for general corporate purposes, including refinancing indebtedness and for acquisitions.

NOTE 17—NON-TRADED INVESTMENTS

The Company has invested in the U.S. affordable housing and historic renovation real estate markets. These non-traded investments have been identified as variable interest entities. However, because the Company does not have the power to direct the day-to-day operations of the investments and the risk of loss is limited to the amount of contributed capital, the Company is not considered the primary beneficiary. In accordance with the Consolidation Topic of the ASC, the investments are not consolidated. The Company uses the effective yield method to determine the carrying value of the investments. Under the effective yield method, the initial cost of the investments is amortized over the period that the tax credits are recognized. The carrying amount of the investments, included in Other assets, was $262.4 million and $257.6 million at September 30, 2013 and 2012, respectively. The liability for estimated future capital contributions to the investments was $223.0 million and $224.0 million at September 30, 2013 and 2012, respectively.

17

Item 2. MANAGEMENT'S DISCUSSION AND
ANALYSIS OF FINANCIAL CONDITION AND
RESULTS OF OPERATIONS

SUMMARY

The Sherwin-Williams Company, founded in 1866, and its consolidated wholly owned subsidiaries (collectively, the "Company") are engaged in the development, manufacture, distribution and sale of paint, coatings and related products to professional, industrial, commercial and retail customers primarily in North and South America with additional operations in the Caribbean region, Europe and Asia. The Company is structured into four reportable segments—Paint Stores Group, Consumer Group, Global Finishes Group and Latin America Coatings Group (collectively, the "Reportable Segments")—and an Administrative segment in the same way it is internally organized for assessing performance and making decisions regarding allocation of resources. See pages 6 through 15 and Note 18, on pages 74 through 76, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more information concerning the Reportable Segments.

The Company's financial condition, liquidity and cash flow continued to be strong in the third quarter of 2013 primarily due to improved operating results in our Paint Stores, Consumer, and Global Finishes Groups. Net working capital increased $1.047 billion at September 30, 2013 compared to the end of the third quarter of 2012 due to an increase in cash and cash equivalents and a decrease in short-term borrowings, which was primarily due to the $700.0 million of 1.35% Senior Notes due 2017 and $300.0 million of 4.00% Senior Notes due 2042 issued on December 4, 2012. The Company has been able to arrange sufficient short-term borrowing capacity at reasonable rates, and the Company has sufficient total available borrowing capacity to fund its current operating needs. Net operating cash improved $208.6 million in the first nine months of 2013 to a cash source of $777.9 million from a cash source of $569.3 million in 2012 primarily due to an increase in net income of $73.5 million, improved working capital management, and a payment to the IRS for the 2011 ESOP settlement of $59.1 million in the first quarter of 2012 partially offset by a payment to the ESOP for the 2012 DOL settlement of $80.0 million in the first quarter of 2013.

Consolidated net sales increased 9.4 percent in the third quarter of 2013 to $2.847 billion from $2.603 billion in the third quarter of 2012, and increased 5.7 percent in the first nine months of 2013 to $7.728 billion from $7.313 billion in the first nine months of 2012 due primarily to higher paint sales volume in our Paint Stores Group. Consolidated gross profit as a percent of consolidated net sales increased in the third quarter to 45.5 percent from 44.2 percent in 2012 and increased to 45.2 percent from 43.9 percent in the first nine months due primarily to increased paint volume, improved operating efficiency and selling price increases. Selling, general and administrative expenses (SG&A) increased as a percent of consolidated net sales to 31.2 percent from 30.7 percent in the third quarter of 2012 and was flat at 32.4 percent in the first nine months primarily due to timing of net new store openings in the quarter and acquisitions. Interest expense increased $5.0 million in the third quarter and $14.8 million in the first nine months of 2013 due to increased long-term debt balances. The effective income tax rate for the third quarter of 2013 was 32.1 percent compared to 31.5 percent in 2012, and the rate for the first nine months of 2013 was 32.1 percent compared to 30.8 percent in 2012. Diluted net income per common share increased to $2.55 per share for the third quarter of 2013, including a 2013 charge of $.13 per share resulting from government tax assessments related to our Brazilian operations, from $2.24 per share a year ago and increased to $6.11 per share, including 2013 charges of $.21 per share related to the Brazil tax assessments, from $5.37 per share in the first nine months of 2012.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

The preparation and fair presentation of the consolidated unaudited interim financial statements and accompanying notes included in this report are the responsibility of management. The financial statements and footnotes have been prepared in accordance with U.S. generally accepted accounting principles for interim financial statements and contain certain amounts that were based upon management's best estimates, judgments and assumptions that were believed to be reasonable under the circumstances. Management considered the impact of the uncertain economic environment and utilized certain outside sources of economic information when developing the basis for their estimates and assumptions. The impact of the global economic conditions on the estimates and assumptions used by management was believed to be reasonable under the circumstances. Management used assumptions based on historical results, considering the current economic trends, and other assumptions to form the basis for determining appropriate carrying values of assets and liabilities that were not readily available from other sources. Actual results could differ from those estimates. Also, materially different amounts may result under materially different conditions, materially different economic trends or from using materially different assumptions. However, management believes that any materially different amounts resulting from materially different conditions or material changes in facts or circumstances are unlikely to significantly impact the current valuation of assets and liabilities that were not readily available from other sources.

A comprehensive discussion of the Company's critical accounting policies and management estimates and significant accounting policies followed in the preparation of the financial statements is included in Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 1, on pages 48 through 51, in the Company's Annual

Report on Form 10-K for the year ended December 31, 2012. There have been no significant changes in critical accounting policies, management estimates or accounting policies followed since the year ended December 31, 2012.

FINANCIAL CONDITION, LIQUIDITY AND CASH FLOW

Overview

The Company's financial condition, liquidity and cash flow continued to be strong through the first nine months of 2013 primarily due to improving domestic architectural paint demand and improved operating results in our Paint Stores, Consumer and Global Finishes Groups. Net working capital increased $1.047 billion at September 30, 2013 compared to the end of the third quarter of 2012 due to an increase in cash and cash equivalents and a decrease in short-term borrowings. Cash and cash equivalents increased $980.5 million, accounts receivable increased $85.5 million, inventories increased $53.9 million and all other current assets increased $41.3 million. Short-term borrowings decreased $34.9 million while accounts payable increased $86.1 million and all other current liabilities increased $63.0 million from September 30, 2012. Net working capital increases were impacted primarily by cash proceeds of long-term debt acquired during the fourth quarter of 2012, acquisitions, increased sales and decreased short-term borrowing needs. The Company continues to maintain sufficient short-term borrowing capacity at reasonable rates and the Company has sufficient cash on hand and total available borrowing capacity to fund its current operating needs. In the first nine months of 2013, accounts receivable increased $316.1 million when normal seasonal trends typically require significant growth in this category along with increases in inventories of $97.3 million, primarily from acquisitions partially offset by lower core business inventories. Accounts payable increased $198.0 million, primarily due to the seasonal increase in need for working capital along with increases from acquisitions, while short-term borrowings increased $226.2 million and all other current liabilities increased $105.6 million, primarily due to timing of accrued taxes and other accrued expense payments partially offset by a payment to the ESOP for the 2012 DOL settlement of $80.0 million. The Company's current ratio was 1.57 at September 30, 2013 compared to 1.14 at September 30, 2012 and 1.68 at December 31, 2012. Total debt at September 30, 2013 increased $960.2 million to $1.930 billion from $969.4 million at September 30, 2012 and increased as a percentage of total capitalization to 50.8 percent from 35.3 percent at the end of the third quarter last year. Total debt increased $224.8 million from December 31, 2012 and increased as a percentage of total capitalization from 48.8 percent. At September 30, 2013, the Company had remaining borrowing ability of $2.083 billion. Net operating cash improved $208.6 million in the first nine months of 2013 to a cash source of $777.9 million from a cash source of $569.3 million in 2012. In the twelve month period from October 1, 2012 through September 30, 2013, the Company generated net operating cash of $1.097 billion, including a payment to the ESOP for the 2012 DOL settlement of $80.0 million in the first quarter of 2013, used $421.3 million in investing activities, and generated $308.7 million in financing activities. In that same period, the Company invested $162.6 million in capital additions and improvements, invested $145.1 million in acquisitions, had net proceeds from total debt of $954.0 million, purchased $616.7 million in treasury stock and paid $194.7 million in cash dividends to its shareholders of common stock.

Net Working Capital, Debt and Other Long-Term Assets and Liabilities

Cash and cash equivalents increased $173.1 million during the first nine months of 2013. Cash and cash equivalents on hand funded cash requirements for increased sales and normal seasonal increases in working capital, capital expenditures of $108.5 million, payments of cash dividends of $154.4 million, treasury stock purchases of $492.0 million, acquisitions of businesses of $92.8 million and net payments made on long-term debt of $1.1 million. At September 30, 2013, the Company's current ratio was 1.57 compared to 1.68 at December 31, 2012 and 1.14 a year ago. The increase from a year ago was primarily due to a significant increase in cash and cash equivalents resulting from proceeds received from issuance of long-term debt during the fourth quarter of 2012 and a decrease in short-term borrowings.

Goodwill and intangible assets decreased $20.9 million from December 31, 2012 and increased $42.8 million from September 30, 2012. The net decrease during the first nine months of 2013 was due primarily to amortization of $21.5 million. The net increase over the twelve month period from September 30, 2012 resulted from acquisitions of $63.7 million, capitalization of software of $3.2 million and foreign currency translation of $8.4 million partially offset by amortization of $28.4 million and impairments of $4.1 million. See Note 4, on pages 52 to 53, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more information concerning goodwill and intangible assets.

Deferred pension assets increased $2.3 million during the first nine months of 2013 and increased $17.2 million from September 30, 2012. The increase in the last twelve months was due primarily to increases in the fair market value of equity securities held by the Company's defined benefit pension plans. See Note 6, on pages 56 to 62, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more information concerning the Company's benefit plan assets.

Other assets at September 30, 2013 increased $38.9 million in the first nine months of 2013, due primarily to increased investments in affordable housing and historic renovation real estate properties along with increases in various other investments, and increased $7.6 million from a year ago due primarily to increases in investments in affordable housing and historic renovation real estate properties.

Net property, plant and equipment increased $45.0 million in the first nine months of 2013 and increased $67.3 million in the twelve months since September 30, 2012. The increase in the first nine months was primarily due capital expenditures of $108.5 million and acquisitions of $58.1 million partially offset by depreciation expense of $117.7 million, sale or disposition of fixed assets of $2.3 million and changes in currency translation rates of $1.5 million. Since September 30, 2012, capital expenditures of $162.6 million, acquisitions of $60.2 million and changes in currency translation rates of $5.9 million were partially offset by depreciation expense of $156.6 million and dispositions or sale of assets with remaining net book value of $4.8 million. Capital expenditures during the first nine months of 2013 primarily represented expenditures associated with improvements and normal equipment replacement in manufacturing and distribution facilities in the Consumer Group and normal equipment replacement in the Paint Stores and Global Finishes Groups.

Short-term borrowings related to the Company's domestic commercial paper program outstanding were $200.0 million at an average rate of .32 percent at September 30, 2013. There were no borrowings under certain other short-term revolving and letter of credit agreements at September 30, 2013. Short-term borrowings outstanding under various foreign programs at September 30, 2013 were $95.3 million with a weighted average interest rate of 6.4 percent. The Company had unused capacity of $850.0 million at September 30, 2013 under the commercial paper program that is backed by the Company's revolving credit agreement. On March 18, 2013, Sherwin-Williams Canada, Inc., a wholly owned subsidiary of the Company, increased the aggregate amount of its existing credit facility to CAD 150.0 million. The credit facility is being used for general corporate purposes, including refinancing indebtedness and for acquisitions. There were no significant changes in long-term debt during the third quarter of 2013. See Note 7, on pages 62 through 63, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more information concerning the Company's debt.

Long-term liabilities for postretirement benefits other than pensions did not change significantly from December 31, 2012 and increased $20.8 million from September 30, 2012. The increase in the liability was due to the increase in the actuarially determined postretirement benefit obligation resulting from changes in actuarial assumptions and unfavorable claims experience. See Note 6, on pages 56 to 62, in the Company's Annual Report on Form 10-K for the year ended December 31, 2012 for more information concerning the Company's benefit plan obligations.

Other long-term liabilities at September 30, 2013 increased $79.3 million in the first nine months of 2013 and increased $74.4 million from a year ago primarily due to acquisitions' pension liabilities.

Environmental-Related Liabilities

The operations of the Company, like those of other companies in the same industry, are subject to various federal, state and local environmental laws and regulations. These laws and regulations not only govern current operations and products, but also impose potential liability on the Company for past operations. Management expects environmental laws and regulations to impose increasingly stringent requirements upon the Company and the industry in the future. Management believes that the Company conducts its operations in compliance with applicable environmental laws and regulations and has implemented various programs designed to protect the environment and promote continued compliance.

Depreciation of capital expenditures and other expenses related to ongoing environmental compliance measures were included in the normal operating expenses of conducting business. The Company's capital expenditures, depreciation and other expenses related to ongoing environmental compliance measures were not material to the Company's financial condition, liquidity, cash flow or results of operations during the first nine months of 2013. Management does not expect that such capital expenditures, depreciation and other expenses will be material to the Company's financial condition, liquidity, cash flow or results of operations in 2013.

The Company is involved with environmental investigation and remediation activities at some of its currently and formerly owned sites (including sites which were previously owned and/or operated by businesses acquired by the Company). In addition, the Company, together with other parties, has been designated a potentially responsible party under federal and state environmental protection laws for the investigation and remediation of environmental contamination and hazardous waste at a number of third party sites, primarily Superfund sites. The Company may be similarly designated with respect to additional third party sites in the future.

The Company accrues for estimated costs of investigation and remediation activities at its currently and formerly owned sites and third party sites for which commitments or clean-up plans have been developed and when such costs can be reasonably estimated based on industry standards and professional judgment. These estimated costs are based on currently available facts

regarding each site. The Company accrues a specific estimated amount when such an amount and a time frame in which the costs will be incurred can be reasonably determined. If the best estimate of costs can only be identified as a range and no specific amount within that range can be determined more likely than any other amount within the range, the minimum of the range is accrued by the Company in accordance with applicable accounting rules and interpretations. The Company continuously assesses its potential liability for investigation and remediation activities and adjusts its environmental-related accruals as information becomes available upon which more accurate costs can be reasonably estimated. At September 30, 2013 and 2012, the Company had accruals for environmental-related activities of $111.9 million and $123.6 million, respectively.

Due to the uncertainties of the scope and magnitude of contamination and the degree of investigation and remediation activities that may be necessary at certain currently or formerly owned sites and third party sites, it is reasonably likely that further extensive investigations may be required and that extensive remedial actions may be necessary not only on such sites but on adjacent properties. Depending on the extent of the additional investigations and remedial actions necessary, the Company's ultimate liability may result in costs that are significantly higher than currently accrued. If the Company's future loss contingency is ultimately determined to be at the maximum of the range of possible outcomes for every site for which costs can be reasonably estimated, the Company's aggregate accruals for environmental-related activities would be $81.9 million higher than the accruals at September 30, 2013.

Two of the Company's currently and formerly owned sites accounted for the majority of the accruals for environmental-related activities and the unaccrued maximum of the estimated range of possible outcomes at September 30, 2013. At September 30, 2013, $58.2 million, or 52.0 percent, related directly to these two sites. Of the aggregate unaccrued exposure at September 30, 2013, $56.9 million, or 69.4 percent, related to the two sites. While environmental investigations and remedial actions are in different stages at these sites, additional investigations, remedial actions and/or monitoring will likely be required at each site. A comprehensive description of the two currently and formerly owned sites that account for the majority of the accruals for environmental-related activities is included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2012. There have been no significant changes in the investigative or remedial status of the two sites since December 31, 2012.

Management cannot presently estimate the ultimate potential loss contingencies related to these two sites or other less significant sites until such time as a substantial portion of the investigative activities at each site is completed and remedial action plans are developed.

In accordance with the Asset Retirement Obligations Topic of the ASC, the Company has identified certain conditional asset retirement obligations at various current manufacturing, distribution and store facilities. These obligations relate primarily to asbestos abatement and closures of hazardous waste containment devices. Using investigative, remediation and disposal methods that are currently available to the Company, the estimated cost of these obligations is not significant.

In the event any future loss contingency significantly exceeds the current amount accrued, the recording of the ultimate liability may result in a material impact on net income for the annual or interim period during which the additional costs are accrued. Management does not believe that any potential liability ultimately attributed to the Company for its environmental-related matters or conditional asset retirement obligations will have a material adverse effect on the Company's financial condition, liquidity, or cash flow due to the extended period of time during which environmental investigation and remediation takes place. An estimate of the potential impact on the Company's operations cannot be made due to the aforementioned uncertainties.

Management expects these contingent environmental-related liabilities and conditional asset retirement obligations to be resolved over an extended period of time. Management is unable to provide a more specific time frame due to the indefinite amount of time to conduct investigation activities at any site, the indefinite amount of time to obtain governmental agency approval, as necessary, with respect to investigation and remediation activities, and the indefinite amount of time necessary to conduct remediation activities.

Contractual Obligations, Commercial Commitments and Warranties

Short-term borrowings increased $226.2 million to $295.3 million at September 30, 2013 from $69.0 million at December 31, 2012. Total long-term debt decreased $1.5 million to $1.634 billion at September 30, 2013 from $1.636 billion at December 31, 2012 and increased $995.1 million from $639.3 million at September 30, 2012. See the

Financial Condition, Liquidity and Cash Flow section of this report for more information. There have been no other significant changes to the Company's contractual obligations and commercial commitments in the third quarter or the first nine months of 2013 as summarized in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Changes to the Company's accrual for product warranty claims in the first nine months of 2013 are disclosed in Note 5.

Contingent Liabilities

Life Shield Engineered Systems, LLC (Life Shield), a wholly-owned subsidiary of the Company, ceased operations in 2012. Life Shield developed and manufactured blast and fragment mitigating systems. The blast and fragment mitigating systems create a potentially higher level of product liability for the Company (as an owner of and supplier to Life Shield) than is normally associated with coatings and related products currently manufactured, distributed and sold by the Company.

Certain of Life Shield's technology has been designated as Qualified Anti-Terrorism Technology and granted a Designation under the Support Anti-Terrorism by Fostering Effective Technologies Act of 2002 (SAFETY Act) and the regulations adopted pursuant to the SAFETY Act. Under the SAFETY Act, the potentially higher level of possible product liability for Life Shield relating to the technology granted the Designation is limited to $6.0 million per occurrence in the event any such liability arises from an Act of Terrorism (as defined in the SAFETY Act). The limitation of liability provided for under the SAFETY Act does not apply to any technology not granted a designation or certification as a Qualified Anti-Terrorism Technology, nor in the event that any such liability arises from an act or event other than an Act of Terrorism. Life Shield maintains insurance for liabilities up to the $6.0 million per occurrence limitation caused by failure of its products in the event of an Act of Terrorism.

Management of the Company has reviewed the potential increased liabilities associated with Life Shield's systems and determined that potential liabilities arising from an Act of Terrorism that could ultimately affect the Company will be appropriately insured or limited by current regulations. However, due to the uncertainties involved in the future development, usage and application of Life Shield's systems, the number or nature of possible future claims and legal proceedings, or the effect that any change in legislation and/or administrative regulations may have on the limitations of potential liabilities, management cannot reasonably determine the scope or amount of any potential costs and liabilities for the Company related to Life Shield or to Life Shield's systems. Any potential liability for the Company that may result from Life Shield or Life Shield's systems cannot reasonably be estimated. However, based upon, among other things, the limitation of liability under the SAFETY Act in the event of an Act of Terrorism, management does not currently believe that the costs or potential liability ultimately determined to be attributable to the Company through its ownership of Life Shield, or as a supplier to Life Shield arising from the use of Life Shield's systems will have a material adverse effect on the Company's results of operations, liquidity or financial conditions.

Litigation

In the course of its business, the Company is subject to a variety of claims and lawsuits, including, but not limited to, litigation relating to product liability and warranty, personal injury, environmental, intellectual property, commercial, contractual and antitrust claims that are inherently subject to many uncertainties regarding the possibility of a loss to the Company. These uncertainties will ultimately be resolved when one or more future events occur or fail to occur confirming the incurrence of a liability or the reduction of a liability. In accordance with the Contingencies Topic of the ASC, the Company accrues for these contingencies by a charge to income when it is both probable that one or more future events will occur confirming the fact of a loss and the amount of the loss can be reasonably estimated. In the event that the Company's loss contingency is ultimately determined to be significantly higher than currently accrued, the recording of the additional liability may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such additional liability is accrued. In those cases where no accrual is recorded because it is not probable that a liability has been incurred and the amount of any such loss cannot be reasonably estimated, any potential liability ultimately determined to be attributable to the Company may result in a material impact on the Company's results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued. In those cases where no accrual is recorded or exposure to loss exists in excess of the amount accrued, the Contingencies Topic of the ASC requires disclosure of the contingency when there is a reasonable possibility that a loss or additional loss may have been incurred.

Lead pigment and lead-based paint litigation. The Company's past operations included the manufacture and sale of lead pigments and lead-based paints. The Company, along with other companies, is and has been a defendant in a number of legal proceedings, including individual personal injury actions, purported class actions, and actions brought by various counties, cities, school districts and other government-related entities, arising from the manufacture and sale of lead pigments and lead-based paints. The plaintiffs' claims have been based upon various legal theories, including negligence, strict liability, breach of warranty, negligent misrepresentations and omissions, fraudulent misrepresentations and omissions, concert of action, civil conspiracy, violations of unfair trade practice and consumer protection laws, enterprise liability, market share liability, public nuisance, unjust enrichment and other theories. The plaintiffs seek various damages and relief, including personal injury and property damage, costs relating to the detection and abatement of lead-based paint from buildings, costs associated with a public education campaign, medical monitoring costs and others. The Company is also a defendant in legal proceedings arising from the manufacture and sale of non-lead-based paints that seek recovery based upon various legal theories, including the failure to adequately warn of potential exposure to lead during surface preparation when using non-lead-based paint on surfaces previously painted with lead-based paint. The Company believes that the litigation brought to date is without merit or subject to

22

meritorious defenses and is vigorously defending such litigation. The Company has not settled any lead pigment or lead-based paint litigation. The Company expects that additional lead pigment and lead-based paint litigation may be filed against the Company in the future asserting similar or different legal theories and seeking similar or different types of damages and relief.

Notwithstanding the Company's views on the merits, litigation is inherently subject to many uncertainties, and the Company ultimately may not prevail. Adverse court rulings or determinations of liability, among other factors, could affect the lead pigment and lead-based paint litigation against the Company and encourage an increase in the number and nature of future claims and proceedings. In addition, from time to time, various legislation and administrative regulations have been enacted, promulgated or proposed to impose obligations on present and former manufacturers of lead pigments and lead-based paints respecting asserted health concerns associated with such products or to overturn the effect of court decisions in which the Company and other manufacturers have been successful.

Due to the uncertainties involved, management is unable to predict the outcome of the lead pigment and lead-based paint litigation, the number or nature of possible future claims and proceedings, or the effect that any legislation and/or administrative regulations may have on the litigation or against the Company. In addition, management cannot reasonably determine the scope or amount of the potential costs and liabilities related to such litigation, or resulting from any such legislation and regulations. The Company has not accrued any amounts for such litigation. With respect to such litigation, including the public nuisance litigation, the Company does not believe that it is probable that a loss has occurred, and it is not possible to estimate the range of potential losses as there is no prior history of a loss of this nature and there is no substantive information upon which an estimate could be based. In addition, any potential liability that may result from any changes to legislation and regulations cannot reasonably be estimated. In the event any significant liability is determined to be attributable to the Company relating to such litigation, the recording of the liability may result in a material impact on net income for the annual or interim period during which such liability is accrued. Additionally, due to the uncertainties associated with the amount of any such liability and/or the nature of any other remedy which may be imposed in such litigation, any potential liability determined to be attributable to the Company arising out of such litigation may have a material adverse effect on the Company's results of operations, liquidity or financial condition. An estimate of the potential impact on the Company's results of operations, liquidity or financial condition cannot be made due to the aforementioned uncertainties.

Public nuisance claim litigation. The Company and other companies are or were defendants in legal proceedings seeking recovery based on public nuisance liability theories, among other theories, brought by the State of Rhode Island, the City of St. Louis, Missouri, various cities and counties in the State of New Jersey, various cities in the State of Ohio and the State of Ohio, the City of Chicago, Illinois, the City of Milwaukee, Wisconsin and the County of Santa Clara, California and other public entities in the State of California. Except for the Santa Clara County, California proceeding, all of these legal proceedings have been concluded in favor of the Company and other defendants at various stages in the proceedings.

The proceedings initiated by the State of Rhode Island included two jury trials. At the conclusion of the second trial, the jury returned a verdict finding that (i) the cumulative presence of lead pigment in paints and coatings on buildings in the State of Rhode Island constitutes a public nuisance, (ii) the Company, along with two other defendants, caused or substantially contributed to the creation of the public nuisance, and (iii) the Company and two other defendants should be ordered to abate the public nuisance. The Company and two other defendants appealed and, on July 1, 2008, the Rhode Island Supreme Court, among other determinations, reversed the judgment of abatement with respect to the Company and two other defendants. The Rhode Island Supreme Court's decision reversed the public nuisance liability judgment against the Company on the basis that the complaint failed to state a public nuisance claim as a matter of law.

The Santa Clara County, California proceeding was initiated in March 2000 in the Superior Court of the State of California, County of Santa Clara. In the original complaint, the plaintiffs asserted various claims including fraud and concealment, strict product liability/failure to warn, strict product liability/design defect, negligence, negligent breach of a special duty, public nuisance, private nuisance, and violations of California's Business and Professions Code. A number of the asserted claims were resolved in favor of the defendants through pre-trial proceedings. The named plaintiffs in the Fourth Amended Complaint, filed on March 16, 2011, are the Counties of Santa Clara, Alameda, Los

Angeles, Monterey, San Mateo, Solano and Ventura, and the Cities of Oakland, San Diego and San Francisco. The Fourth Amended Complaint asserts a sole claim for public nuisance, alleging that the presence of lead products for use in paint and coatings in, on and around buildings in the plaintiffs' jurisdictions constitutes a public nuisance. The plaintiffs seek the abatement of the alleged public nuisance that exists within the plaintiffs' jurisdictions. A trial commenced on July 15, 2013 and ended on August 22, 2013. Closing arguments were heard on September 23, 2013. The trial court is expected to issue its decision by December 31, 2013.

Litigation seeking damages from alleged personal injury. The Company and other companies are defendants in a number of legal proceedings seeking monetary damages and other relief from alleged personal injuries. These proceedings include claims by children allegedly injured from ingestion of lead pigment or lead-containing paint, claims for damages allegedly incurred by the children's parents or guardians, and claims for damages allegedly incurred by professional painting contractors. These

proceedings generally seek compensatory and punitive damages, and seek other relief including medical monitoring costs. These proceedings include purported claims by individuals, groups of individuals and class actions.
The plaintiff in Thomas v. Lead Industries Association, et al., initiated an action in state court against the Company, other alleged former lead pigment manufacturers and the Lead Industries Association in September 1999. The claims against the Company and the other defendants included strict liability, negligence, negligent misrepresentation and omissions, fraudulent misrepresentation and omissions, concert of action, civil conspiracy and enterprise liability. Implicit within these claims is the theory of “risk contribution” liability (Wisconsin’s theory which is similar to market share liability) due to the plaintiff’s inability to identify the manufacturer of any product that allegedly injured the plaintiff. The case ultimately proceeded to trial and, on November 5, 2007, the jury returned a defense verdict, finding that the plaintiff had ingested white lead carbonate, but was not brain damaged or injured as a result. The plaintiff appealed and, on December 16, 2010, the Wisconsin Court of Appeals affirmed the final judgment in favor of the Company and other defendants.
Wisconsin is the only jurisdiction to date to apply a theory of liability with respect to alleged personal injury (i.e., risk contribution/market share liability) that does not require the plaintiff to identify the manufacturer of the product that allegedly injured the plaintiff in the lead pigment and lead-based paint litigation. Although the risk contribution liability theory was applied during the Thomas trial, the constitutionality of this theory as applied to the lead pigment cases has not been judicially determined by the Wisconsin state courts. However, in an unrelated action filed in the United States District Court for the Eastern District of Wisconsin, Gibson v. American Cyanamid, et al., on November 15, 2010, the District Court held that Wisconsin’s risk contribution theory as applied in that case violated the defendants’ right to substantive due process and is unconstitutionally retroactive. The District Court's decision in Gibson v. American Cyanamid, et al., has been appealed by the plaintiff.
Insurance coverage litigation. The Company and its liability insurers, including certain underwriters at Lloyd’s of London, initiated legal proceedings against each other to primarily determine, among other things, whether the costs and liabilities associated with the abatement of lead pigment are covered under certain insurance policies issued to the Company. The Company’s action, filed on March 3, 2006 in the Common Pleas Court, Cuyahoga County, Ohio, is currently stayed and inactive. The liability insurers’ action, which was filed on February 23, 2006 in the Supreme Court of the State of New York, County of New York, has been dismissed. An ultimate loss in the insurance coverage litigation would mean that insurance proceeds could be unavailable under the policies at issue to mitigate any ultimate abatement related costs and liabilities. The Company has not recorded any assets related to these insurance policies or otherwise assumed that proceeds from these insurance policies would be received in estimating any contingent liability accrual. Therefore, an ultimate loss in the insurance coverage litigation without a determination of liability against the Company in the lead pigment or lead-based paint litigation will have no impact on the Company’s results of operation, liquidity or financial condition. As previously stated, however, the Company has not accrued any amounts for the lead pigment or lead-based paint litigation and any significant liability ultimately determined to be attributable to the Company relating to such litigation may result in a material impact on the Company’s results of operations, liquidity or financial condition for the annual or interim period during which such liability is accrued.

Department of Labor (DOL) leveraged ESOP settlement. As previously disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012, on February 20, 2013, the Company reached a settlement with the DOL of the DOL's investigation of transactions related to the Company's ESOP that were implemented on August 1, 2006 and August 27, 2003. The DOL had notified the Company, among others, of potential enforcement claims asserting breaches of fiduciary obligations and sought compensatory and equitable remedies. The Company resolved all ESOP related claims with the DOL by agreeing, in part, to make a one-time payment of $80.0 million to the ESOP, resulting in a $49.2 million after tax charge to earnings in the fourth quarter of 2012. The Company made this required $80.0 million payment to the ESOP during the first quarter of 2013.

Government tax assessment settlements related to Brazilian operations. Charges of $16.9 million and $28.7 million were recorded to cost of goods sold in the quarter and nine months, respectively, and $2.9 million to SG&A in the quarter and nine months. The charges in the quarter and nine months were primarily related to import duty taxes paid to the Brazilian government related to the handling of import duties on products brought into the country for the years 2006 through 2012. The Company elected to pay the taxes through an existing voluntary amnesty program offered by the government to resolve these issues rather than contest them in court. The after-tax charges were $13.5 million and $21.9 million, respectively, for the quarter and nine months. The Company's import duty process in Brazil was changed to reach a final resolution of this matter with the Brazilian government.

Shareholders' Equity

Shareholders' equity increased $77.8 million to $1.870 billion at September 30, 2013 from $1.792 billion at December 31, 2012 and increased $90.2 million from $1.779 billion at September 30, 2012. The increase in Shareholders' equity for the first nine months of 2013 resulted primarily from net income of $636.4 million and an increase in Other capital of $125.0 million, resulting primarily from stock option exercises, partially offset by purchases of treasury stock of $492.0 million, cash dividends paid on common stock of $154.4 million, and an increase in Cumulative other comprehensive loss of $18.7 million. Since September 30, 2012, net income of $704.5 million and an increase in Other capital of $246.6 million more than offset purchases of treasury stock for $616.7 million, cash dividends paid on common stock of $194.7 million and an increase in Cumulative other comprehensive loss of $31.7 million in twelve months. During the first nine months of 2013, the Company purchased 2.80 million shares of its common stock for treasury purposes through open market purchases. The Company purchased 3.60 million shares of its common stock since September 30, 2012 for treasury. The Company acquires its common stock for general corporate purposes, and depending on its cash position and market conditions, it may acquire additional shares in the future. The Company had remaining authorization at September 30, 2013 to purchase 13.65 million shares of its common stock. At a meeting held on February 13, 2013, the Board of Directors increased the quarterly cash dividend from $.39 per common share to $.50 per common share. This quarterly dividend will result in an annual dividend for 2013 of $2.00 per common share or a 33.2 percent payout of 2012 diluted net income per common share.

Cash Flow

Net operating cash improved $208.6 million in the first nine months of 2013 to a cash source of $777.9 million from a cash source of $569.3 million in 2012 primarily due to an increase in net income of $73.5 million, improved working capital management, and a payment to the IRS for the 2011 ESOP settlement of $59.1 million in the first quarter of 2012 partially offset by a payment to the ESOP for the 2012 DOL settlement of $80.0 million in the first quarter of 2013. Net investing cash usage increased $78.8 million in the first nine months of 2013 to a usage of $253.9 million from a usage of $175.0 million in 2012 primarily due to acquisitions of businesses and increased cash used in other investments. Net financing cash usage decreased $22.1 million to a usage of $347.5 million in the first nine months of 2013 from a usage of $369.6 million in 2012 primarily due to net increases in short-term borrowings of $243.5 million in the first nine months of 2013 partially offset by decreased proceeds from stock options exercised of $113.4 million and increases in treasury stock purchases of $59.0 million. In the twelve month period from October 1, 2012 through September 30, 2013, the Company generated net operating cash of $1.097 billion, including a payment to the ESOP for the 2012 DOL settlement of $80.0 million in the first quarter of 2013, used $421.3 million in investing activities, and generated $308.7 million in financing activities. In that same period, the Company invested $162.6 million in capital additions and improvements and $145.1 million in acquisitions, received net proceeds from total debt of $954.0 million, purchased $616.7 million in treasury stock and paid $194.7 million in cash dividends to its shareholders of common stock.

Market Risk

The Company is exposed to market risk associated with interest rate, foreign currency and commodity fluctuations. The Company occasionally utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. In the first nine months of 2013, the Company entered into forward currency exchange contracts with maturity dates of less than twelve months to hedge against value changes in foreign currency. The Company believes it may be exposed to continuing market risk from foreign currency exchange rate and commodity price fluctuations. However, the Company does not expect that foreign currency exchange rate and commodity price fluctuations or hedging contract losses will have a material adverse effect on the Company's financial condition, results of operations or cash flows.

Financial Covenant

Certain borrowings contain a consolidated leverage covenant. The covenant states the Company's leverage ratio is not to exceed 3.00 to 1.00. In connection with the new credit facility entered into on July 8, 2011, the leverage ratio for that facility was increased to 3.25 to 1.00. The leverage ratio is defined as the ratio of total indebtedness (the sum of Short-term borrowings, Current portion of long-term debt and Long-term debt) at the reporting date to consolidated "Earnings Before Interest, Taxes, Depreciation, and Amortization" (EBITDA) for the twelve month period ended on the same date. Refer to the “Results of Operations” caption below for a reconciliation of EBITDA to Net income. At September 30, 2013, the Company was in compliance with the covenant. The Company’s Notes, Debentures and revolving credit agreements contain various default and cross-default provisions. In the event of default under any one of these arrangements, acceleration of the maturity of any one or more of these borrowings may result. See Note 7, on page 62 and 63, in the Company’s Annual Report on Form 10-K for the year ended December 31, 2012 for more information concerning the Company’s debt and related covenant.

RESULTS OF OPERATIONS

Shown below are net sales and income before taxes by segment for the third quarter and first nine months:

(Thousands of dollars)	Three Months Ended September 30,			Nine Months Ended September 30,		
	2013	2012	Change	2013	2012	Change
Net Sales:						
Paint Stores Group	$1,763,404	$1,553,461	13.5 %	$4,537,849	$4,164,648	9.0 %
Consumer Group	366,845	348,001	5.4 %	1,069,085	1,066,123	0.3 %
Global Finishes Group	507,284	491,816	3.1 %	1,507,626	1,473,584	2.3 %
Latin America Coatings Group	208,645	208,726	0.0 %	610,271	604,600	0.9 %
Administrative	1,239	1,222	1.4 %	3,643	3,637	0.2 %
Total	$2,847,417	$2,603,226	9.4 %	$7,728,474	$7,312,592	5.7 %

(Thousands of dollars)	Three Months Ended September 30,			Nine Months Ended September 30,		
	2013	2012	Change	2013	2012	Change
Income Before Income Taxes:						
Paint Stores Group	$359,352	$300,563	19.6 %	$822,037	$680,257	20.8 %
Consumer Group	73,065	57,054	28.1 %	206,079	193,117	6.7 %
Global Finishes Group	44,536	36,415	22.3 %	132,929	113,084	17.5 %
Latin America Coatings Group	(983)	21,931	-104.5 %	20,712	51,099	-59.5 %
Administrative	(88,508)	(72,965)	-21.3 %	(245,027)	(224,441)	-9.2 %
Total	$387,462	$342,998	13.0 %	$936,730	$813,116	15.2 %

Consolidated net sales increased in the third quarter and first nine months of 2013 due primarily to higher paint sales volume in our Paint Stores Group. Acquisitions increased consolidated net sales 1.1 percent and 0.9 percent in the quarter and nine months, respectively, while unfavorable currency translation rate changes decreased consolidated net sales 0.8 percent and 0.7 percent in the quarter and nine months, respectively.

Net sales of all consolidated foreign subsidiaries were up 5.3 percent to $523.7 million in the quarter and up 5.4 percent to $1.572 billion in the first nine months versus $497.6 million and $1.491 billion in the same periods last year. The increase in net sales for all consolidated foreign subsidiaries in the quarter was due primarily to acquisitions, which increased net sales 5.9 percent in the quarter, and selling price increases partially offset by a 4.0 percent negative impact of foreign currency translation rate changes. The increase in the first nine months was due primarily to acquisitions, which increased net sales 4.6 percent in the first nine months, and selling price increases partially offset by a 3.0 percent negative impact of foreign currency translation rate changes. Net sales of all operations other than consolidated foreign subsidiaries were up 10.4 percent to $2.324 billion in the quarter and up 5.8 percent to $6.156 billion in the first nine months as compared to $2.106 billion and $5.821 billion in the same periods last year.

Net sales in the Paint Stores Group increased in the third quarter and first nine months due primarily to higher architectural paint sales volume and acquisitions. Net sales from stores open for more than twelve calendar months increased 10.9 percent in the quarter and increased 7.4 percent in the first nine months compared to last year’s comparable periods. Total paint sales volume percentage increases exceeded 10.0 percent for the quarter and first nine months as compared to last year’s comparable periods. Sales of non-paint products increased by 13.7 percent over last year’s third quarter and increased by 10.2 percent over last year's first nine months. A discussion of changes in volume versus pricing for sales of products other than paint is not pertinent due to the wide assortment of general merchandise sold. Net sales of the Consumer Group increased in the third quarter due primarily to timing of seasonal shipments to some customers and acquisitions, and was nearly flat in the first nine months, primarily due to acquisitions partially offset by the previously disclosed elimination of a portion of a paint program with a large retail customer. Acquisitions increased net sales 0.2 percent and 2.7 percent in the quarter and first nine months, respectively. Net sales in the Global Finishes Group stated in U.S. dollars increased in the third quarter and first nine months, due primarily to selling price increases and acquisitions. Acquisitions increased net sales in U.S. dollars by 1.3 percent and

1.2 percent for the third quarter and first nine months, respectively, which offset the slight impacts of unfavorable currency translation rate changes in the quarter and first nine months. Net sales in the Latin America Coatings Group stated in U.S.

26

dollars decreased slightly in the third quarter and first nine months, which can primarily be attributed to selling price increases and higher paint sales volume partially offset by unfavorable currency translation rate changes. Currency translation rate changes decreased net sales by 8.9 percent in the quarter and 6.2 percent in the first nine months. Net sales in the Administrative segment, which primarily consist of external leasing revenue of excess headquarters space and leasing of facilities no longer used by the Company in its primary business, were essentially flat in the third quarter and first nine months.

Consolidated gross profit increased $145.7 million in the third quarter and increased $281.7 million in the first nine months of 2013 compared to the same periods in 2012. As a percent of sales, consolidated gross profit increased to 45.5 percent in the quarter from 44.2 percent in the third quarter of 2012 and improved to 45.2 percent in the first nine months of 2013 from 43.9 percent last year. The percent to sales and dollar increases were primarily due to increased paint sales volume and selling price increases.

The Paint Stores Group’s gross profit was higher than last year by $129.4 million in the third quarter and was higher than last year by $250.0 million in the first nine months due to increased paint sales volume. The Paint Stores Group’s gross profit margins were higher in the quarter and first nine months compared to the same periods last year. The Consumer Group’s gross profit increased by $17.5 million in the quarter and increased by $20.0 million in the first nine months and gross profit margins increased as a percent of sales for the third quarter and first nine months compared to the same periods last year primarily due to improved operating efficiencies. The Global Finishes Group’s gross profit increased $12.7 million in the third quarter and increased $35.0 million in the first nine months compared to the same periods last year, when stated in U.S. dollars, due primarily to selling price increases, acquisitions and improved operating efficiencies partially offset by unfavorable currency translation rate changes. The Global Finishes Group’s gross profit margins were up as a percent of sales in the quarter and first nine months compared to last year primarily due to selling price increases and improved operating efficiencies. The Latin America Coatings Group’s gross profit decreased by $12.3 million in the third quarter and $22.4 million in the first nine months from the same periods in the prior year, when stated in U.S. dollars, primarily due to a government import duty assessments related to our Brazilian operations and unfavorable currency translation rate changes partially offset by selling price increases. Charges of $16.9 million and $28.7 million were recorded to cost of goods sold in the quarter and nine months, respectively. The charges in the quarter and nine months were primarily related to import duty taxes paid to the Brazilian government related to the handling of import duties on products brought into the country for the years 2006 through 2012. The Company elected to pay the taxes through an existing voluntary amnesty program offered by the government to resolve these issues rather than contest them in court. The Latin America Coatings Group’s gross profit margins were down as a percent of sales for the third quarter and first nine months as compared to the same periods last year for these same reasons. The Administrative segment’s gross profit decreased by an insignificant amount in the third quarter and first nine months compared to the same periods last year.

Selling, general and administrative expenses (SG&A) increased $89.9 million in the third quarter and increased $137.8 million in the first nine months of 2013 versus last year due primarily to increased expenses to support higher sales levels and net new store openings. As a percent of sales, consolidated SG&A increased to 31.2 percent in the quarter from 30.7 percent in the third quarter of 2012 and was flat at 32.4 percent in the first nine months primarily due to timing of net new store openings in the quarter and acquisitions.

The Paint Stores Group’s SG&A increased $70.6 million in the third quarter and increased $107.1 million in the first nine months due primarily to net new store openings and general comparable store expenses to support higher sales levels. The Consumer Group’s SG&A was up $1.2 million in the quarter and increased $6.2 million in the first nine months compared to the same periods last year primarily due to acquisitions. The Global Finishes Group’s SG&A increased $3.4 million in the quarter and increased $4.5 million in the first nine months primarily due to acquisitions. The Latin America Coatings Group’s SG&A increased $5.5 million in the third quarter and increased $5.8 million in the first nine months due primarily government tax assessment settlements related to Brazilian operations of $2.9 million and timing of spending partially offset by currency translation rate changes. The Administrative segment’s SG&A increased $9.2 million in the third quarter and increased $14.2 million in the first nine months primarily due to acquisition due diligence efforts and information systems costs.

Other general expense—net decreased $0.3 million in the third quarter and decreased $4.0 million in the first nine months. The decrease in the first nine months was primarily due to decreased provisions for environmental expenses and a current period loss on disposal of assets versus prior period gain on disposal of assets both in the Administrative segment.

Other income—net decreased $6.7 million in the third quarter and decreased $9.8 million in the first nine months primarily due to 2013 foreign currency losses versus 2012 gains for both time periods partially offset by increased miscellaneous income both primarily impacting the Global Finishes and Latin America Coatings Groups.

27

Consolidated income before income taxes increased $44.5 million in the third quarter and increased $123.6 million in the first nine months of 2013 due to higher segment profits in Paint Stores, Consumer and Global Finishes Groups partially offset by lower segment profits in the Latin America Coatings Groups and increased expenses in the Administrative segment.

The effective income tax rate of 32.1 percent for the third quarter of 2013 was higher than the 31.5 percent effective income tax rate for the third quarter of 2012 due primarily to the timing of discrete items. The effective income tax rate of 32.1 percent for the first nine months of 2013 was higher than the 30.8 percent effective income tax rate for the first nine months of 2012 due primarily to the timing of discrete items.

Net income for the quarter increased $28.0 million to $263.0 million from $235.0 million in the third quarter of 2012 and increased $73.5 million to $636.4 million from $563.0 million in the first nine months of 2012. Diluted net income per common share increased 13.8 percent from $2.24 per share in the third quarter of 2012 to $2.55 per share in the third quarter of 2013, including after tax charges of $.13 per share resulting from government tax assessments related to our Brazilian operations. Diluted net income per common share increased 13.8 percent from $5.37 in the first nine months of 2012 to $6.11 in the first nine months of 2013, including after tax charges of $.21 per share resulting from government tax assessments related to our Brazilian operations.

Management considers a measurement that is not in accordance with U.S. generally accepted accounting principles a useful measurement of the operational profitability of the Company. Some investment professionals also utilize such a measurement as an indicator of the value of profits and cash that are generated strictly from operating activities, putting aside working capital and certain other balance sheet changes. For this measurement, management increases net income for significant non-operating and non-cash expense items to arrive at an amount known as “Earnings Before Interest, Taxes, Depreciation and Amortization” (EBITDA). The reader is cautioned that the following value for EBITDA should not be compared to other entities unknowingly. EBITDA should not be considered an alternative to net income or cash flows from operating activities as an indicator of operating performance or as a measure of liquidity. The reader should refer to the determination of net income and cash flows from operating activities in accordance with U. S. generally accepted accounting principles disclosed in the Statements of Consolidated Income and Statements of Consolidated Cash Flows. EBITDA as used by management is calculated as follows:

(Thousands of dollars)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	$262,966	$234,953	$636,438	$562,982
Interest expense	15,394	10,358	45,774	30,925
Income taxes	124,496	108,045	300,292	250,134
Depreciation	39,392	37,829	117,693	113,336
Amortization	7,346	7,136	21,473	20,099
EBITDA	$449,594	$398,321	$1,121,670	$977,476

28

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain statements contained in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and elsewhere in this report constitute “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. These forward-looking statements are based upon management’s current expectations, estimates, assumptions and beliefs concerning future events and conditions and may discuss, among other things, anticipated future performance (including sales and earnings), expected growth, future business plans and the costs and potential liability for environmental-related matters and the lead pigment and lead-based paint litigation. Any statement that is not historical in nature is a forward-looking statement and may be identified by the use of words and phrases such as “expects,” “anticipates,” “believes,” “will,” “will likel result,” “will continue,” “plans to” and similar expressions.

Readers are cautioned not to place undue reliance on any forward-looking statements. Forward-looking statements are necessarily subject to risks, uncertainties and other factors, many of which are outside the control of the Company, that could cause actual results to differ materially from such statements and from the Company’s historical results and experience. These risks, uncertainties and other factors include such things as: (a) the duration and severity of the current negative global economic and financial conditions; (b) general business conditions, strengths of retail and manufacturing economies and the growth in the coatings industry; (c) competitive factors, including pricing pressures and product innovation and quality; (d) changes in raw material and energy supplies and pricing; (e) changes in the Company’s relationships with customers and suppliers; (f) the Company’s ability to attain cost savings from productivity initiatives; (g) the Company’s ability to successfully integrate past and future acquisitions into its existing operations, including the planned acquisition of the Comex business in Mexico and the recent acquisitions of the Comex business in the United States and Canada, Leighs Paints, Geocel and Jiangsu Pulanna, as well as the performance of the businesses acquired; (h) risks and uncertainties associated with the Company’s ownership of Life Shield Engineered Systems LLC; (i) changes in general domestic economic conditions such as inflation rates, interest rates, tax rates, unemployment rates, higher labor and healthcare costs, recessions, and changing government policies, laws and regulations; (j) risks and uncertainties associated with the Company’s expansion into and its operations in Asia, Europe, Mexico, South America and other foreign markets, including general economic conditions, inflation rates, recessions, foreign currency exchange rates, foreign investment and repatriation restrictions, legal and regulatory constraints, civil unrest and other external economic and political factors; (k) the achievement of growth in foreign markets, such as Asia, Europe, Mexico and South America; (l) increasingly stringent domestic and foreign governmental regulations including those affecting health, safety and the environment; (m) inherent uncertainties involved in assessing the Company’s potential liability for environmental-related activities; (n) other changes in governmental policies, laws and regulations, including changes in accounting policies and standards and taxation requirements (such as new tax laws and new or revised tax law interpretations); (o) the nature, cost, quantity and outcome of pending and future litigation and other claims, including the lead pigment and lead-based paint litigation, and the effect of any legislation and administrative regulations relating thereto; and (p) unusual weather conditions.

Readers are cautioned that it is not possible to predict or identify all of the risks, uncertainties and other factors that may affect future results and that the above list should not be considered to be a complete list. Any forward-looking statement speaks only as of the date on which such statement is made, and the Company undertakes no obligation to update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk associated with interest rate, foreign currency and commodity fluctuations. The Company occasionally utilizes derivative instruments as part of its overall financial risk management policy, but does not use derivative instruments for speculative or trading purposes. The Company enters into option and forward currency exchange contracts and commodity swaps to hedge against value changes in foreign currency and commodities. The Company believes it may experience continuing losses from foreign currency translation and commodity price fluctuations. However, the Company does not expect currency translation, transaction, commodity price fluctuations or hedging contract losses to have a material adverse effect on the Company's financial condition, results of operations or cash flows. There were no material changes in the Company's exposure to market risk since the disclosure included in Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Item 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chairman and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 and Rule 15d-15 of the Securities Exchange Act of 1934, as amended ("Exchange Act"). Based upon that evaluation, our Chairman and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer concluded that as of the end of the period covered by this report our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and accumulated and communicated to our management including our Chairman and Chief Executive Officer and our Senior Vice President—Finance and Chief Financial Officer, to allow timely decisions regarding required disclosure.
There were no changes in our internal control over financial reporting identified in connection with the evaluation that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

For information with respect to certain environmental-related matters and legal proceedings, see the information included under the captions entitled “Environmental-Related Liabilities” and “Litigation” of “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and Notes 8 and 9 of the “Notes to Condensed Consolidated Financial Statements,” which is incorporated herein by reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.
A summary of the repurchase activity for the Company's third quarter is as follows:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Number of Shares Purchased as Part of a Publicly Announced Plan	Number of Shares That May Yet Be Purchased Under the Plan
July 1 - July 31				
Share repurchase program (1)	500,000	$172.63	500,000	14,650,000
August 1 - August 31				
Share repurchase program (1)	750,000	$170.81	750,000	13,900,000
Employee transactions (2)	584	171.11		NA
September 1 - September 30				
Share repurchase program (1)	250,000	$180.30	250,000	13,650,000
Total				
Share repurchase program (1)	1,500,000	$173.00	1,500,000	13,650,000
Employee transactions (2)	584	171.11		NA

(1) All shares were purchased through the Company's publicly announced share repurchase program. The Company had remaining authorization at September 30, 2013 to purchase 13,650,000 shares. There is no expiration date specified for the program. The Company intends to repurchase stock under the program in the future.

(2) All shares were delivered to satisfy the exercise price and/or tax withholding obligations by employees who exercised stock options or had shares of restricted stock vest.

33

Item 5. Other Information.

During the fiscal quarter ended September 30, 2013, the Audit Committee of the Board of Directors of the Company approved permitted non-audit services to be performed by Ernst & Young LLP, the Company’s independent registered public accounting firm. These non-audit services were approved within categories related to domestic advisory tax and tax compliance services and international tax compliance.

34

Item 6. Exhibits.

10(a)	Amendment No. 2 to Stock Purchase Agreement, dated August 21, 2013, by and among Avisep, S.A. de C.V., Bevisep, S.A. de C.V., Sherwin-Williams (Caribbean) N.V. and the Company (filed herewith).
10(b)	Amended and Restated Stock Purchase Agreement, dated September 16, 2013, by and among Avisep, S.A. de C.V., Bevisep, S.A. de C.V., Sherwin-Williams (Caribbean) N.V. and the Company (filed herewith).*
10(c)	Stock Purchase Agreement, dated September 16, 2013, by and among Avisep, S.A. de C.V., Bevisep, S.A. de C.V., Consorcio Comex, S.A. de C.V., SWC Acquisition Corp. and the Company (filed herewith).*
31(a)	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer (filed herewith).
31(b)	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer (filed herewith).
32(a)	Section 1350 Certification of Chief Executive Officer (filed herewith).
32(b)	Section 1350 Certification of Chief Financial Officer (filed herewith).
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

*Schedules have been omitted pursuant to Item 601(b)(2) of Regulation S-K. The Company agrees to furnish supplementally to the Securities and Exchange Commission a copy of any omitted schedule upon request.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

		THE SHERWIN-WILLIAMS COMPANY
October 30, 2013	By:	/s/ Allen J. Mistysyn Allen J. Mistysyn Vice President-Corporate Controller
October 30, 2013	By:	/s/ Catherine M. Kilbane Catherine M. Kilbane Senior Vice President, General Counsel and Secretary

36

INDEX TO EXHIBITS

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