

PENSKE AUTOMOTIVE GROUP, INC.

Form 10-Q

August 03, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q

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

For the quarterly period ended June 30, 2007

or

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 1-12297

Penske Automotive Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

22-3086739

(I.R.S. Employer Identification No.)

**2555 Telegraph Road,
Bloomfield Hills, Michigan**

(Address of principal executive offices)

48302-0954

(Zip Code)

Registrant's telephone number, including area code:

(248) 648-2500

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 No
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

Accelerated Filer

Non-accelerated Filer

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

As of July 23, 2007, there were 94,948,516 shares of voting common stock outstanding.

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**PENSKE AUTOMOTIVE GROUP, INC.
CONSOLIDATED CONDENSED BALANCE SHEETS**

	June 30, 2007	December 31, 2006
	(Unaudited)	
	(In thousands, except per share amounts)	
ASSETS		
Cash and cash equivalents	\$ 18,256	\$ 13,147
Accounts receivable, net of allowance for doubtful accounts of \$2,717 and \$2,867	474,674	470,301
Inventories, net	1,635,690	1,525,800
Other current assets	99,653	71,526
Assets held for sale	139,907	190,881
Total current assets	2,368,180	2,271,655
Property and equipment, net	563,548	582,407
Goodwill	1,328,707	1,259,886
Franchise value	297,552	246,118
Other assets	93,094	109,736
Total assets	\$ 4,651,081	\$ 4,469,802
 LIABILITIES AND STOCKHOLDERS EQUITY		
Floor plan notes payable	\$ 1,108,688	\$ 874,326
Floor plan notes payable non-trade	452,850	298,703
Accounts payable	290,911	301,592
Accrued expenses	257,126	214,544
Current portion of long-term debt	14,725	13,385
Liabilities held for sale	69,959	50,560
Total current liabilities	2,194,259	1,753,110
Long-term debt	831,771	1,168,666
Other long-term liabilities	277,135	252,373
Total liabilities	3,303,165	3,174,149
Commitments and contingent liabilities		
Stockholders Equity		
Preferred Stock, \$0.0001 par value; 100 shares authorized; none issued and outstanding		
	9	9

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Common Stock, \$0.0001 par value, 240,000 shares authorized; 94,933 shares issued at June 30, 2007; 94,468 shares issued at December 31, 2006		
Non-voting Common Stock, \$0.0001 par value, 7,125 shares authorized; none issued and outstanding		
Class C Common Stock, \$0.0001 par value, 20,000 shares authorized; none issued and outstanding		
Additional paid-in-capital	727,893	768,794
Retained earnings	529,959	492,704
Accumulated other comprehensive income	90,055	79,379
Treasury stock, at cost; 0 shares at June 30, 2007 and 5,306 shares at December 31, 2006		(45,233)
Total stockholders' equity	1,347,916	1,295,653
Total liabilities and stockholders' equity	\$ 4,651,081	\$ 4,469,802

See Notes to Consolidated Condensed Financial Statements

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PENSKE AUTOMOTIVE GROUP, INC.
CONSOLIDATED CONDENSED STATEMENTS OF INCOME

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006 (Restated)*	2007	2006 (Restated)*
	(Unaudited)			
	(In thousands, except per share amounts)			
Revenue:				
New vehicle	\$ 1,831,369	\$ 1,583,639	\$ 3,479,067	\$ 3,017,486
Used vehicle	829,057	631,982	1,617,464	1,187,322
Finance and insurance, net	75,698	65,680	144,666	123,745
Service and parts	357,377	306,924	710,310	600,905
Fleet and wholesale vehicle	288,137	249,502	538,570	462,725
Total revenues	3,381,638	2,837,727	6,490,077	5,392,183
Cost of sales:				
New vehicle	1,678,521	1,444,861	3,187,699	2,752,530
Used vehicle	763,636	577,581	1,490,807	1,082,744
Service and parts	156,407	137,730	313,501	269,806
Fleet and wholesale vehicle	287,089	248,064	534,586	458,554
Total cost of sales	2,885,653	2,408,236	5,526,593	4,563,634
Gross profit	495,985	429,491	963,484	828,549
Selling, general and administrative expenses	389,276	334,600	764,862	657,345
Depreciation and amortization	13,337	10,805	26,147	20,982
Operating income	93,372	84,086	172,475	150,222
Floor plan interest expense	(19,546)	(16,218)	(35,721)	(30,191)
Other interest expense	(12,917)	(11,436)	(31,776)	(23,383)
Equity in earnings of affiliates	2,529	1,968	1,708	3,118
Loss on debt redemption			(18,634)	
Income from continuing operations before income taxes and minority interests	63,438	58,400	88,052	99,766
Income taxes	(23,473)	(21,457)	(31,829)	(36,521)
Minority interests	(702)	(636)	(996)	(1,058)

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Income from continuing operations	39,263	36,307	55,227	62,187
Income (loss) from discontinued operations, net of tax	1,092	386	(290)	(1,539)
Net income	\$ 40,355	\$ 36,693	\$ 54,937	\$ 60,648
Basic earnings per share:				
Continuing operations	\$ 0.42	\$ 0.39	\$ 0.59	\$ 0.67
Discontinued operations	0.01	0.00	0.00	(0.02)
Net income	0.43	0.39	0.58	0.65
Shares used in determining basic earnings per share	94,033	93,900	93,940	93,461
Diluted earnings per share:				
Continuing operations	\$ 0.42	\$ 0.38	\$ 0.58	\$ 0.66
Discontinued operations	0.01	0.00	0.00	(0.02)
Net income	0.43	0.39	0.58	0.64
Shares used in determining diluted earnings per share	94,532	94,636	94,483	94,499
Cash dividends per share	\$ 0.07	\$ 0.07	\$ 0.14	\$ 0.13

* See Note 1

See Notes to Consolidated Condensed Financial Statements

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PENSKE AUTOMOTIVE GROUP, INC.
CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

	Six Months Ended June 30,	
	2007	2006 (Restated)*
	(Unaudited)	
	(In thousands)	
Operating Activities:		
Net income	\$ 54,937	\$ 60,648
Adjustments to reconcile net income to net cash from continuing operating activities:		
Depreciation and amortization	26,147	20,982
Undistributed earnings of equity method investments	(1,708)	(3,114)
Loss from discontinued operations, net of tax	290	1,539
Deferred income taxes	9,314	10,181
Loss on debt redemption	18,634	
Minority interests	996	1,058
Changes in operating assets and liabilities:		
Accounts receivable	14,703	19,402
Inventories	(66,974)	(121,157)
Floor plan notes payable	234,362	138,298
Accounts payable and accrued expenses	22,186	91,802
Other	(32,068)	(33,154)
Net cash from continuing operating activities	280,819	186,485
Investing Activities:		
Purchase of equipment and improvements	(73,193)	(110,910)
Proceeds from sale-leaseback transactions	76,509	21,443
Dealership acquisitions net, including repayment of sellers' floorplan notes payable of \$42,959 and \$86,886, respectively	(151,528)	(225,220)
Other	13,264	
Net cash from continuing investing activities	(134,948)	(314,687)
Financing Activities:		
Proceeds from borrowings under U.S. credit agreement	241,500	200,000
Repayments under U.S. credit agreement	(241,500)	(440,000)
Redemption 9 5/8% Senior Subordinated debt	(314,439)	
Issuance of convertible subordinated debt		375,000
Net borrowings (repayments) of other long-term debt	(38,828)	4,463
Net borrowings of floor plan notes payable - non-trade	154,147	22,250
Payment of deferred financing costs		(11,771)

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Proceeds from exercises of options, including excess tax benefit	1,527	17,492
Repurchase of common stock		(18,955)
Dividends	(13,252)	(12,063)
Net cash from continuing financing activities	(210,845)	136,416
Discontinued operations:		
Net cash from discontinued operating activities	13,866	6,431
Net cash from discontinued investing activities	40,058	8,056
Net cash from discontinued financing activities	16,159	(4,645)
Net cash from discontinued operations	70,083	9,842
Net change in cash and cash equivalents	5,109	18,056
Cash and cash equivalents, beginning of period	13,147	8,957
Cash and cash equivalents, end of period	\$ 18,256	\$ 27,013

Supplemental disclosures of cash flow information:

Cash paid for:		
Interest	\$ 76,418	\$ 50,874
Income taxes	12,598	14,244
Seller financed debt	4,953	

* See Note 1

See Notes to Consolidated Condensed Financial Statements

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PENSKE AUTOMOTIVE GROUP, INC.
CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS EQUITY

	Common Stock Issued Shares	Amount	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income	Treasury Stock	Total Stockholders Equity
(Unaudited) (Dollars in thousands)							
Balances, January 1, 2007	94,468,013	\$ 9	\$ 768,794	\$ 492,704	\$ 79,379	\$ (45,233)	\$ 1,295,653
Adoption of FIN 48 (Note 1)				(4,430)			(4,430)
Restricted stock	348,182		2,805				2,805
Exercise of options, including tax benefit of \$652	116,385		1,527				1,527
Dividends				(13,252)			(13,252)
Foreign currency translation					10,209		10,209
Other					467		467
Retirement of Treasury Stock			(45,233)			45,233	
Net income				54,937			54,937
Balances, June 30, 2007	94,932,580	\$ 9	\$ 727,893	\$ 529,959	\$ 90,055	\$	\$ 1,347,916

See Notes to Consolidated Condensed Financial Statements

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PENSKE AUTOMOTIVE GROUP, INC.
NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Unaudited)
(In thousands, except per share amounts)

1. Interim Financial Statements

Basis of Presentation

The following unaudited consolidated condensed financial statements of Penske Automotive Group, Inc. (the Company) have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and disclosures normally included in the Company s annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to the SEC rules and regulations. The information presented as of June 30, 2007 and December 31, 2006 and for the three and six month periods ended June 30, 2007 and 2006 is unaudited, but includes all adjustments which the management of the Company believes to be necessary for the fair presentation of results for the periods presented. The consolidated condensed financial statements for prior periods have been revised for entities which have been treated as discontinued operations through June 30, 2007. The results for the interim periods are not necessarily indicative of results to be expected for the year. These consolidated condensed financial statements should be read in conjunction with the Company s audited financial statements for the year ended December 31, 2006, which are included as part of the Company s Annual Report on Form 10-K.

On July 2, 2007, the Company changed its corporate name from United Auto Group, Inc. to Penske Automotive Group, Inc.

On June 1, 2006, the Company effected a two-for-one split of its voting common stock in the form of a dividend. Shareholders of record as of May 11, 2006 received one additional share for each share they owned. All share and per share information herein reflects the stock split.

Tax returns filed by the Company in all jurisdictions are subject to periodic audit by various tax authorities, certain of which are currently underway. To date, no material adjustments have been proposed in connection with these audits, and the Company does not anticipate that these audits will result in a material change to its financial position or results of operations. FASB Interpretation (FIN) No. 48 Accounting for Uncertainty in Income Taxes clarifies the accounting for uncertain tax positions, prescribing a minimum recognition threshold a tax position is required to meet before being recognized, and providing guidance on the derecognition, measurement, classification and disclosure relating to income taxes.

The Company adopted FIN No. 48 as of January 1, 2007, pursuant to which the Company recorded a \$4,430 increase in the liability for unrecognized tax benefits, which was accounted for as a reduction to the January 1, 2007 balance of retained earnings. As of January 1, 2007, the Company s total amount of unrecognized tax benefit was approximately \$36,600, of which approximately \$23,600 could favorably impact the Company s effective tax rate in the future. The Company recognizes interest and penalties related to income tax matters in income tax expense. The Company does not expect the amount of unrecognized tax benefits to change materially in the next twelve months.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements (SAB 108), which permitted the Company to adjust for the cumulative effect of prior period immaterial errors in the carrying amount of assets and liabilities as of the beginning of 2006, with an offsetting adjustment to retained earnings as of January 1, 2006. SAB 108 requires the adjustment of any previously issued quarterly financial statements within 2006 for the effects of such errors on the quarters when the information is next presented. Such adjustments do not require previously filed reports with the SEC to be amended. In accordance with SAB 108, the Company adjusted its opening retained earnings as of January 1, 2006 and its financial results for the first three quarters of fiscal 2006 to correct an error related to operating leases with scheduled rent increases which were not accounted for on a straight line basis over the rental period. The error, which was previously determined to be immaterial on a quantitative and qualitative basis under the Company s assessment methodology for each individual period, impacted net income by \$804 and \$2,115 during the years ended December 31, 2005 and 2004, respectively. A summary of the impact of the error on previously issued 2006 quarterly financial statements follows:

	2006
Cumulative effect on stockholders' equity as of January 1,	\$ (10,792)
Effect on:	
Net income for the three months ended March 31,	\$ (138)
Net income for the three months ended June 30,	\$ (143)
Net income for the three months ended September 30,	\$ (143)

Table of Contents**PENSKE AUTOMOTIVE GROUP, INC.****NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS (Continued)*****Discontinued Operations***

The Company accounts for dispositions as discontinued operations when it is evident that the operations and cash flows of a franchise being disposed of will be eliminated from the Company's on-going operations and that the Company will not have any significant continuing involvement in its operations. In reaching the determination as to whether the cash flows of a dealership will be eliminated from ongoing operations, the Company considers whether it is likely that customers will migrate to similar franchises that it owns in the same geographic market. The Company's consideration includes an evaluation of the brands sold at other dealerships it operates in the market and their proximity to the disposed dealership. When the Company disposes of franchises, it typically does not have continuing brand representation in that market. If the franchise being disposed of is located in a complex of Company dealerships, the Company does not treat the disposition as a discontinued operation if the Company believes that the cash flows generated by the disposed franchise will be replaced by expanded operations of the remaining franchises. Combined financial information regarding dealerships accounted for as discontinued operations follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenues	\$ 128,953	\$ 234,117	\$ 266,068	\$ 460,622

and methodology remain effective. The S&P Index Committee may at times consult with investors, market participants, security issuers included in or potentially included in the Reference Asset, or investment and financial

Pre-tax income (loss)

819experts.

To prevent the level of the Reference Asset from changing due to corporate actions, all corporate actions which affect the total market value of the Reference Asset require an index divisor adjustment. By adjusting the index divisor for the change in total market value, the level of the Reference Asset remains constant. This helps maintain the level of the Reference Asset as an accurate barometer of stock market performance and ensures that the movement of the Reference Asset does not reflect the corporate actions of individual companies in the Reference Asset. All index divisor adjustments are made after the close of trading and after the calculation of the closing level of the Reference Asset. Some corporate actions, such as stock splits and stock dividends, require simple changes in the common shares outstanding and the stock prices of the companies in the Reference Asset and do not require index divisor adjustments.

The table below summarizes the types of index maintenance adjustments and indicates whether or not an index divisor adjustment is required:

Type of Corporate Action	Adjustment Factor	Divisor Adjustment Required
Stock Split <i>(i.e., 2-for-1)</i>	Shares outstanding multiplied by 2; Stock price divided by 2	No
Share Issuance <i>(i.e., change ≥ 5%)</i>	Shares outstanding plus newly issued shares	Yes
Share Repurchase <i>(i.e., change ≥ 5%)</i>	Shares outstanding minus repurchased shares	Yes
Special Cash Dividends	Share price minus special dividend	Yes
Company Change	Add new company market value minus old company market value	Yes
Rights Offering	Price of parent company minus <u>price of rights offering</u> rights ratio Price of parent company minus	Yes
Spin-Off	<u>price of spin-off co.</u> share exchange ratio	Yes

Stock splits and stock dividends do not affect the index divisor of the Reference Asset, because following a split or dividend both the stock price and number of shares outstanding are adjusted by S&P so that there is no change in the market value of the component stocks. All stock split and dividend adjustments are made after the close of trading on the day before the ex-date.

Each of the corporate events exemplified in the table requiring an adjustment to the index divisor has the effect of altering the market value of the component stocks and consequently of altering the aggregate market value of the component stocks, which we refer to as the post-event aggregate market value. In order that the level of the Reference Asset, which we refer to as the pre-event index value, not be affected by the altered market value (whether increase or decrease) of the affected component stocks, a new index divisor, which we refer to as the new index divisor, is derived as follows:

$$\frac{\text{post-event aggregate market value}}{\text{new index divisor}} = \text{pre-event index value}$$

$$\text{new index divisor} = \frac{\text{post-event market value}}{\text{pre-event index value}}$$

Changes in a company's shares outstanding of 5.00% or more due to mergers, acquisitions, public offerings, tender offers, Dutch auctions, or exchange offers are made as soon as reasonably possible. All other changes of 5.00% or more (due to, for example, company stock repurchases, private placements, redemptions, exercise of options, warrants, conversion of preferred stock, notes, debt, equity participation units, at the market offerings, or other recapitalizations) are made weekly and are announced on Fridays for implementation after the close of trading on the following Friday. Changes of less than 5.00% due to a company's acquisition of another company in the Reference Asset are made as soon as reasonably possible. All other changes of less than 5.00% are accumulated and made quarterly on the third Friday of March, June, September, and December, and are usually announced two to five days prior.

Changes in IWFs of more than five percentage points caused by corporate actions (such as merger and acquisition activity, restructurings, or spinoffs) will be made as soon as reasonably possible. Other changes in IWFs will be made annually when IWFs are reviewed.

Recalculation Policy

S&P reserves the right to recalculate and republish the Reference Asset under certain limited circumstances. S&P may recalculate and republish the Reference Asset if it determines that the Reference Asset incorrect or inconsistent within two trading days of the publication of the index level because of an incorrect or revised closing price, missed corporate event, late announcement of a corporate event, incorrect application of corporate action or index methodology or for such

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other extraordinary circumstances that the S&P Index Committee determines is necessary to reduce or avoid a possible market impact or disruption.

Calculations and Pricing Disruptions

Closing levels for the Reference Asset are calculated by S&P based on the closing price of the individual constituents of the index as set by their primary exchange. Closing prices are received by S&P from one of its third party vendors and verified by comparing them with prices from an alternative vendor. The vendors receive the closing price from the primary exchanges. Real-time intraday prices are calculated similarly without a second verification. If there is a failure or interruption on one or more exchanges, real time calculations switch to the “Composite Tape” for all securities listed on the affected exchange and an announcement is published on the S&P Dow Jones Indices Web site at www.spdji.com. If the interruption is not resolved before the market close and the exchange(s) in question publishes a list of closing prices, those prices are used. If no list is published, the last trade as of 4 p.m. Eastern Time on the “Composite Tape” is used (or the previous close adjusted for corporate actions if no intraday trades were reported). A notice is published on the S&P Web site at www.spdji.com indicating any changes to the prices used in Reference Asset calculations. In extreme circumstances, S&P may decide to delay index adjustments or not publish the Reference Asset. Real-time indices are not restated.

Unscheduled Market Closures

In situations where an exchange is forced to close early due to unforeseen events, such as computer or electric power failures, weather conditions or other events, S&P will calculate the closing price of the Reference Asset based on (1) the closing prices published by the exchange, or (2) if no closing price is available, the last regular trade reported for each stock before the exchange closed. If the exchange fails to open due to unforeseen circumstances, S&P treats this closure as a standard market holiday. The Reference Asset will use the prior day’s closing prices and shifts any corporate actions to the following business day. If all exchanges fail to open or in other extreme circumstances, S&P may determine not to publish the Reference Asset for that day.

License Agreement

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Reference Asset will accurately track index performance or provide positive investment returns. S&P and its subsidiaries are not investment advisors. Inclusion of a security or futures contract within an index is not a recommendation by S&P Dow Jones Indices to buy, sell, or hold such security or futures contract, nor is it considered to be investment advice. Notwithstanding the foregoing, CME Group Inc. and its affiliates may independently issue and/or sponsor financial products unrelated to the Notes currently being issued by us, but which may be similar to and competitive with the Notes. In addition, CME Group Inc. and its affiliates may trade financial products which are linked to the performance of the Reference Asset. It is possible that this trading activity will affect the value of the Notes.

S&P DOW JONES INDICES DO NOT GUARANTEE THE ADEQUACY, ACCURACY, TIMELINESS AND/OR THE COMPLETENESS OF THE REFERENCE ASSET OR ANY DATA RELATED THERETO OR ANY COMMUNICATION, INCLUDING BUT NOT LIMITED TO, ORAL OR WRITTEN COMMUNICATION (INCLUDING ELECTRONIC COMMUNICATIONS) WITH RESPECT THERETO. S&P DOW JONES INDICES SHALL NOT BE SUBJECT TO ANY DAMAGES OR LIABILITY FOR ANY ERRORS, OMISSIONS, OR DELAYS THEREIN. S&P DOW JONES INDICES MAKE NO EXPRESS OR IMPLIED WARRANTIES, AND EXPRESSLY DISCLAIMS ALL WARRANTIES, OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE OR AS TO RESULTS TO BE OBTAINED BY US, HOLDERS OF THE NOTES, OR ANY OTHER PERSON OR ENTITY FROM THE USE OF THE REFERENCE

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Historical Information

The graph below shows the daily historical Closing Levels of the Reference Asset from January 2, 2007 through January 11, 2017.

We obtained the information regarding the historical performance of the Reference Asset in the graph below from Bloomberg.

We have not independently verified the accuracy or completeness of the information obtained from Bloomberg. The historical performance of the Reference Asset should not be taken as an indication of its future performance, and no assurance can be given as to the Final Level of the Reference Asset. We cannot give you assurance that the performance of the Reference Asset will result in any positive return on your initial investment.

PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

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Supplemental Discussion of U.S. Federal Income Tax Consequences

General. The following is a general description of certain U.S. federal tax considerations relating to the Notes. Prospective purchasers of the Notes should consult their tax advisors as to the consequences under the tax laws of the country of which they are a resident for tax purposes and the tax laws of the U.S. of acquiring, holding and disposing of the Notes and receiving payments under the Notes. This summary is based upon the law as in effect on the date of this pricing supplement and is subject to any change in law that may take effect after such date. This discussion replaces the U.S. federal income tax discussions in the product prospectus supplement and accompanying prospectus.

This discussion applies to you only if you are the original investor in the Notes and you hold your Notes as capital assets for U.S. federal income tax purposes. This section does not apply to you if you are a member of a class of holders subject to special rules, such as:

- a dealer in securities or currencies,
- a trader in securities that elects to use a mark-to-market method of accounting for your securities holdings,
- a financial institution or a bank,
- a regulated investment company or a real estate investment trust or a common trust fund,
- a life insurance company,
- a tax-exempt organization or an investor holding the Notes in a tax-advantaged account (such as an “Individual Retirement Account” or “Roth IRA”),
- a person that owns Notes as part of a straddle or a hedging or conversion transaction, or who has entered into a “constructive sale” with respect to a note for tax purposes, or
- a U.S. holder (as defined below) whose functional currency for tax purposes is not the U.S. dollar.

This discussion is based on the Internal Revenue Code of 1986, as amended (the “Code”), its legislative history, existing and proposed regulations under the Code, published rulings and court decisions, all as currently in effect as of the date of this pricing supplement. These laws are subject to change, possibly on a retroactive basis.

This discussion, other than the section entitled “Non-U.S. Holders” below, is applicable to you only if you are a U.S. holder. You are a U.S. holder if you are a beneficial owner of a Note and you are: (i) a citizen or resident of the U.S., (ii) a domestic corporation, (iii) an estate whose income is subject to U.S. federal income tax regardless of its source, or (iv) a trust if a U.S. court can exercise primary supervision over the trust’s administration and one or more U.S. persons are authorized to control all substantial decisions of the trust.

An individual may, subject to certain exceptions, be deemed to be a resident of the U.S. by reason of being present in the U.S. for at least 31 days in the calendar year and for an aggregate of at least 183 days during a three-year period ending in the current calendar year (counting for such purposes all of the days present in the current year, one-third of the days present in the immediately preceding year, and one-sixth of the days present in the second preceding year).

If a partnership holds the Notes, the U.S. federal income tax treatment of a partner will generally depend on the status of the partner and the tax treatment of the partnership. A partner in a partnership holding the Notes should consult its tax advisor with regard to the U.S. federal income tax treatment of an investment in the Notes.

U.S. Tax Treatment. No statutory, judicial or administrative authority directly discusses how the Notes should be treated for U.S. federal income tax purposes. As a result, the U.S. federal income tax consequences of your investment in the Notes are uncertain. Accordingly, we urge you to consult your tax advisor as to the tax consequences of your investment in the Notes (and of having agreed to the required tax treatment of your Notes described below) and as to the application of state, local or other tax laws to your investment in your Notes and the possible effects of changes in federal or other tax laws.

Pursuant to the terms of the Notes, the Bank and you agree, in the absence of a statutory, regulatory, administrative or judicial ruling to the contrary, to characterize your Notes as pre-paid derivative contracts with respect to the Reference Asset. If your Notes are so treated, you should generally recognize gain or loss upon the sale, exchange, redemption or maturity of your Notes in an amount equal to the difference between the amount you receive at such time and the amount you paid for your Notes. Such gain or loss should generally be long-term capital gain or loss if you have held your Notes for more than one year (otherwise such gain or loss should be short-term capital gain or loss). The deductibility of capital losses is subject to limitations.

In the opinion of our counsel, Cadwalader, Wickersham & Taft LLP, it would be reasonable to treat your Notes in the manner described above. However, because there is no authority that specifically addresses the tax treatment of the Notes, it is possible that your Notes could alternatively be treated for tax purposes as a single contingent payment debt

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instrument, or pursuant to some other characterization, such that the timing and character of your income from the Notes could differ materially from the treatment described above.

Possible Change in Law. The Internal Revenue Service (“IRS”) released a notice that may affect the taxation of holders of the Notes. According to Notice 2008-2, the IRS and the Treasury Department are actively considering whether a holder of an instrument such as the Notes should be required to accrue ordinary income on a current basis, and they are seeking taxpayer comments on the subject. It is not possible to determine what guidance they will ultimately issue, if any. It is possible, however, that under such guidance, holders of the Notes will ultimately be required to accrue income currently and this could be applied on a retroactive basis. The IRS and the Treasury Department are also considering other relevant issues, including whether additional gain or loss from such instruments should be treated as ordinary or capital, whether foreign holders of such instruments should be subject to withholding tax on any deemed income accruals, and whether the special “constructive ownership rules” of Section 1260 of the Code should be applied to such instruments.

In 2007, legislation was introduced in Congress that, if it had been enacted, would have required holders of Notes purchased after the bill was enacted to accrue interest income over the term of the Notes despite the fact that there will be no interest payments over the term of the Notes. It is not possible to predict whether a similar or identical bill will be enacted in the future, or whether any such bill would affect the tax treatment of your Notes.

Additionally, in 2013, the House Ways and Means Committee released in draft form certain proposed legislation relating to financial instruments. If enacted, the effect of this legislation generally would be to require instruments such as the Notes to be marked to market on an annual basis with all gains and losses to be treated as ordinary, subject to certain exceptions.

It is impossible to predict what any such legislation or administrative or regulatory guidance might provide, and whether the effective date of any legislation or guidance will affect Notes that were issued before the date that such legislation or guidance is issued. You are urged to consult your tax advisor as to the possibility that any legislative or administrative action may adversely affect the tax treatment of your Notes.

Medicare Tax on Net Investment Income. U.S. holders that are individuals or estates and certain trusts are subject to an additional 3.8% tax on all or a portion of their “net investment income,” or “undistributed net investment income” in the case of an estate or trust, which may include any income or gain with respect to the Notes, to the extent of their net investment income or undistributed net investment income (as the case may be) that, when added to their other modified adjusted gross income, exceeds \$200,000 for an unmarried individual, \$250,000 for a married taxpayer filing a joint return (or a surviving spouse), \$125,000 for a married individual filing a separate return, or the dollar amount at which the highest tax bracket begins for an estate or trust (which, in 2016, is \$12,400). The 3.8% Medicare tax is determined in a different manner than the regular income tax. U.S. holders should consult their advisors with respect to the 3.8% Medicare tax.

Specified Foreign Financial Assets. U.S. holders may be subject to reporting obligations with respect to their Notes if they do not hold their Notes in an account maintained by a financial institution and the aggregate value of their Notes and certain other “specified foreign financial assets” (applying certain attribution rules) exceeds \$50,000. Significant penalties can apply if a U.S. holder is required to disclose its Notes and fails to do so.

Treasury Regulations Requiring Disclosure of Reportable Transactions. Treasury regulations require U.S. taxpayers to report certain transactions (“Reportable Transactions”) on IRS Form 8886. An investment in the Notes or a sale of the Notes should generally not be treated as a Reportable Transaction under current law, but it is possible that future legislation, regulations or administrative rulings could cause your investment in the Notes or a sale of the Notes to be treated as a Reportable Transaction. You should consult with your tax advisor regarding any tax filing and reporting

obligations that may apply in connection with acquiring, owning and disposing of Notes.

Backup Withholding and Information Reporting. The proceeds received from a sale, exchange, redemption or maturity of the Notes will be subject to information reporting unless you are an “exempt recipient” and may also be subject to backup withholding at the rate specified in the Code if you fail to provide certain identifying information (such as an accurate taxpayer number, if you are a U.S. holder) or meet certain other conditions.

Amounts withheld under the backup withholding rules are not additional taxes and may be refunded or credited against your U.S. federal income tax liability, provided the required information is furnished to the IRS.

Non-U.S. Holders. This section applies only if you are a non-U.S. holder. For these purposes, you are a non-U.S. holder if you are the beneficial owner of the Notes and are, for U.S. federal income tax purposes:

a non-resident alien individual;

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a non-U.S. corporation; or

an estate or trust that, in either case, is not subject to U.S. federal income tax on a net income basis on income or gain from the Notes.

Section 871(m). A 30% withholding tax (which may be reduced by an applicable income tax treaty) is imposed under Section 871(m) of the Code on certain “dividend equivalents” paid or deemed paid to a non-U.S. holder with respect to a “specified equity-linked instrument” that references one or more dividend-paying U.S. equity securities or indices containing U.S. equity securities. The withholding tax can apply even if the instrument does not provide for payments that reference dividends. Treasury regulations provide that the withholding tax applies to all dividend equivalents paid or deemed paid on specified equity-linked instruments issued after 2016.

However, on December 2, 2016, the IRS issued Notice 2016-76, which states that the Treasury Department and the IRS intend to amend the applicability dates of the Treasury regulations under Section 871(m) of the Code to provide that the withholding tax will apply to all dividend equivalents paid or deemed paid on specified equity-linked instruments that have a delta of one (“delta one specified equity-linked instruments”) issued after 2016 and to all dividend equivalents paid or deemed paid on all other specified equity-linked instruments issued after 2017.

Based on our determination that the Notes are not “delta-one” with respect to any U.S. Reference Asset Constituent our counsel is of the opinion that the Notes should not be delta one specified equity-linked instruments and thus should not be subject to withholding on dividend equivalents. Our determination is not binding on the IRS, and the IRS may disagree with this determination. Furthermore, the application of Section 871(m) of the Code will depend on our determinations made upon issuance of the Notes. If withholding is required, we will not make payments of any additional amounts.

Nevertheless, after issuance, it is possible that your Notes could be deemed to be reissued for tax purposes upon the occurrence of certain events affecting the Reference Asset Constituents or your Notes, and following such occurrence your Notes could be treated as delta one specified equity-linked instruments that are subject to withholding on dividend equivalents. It is also possible that withholding tax or other tax under Section 871(m) of the Code could apply to the Notes under these rules if a non-U.S. holder enters, or has entered, into certain other transactions in respect of the Reference Asset Constituents or the Notes. A non-U.S. holder that enters, or has entered, into other transactions in respect of the Reference Asset Constituents or the Notes should consult its own tax advisor regarding the application of Section 871(m) of the Code to its Notes in the context of its other transactions.

Because of the uncertainty regarding the application of the 30% withholding tax on dividend equivalents to the Notes, you are urged to consult your own tax advisor regarding the potential application of Section 871(m) of the Code and the 30% withholding tax to an investment in the Notes.

If you are a non-U.S. holder, you should generally not be subject to U.S. withholding tax with respect to payments on your Notes or to generally applicable information reporting and backup withholding requirements with respect to payments on your Notes if you comply with certain certification and identification requirements as to your foreign status including providing us (and/or the applicable withholding agent) a properly executed and fully completed applicable IRS Form W-8. Subject to Section 897 of the Code, as discussed below, gain from the sale, exchange, redemption or maturity of the Notes generally will not be subject to U.S. tax unless such gain is effectively connected with a trade or business conducted by you in the U.S. or unless you are a non-resident alien individual and are present in the U.S. for 183 days or more during the taxable year of such sale, exchange, redemption or maturity and certain other conditions are satisfied.

Section 897. We will not attempt to ascertain whether the issuer of any Reference Asset Constituent would be treated as a United States real property holding corporation (a “USRPHC”), within the meaning of Section 897 of the Code. We also have not attempted to determine whether the Notes should be treated as “United States real property interests,” as

defined in Section 897 of the Code. If any such entity and the Notes were so treated, certain adverse U.S. federal income tax consequences could possibly apply, including subjecting any gain to a non-U.S. holder in respect of a Note upon a sale, exchange, redemption or maturity of the Note to the U.S. federal income tax on a net basis, and the proceeds from such a taxable disposition to a 15% withholding tax. Non-U.S. holders should consult their tax advisors regarding the potential treatment of the issuer of a Reference Asset Constituent as a USRPHC and the Notes as United States real property interests.

As discussed above, alternative characterizations of the Notes for U.S. federal income tax purposes are possible. Should an alternative characterization of the Notes cause payments with respect to the Notes to become subject to withholding tax, we will withhold tax at the applicable statutory rate and we will not make payments of any additional amounts.

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Both U.S. and non-U.S. holders should consult their tax advisors regarding the U.S. federal income tax consequences of an investment in the Notes, as well as any tax consequences arising under the laws of any state, local or non-U.S. taxing jurisdiction (including that of the Bank).

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Supplemental Plan of Distribution (Conflicts of Interest)

We have appointed TDS, an affiliate of TD, as the agent for the sale of the Notes. Pursuant to the terms of a distribution agreement, TDS will purchase the Notes from TD at the public offering price less the underwriting discount set forth on the cover page of this pricing supplement for distribution to GS&Co., or will offer the Notes directly to investors. GS&Co. and its affiliates will receive a discount of \$17.50 per \$1,000 principal amount, comprised of \$2.50 of fees and \$15.00 of selling commission for Notes that it sells to investors. The Issuer or an affiliate expects to enter into swap agreements or related hedge transactions with Goldman Sachs International and/or its affiliates in connection with the sale of the Notes, and Goldman Sachs International and/or an affiliate may earn income as a result of payments pursuant to the swap, or the related hedge transactions. See “Supplemental Plan of Distribution (Conflicts of Interest)” in the product prospectus supplement. TD will reimburse TDS for certain expenses in connection with its role in the offer and sale of the Notes, and TD will pay TDS a fee in connection with its role in the offer and sale of the Notes.

We expect that delivery of the Notes will be made against payment for the Notes on or about [], which is the fifth (5th) Business Day following the Pricing Date (this settlement cycle being referred to as “T+5”). Under Rule 15c6-1 of the Securities Exchange Act of 1934, trades in the secondary market generally are required to settle in three Business Days, unless the parties to any such trade expressly agree otherwise. Accordingly, if the initial settlement of the Notes occurs more than three Business Days from the Pricing Date, purchasers who wish to trade the Notes more than three Business Days prior to the Issue Date will be required to specify alternative settlement arrangements to prevent a failed settlement.

Conflicts of Interest. TDS is an affiliate of TD and, as such, has a “conflict of interest” in this offering within the meaning of Financial Industry Regulatory Authority, Inc. (“FINRA”) Rule 5121. In addition, TD will receive the net proceeds from the initial public offering of the Notes, thus creating an additional conflict of interest within the meaning of FINRA Rule 5121. Consequently, the offering is being conducted in compliance with the provisions of FINRA Rule 5121. TDS is not permitted to sell Notes in this offering to an account over which it exercises discretionary authority without the prior specific written approval of the account holder.

We or GS&Co., or any of our or their respective affiliates, may use this pricing supplement in the initial sale of the Notes. In addition, we or GS&Co. or any of our or their respective affiliates may use this pricing supplement in a market-making transaction in a Note after its initial sale. ***If a purchaser buys the Notes from us or GS&Co. or any of our or their respective affiliates, this pricing supplement is being used in a market-making transaction unless we or GS&Co. or any of our or their respective affiliates informs such purchaser otherwise in the confirmation of sale.***

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