

Automotive distributors – Defensive qualities

21 November 2008

Investment summary: More than just new cars

The motor distribution segment of the Retail Sector has seen an average 74% share price fall from its 2008 highs. This reflects natural fears related to consumer spending, epitomised by the fall off in new car registrations over the past three months. Genuine fears have been voiced about the medium-term viability of several companies across the sector. However, these fears fail to recognise defensive qualities that are not apparent in the vast majority of retail businesses. A good motor retailer has several sources of income other than new car sales and, despite registrations likely to be materially lower again in 2009, the sector offers strong recovery potential from 2010 onwards. The sector is oversold and we draw attention to Vertu and Lookers as having performance potential on a two to three year view.

Replacement cycle

Demand for new cars is affected by consumer confidence. However, vehicles tend to be replaced on a three to four year cycle. In the past two recessions, after a two-year setback, demand recovered within two further years, followed by a period of steady growth. Most consumer durables have a less clearly defined replacement cycle.

Viable used car market

There is an active and viable market for used cars. The market suffered during 2008, when prices dropped by some 15-20% during the third quarter, virtually wiping out margins. Such movements occur every five years or so and margins have been quickly restored. Franchised dealers tend to command a significant share of the quality end of the market, especially for vehicles up to three years old. Gross margins are similar to those on new cars and with high operational gearing the incremental operating margin can improve as the ratio of used car sales is developed.

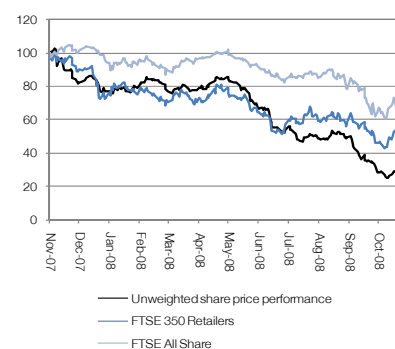
Aftermarket consistency

The servicing and repair of vehicles continues despite recession. Servicing is an essential part of warranty agreements; while minor repairs can be deferred, they will tend to be completed prior to the disposal of a vehicle. Aftermarket margins are well-above those on vehicle sales and usually contribute over 40% of a dealership's profit.

Valuation

Share prices across the sector have fallen by an average 74% from their 2008 high, compared with a 42% adverse movement for a cross section of leading retailers. We believe that this setback reflects fears about the long-term viability of the sector and ignores the defensive qualities mentioned above. With prospective PE ratings around half that of other retailers, the sector looks distinctly oversold.

Price performance (100 = 20 Nov 2007)



Company	P/E FY1	P/E FY2	Gearing
HR Owen	13.2	13.2	85%
Inchcape	1.5	1.9	31%
Lookers	3.5	4.6	98%
Pendragon	N/A	2.8	85%
Vertu	6.3	6.0	26%

Bull

- The cycle usually recovers after two years
- Ongoing aftermarket profits
- Efficiency improvements across the sector

Bear

- Cyclical downturn in vehicle registrations
- Weak used car prices during 2008
- Availability of finance for customers

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What has happened in 2008?

Back in January, there were natural, growing fears about the likely impact of the deteriorating trading climate on the sector. Forecasts published by the Society of Motor Manufacturers and Traders (SMMT) suggested a modest downturn in new vehicle registrations and a flat used car market. These forecasts remained intact for several months as the market seemed to defy logic, with registrations running slightly ahead of expectations as fleet demand continued to rise, largely balancing a fall away in retail demand. In truth, margins were being eroded by the fall in retail demand, where gross margins are materially higher. With used car and aftermarket revenues holding up well there was only a modest profit shortfall relative to expectations.

Consequently, share prices held up well during this period, although there was a growing unease, especially related to market leader Pendragon. It had been far more ambitious than most during recent years and was seen to be suffering from serious difficulties in managing its more extensive network and in integrating its volume businesses.

Several trends became evident and intensified as the year progressed. Environmental and cost pressures were leading to a change in market focus, with a distinct shift towards diesel and smaller vehicles. Sales of 'gas guzzlers' and performance vehicles fell away sharply, while there was also a modest trend towards volume cars for the first time in several years with operating margins levelling out across vehicle types.

The onset of the credit crunch rapidly affected sentiment. Once the level of new registrations started to fall away sharply in July, share prices became very weak. Companies were seen to be suffering from the twin effects of reduced new car sales and an almost unprecedented downward shift in used car values, which in turn led to a series of profit estimate reductions. The downward momentum of share prices continued amid unsubstantiated rumours about the breaching of borrowing covenants and fears that certain underlying businesses would never recover.

Exhibit 1: Motor retailers share price performance

Note: Prices at 20 November 2008

	Current price	3-year high	2008 high	2008 low	From 3-year high	From 2008 high	From 2008 low
	p	p	p	p	%	%	%
Inchcape	46	593	451	46	(92)	(90)	0
Pendragon	5	126	43	5	(96)	(88)	0
Vertu Motors	18	102	48	18	(82)	(63)	0
Lookers	32	220	113	23	(85)	(72)	39
H R Owen	70	159	157	60	(56)	(55)	17

Source: London Stock Exchange

After the instability of the third quarter of 2008, the automotive market seems to have settled at lower levels. New registrations are currently running some 20-25% below those of the same period in 2007, with the manufacturers (OEMs) apparently accepting the situation and not withholding performance bonuses in the event of a sound result. More significantly for profits, used car prices appear to have stabilised. While the efficient distributor is beginning to restore margins, the process is proving more protracted, with customers struggling to recognise the falls in the value of their existing vehicles. Nevertheless, with the SMMT now forecasting an overall 11% decline in

registrations for 2008 to 2.15m vehicles, results across the sector will undoubtedly fall well short of 2007 levels.

Most companies have issued trading statements in the last few weeks and we hope that the latest profit downgrades should now prove adequate. There may be some pressure on distributors to build inventories late in the year, because several OEMs appear to have been slow to reduce production and have built up unhealthy stock levels. However, we expect any pressure to be realistically applied and not be detrimental to the distributors.

Another factor is the deteriorating financial position of the leading US owned OEMs, Ford and General Motors (operating as Vauxhall in the UK). We do not propose to speculate on the likelihood of them securing protection under Chapter 11. However, there is a recognition that their European operations are performing significantly better than their North American operations and should be less affected by any future changes. However, we cannot believe that the US authorities will not be seeking a speedy solution to their problems and any action to reschedule their debts will be welcomed across the industry and improve stability in the market.

The City appears to have suspended any belief in the sector's defensive qualities, although share prices have recovered from their lowest levels. This caution probably reflects the outlook for 2009, with the SMMT now forecasting a further 11% downturn in registrations to 1.92m, which would represent the lowest annual total for more than 10 years and a shortfall of more than 20% compared to its forecasts prevailing earlier in 2008. We expect to see the 20-25% year-on-year shortfall in new vehicle registrations to prevail for most of the first half of 2009, suggesting that the SMMT projection may prove optimistic.

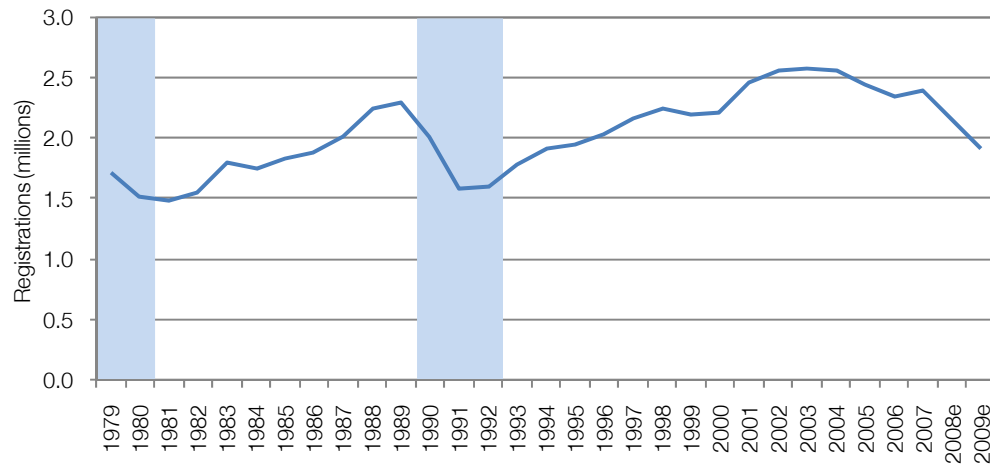
We believe that most City estimates for 2009 reflect a measure of caution about the SMMT forecasts, but have profit targets little changed compared to 2008. The OEMs are obviously aware of the forecast and will try to match demand with production. We understand that current production schedules are well short of expected registrations and we are hopeful that the current overhang of stocks will be reduced in the coming months. Similarly, the almost unprecedented falls in used car prices are unlikely to be repeated – the market already appears to have stabilised, with margins showing signs of recovering. Aftermarket operations should again not be materially affected, with cars tending to require more service and repair with age. The consensus of largely unchanged profits in 2009 may prove a little optimistic, but does look largely realistic.

When will things improve?

Recent history has shown that the new car market is both mature and quite robust and rarely falls sharply for more than a year or two. This is largely because of the replacement cycle and the fact that motorists believe that running costs increase with the age of the vehicle. Indeed, as has been demonstrated in recent years, there is ample room in the market for the leading distributors to grow their businesses in a flat or moderately falling new car market. It is only the extreme conditions of recent months that have blunted the aspirations of most of these leading groups, with useful earnings per share growth delivered between 2003 (the peak year for registrations) and 2007, despite a gradually falling market.

Exhibit 2: Motor vehicle registrations

Note: Shaded areas indicate periods of negative UK GDP growth.



Source: SMMT

In the past there has been a steady and consistent recovery following rare, sharp setbacks. In the early 1980s, registrations came back by 12% in 1980 and by a further 2% the following year; recovery took registrations back above the 1979 level in 1983, followed by growth in every year until 1989. The following recession saw a 21% reduction in registrations in 1991, followed by a flat year and then again there was a steady and consistent recovery over the subsequent few years, beating the previous peak level in 1994.

Current industry projections for 2008 and 2009 suggest an 11% reduction in both years and a drop below 2m vehicles for the first time since 1995. This indicates a similar reduction to that seen in the early 1990s and a slightly better performance than was seen in the early 1980s. On the basis of past experience, there should be some recovery in 2010, with registrations rising back towards 2.4m cars by 2012. We fully understand the caution being expressed in the City, but history tells us that the situation may be less severe than is being indicated in certain quarters.

If, as we believe, the extent of next year's downturn is more severe than industry expectations, the room for the market to bounce back will be that much greater and, by that time, we sense that the market will have become less fragmented. Moreover, the fall in registrations could well lead to shortages of good quality used cars, to help margins when the sector recovers.

Defensive qualities

Motor retailing differs from other segments of the sector in several key ways, most of which suggest far greater defensive qualities than are fully appreciated.

- **Aftermarket.** All vehicles require regular servicing, at least once a year. Margins are materially higher on service and parts, while the business is largely impervious to recession. Naturally, some motorists will try to reduce the number of service visits, or use the local garage (which may be cheaper), but most warranties require servicing by the franchised dealer for at least the first three years of a vehicle's life. We are already also seeing an element of resistance to non-essential repairs which tend to be highlighted during the servicing of a vehicle. However, the complexity of modern cars is such that not

only can few owners carry out work at home, but the work will not be easy for many small garages. If mileage is reduced, there may be less accident damage and minor repairs may be deferred, but this will all impact on the vehicle's resale value with the maintenance likely to be completed prior to a sale. The number of new cars coming on to UK roads exceeds the number of vehicles taken off the road in virtually every year. This implies a progressively increasing number of vehicles requiring aftermarket services even during periods of recession. Aftermarket operations typically contribute in excess of 40% of a dealership's gross profit and an even larger proportion of operating profits; in certain quoted dealership groups this figure is considerably higher.

- **Used cars.** Motor vehicles are among a small number of consumer durables with an active market for used product. The average car changes hands at least four times during its life, with vehicles often sold in part exchange to the dealer supplying the replacement vehicle. Most franchised dealers have an active used car operation adjacent to the new car dealership, often targeted to sell as many vehicles as the new car operation. Gross margins tend to be similar to or slightly lower than those for new cars, but because of operational gearing, they tend to make an important contribution to a dealership's operating profits.
- **Replacement cycle.** Cars deteriorate with age. Most owners tend to replace their vehicles every three to four years, to avoid the perceived increase in aftermarket costs, which are seen to rise exponentially as vehicles move out of their warranty period and the annual MOT test leads to repair work. In times of recession, the replacement cycle tends to be extended by about 12 months, but motorists tend not to delay much longer. This attitude is reinforced by the vehicle registration system, which makes the age of a vehicle readily available at a glance; the vanity of certain motorists discourages them from wanting to be seen in an old vehicle.
- **Management action.** Management across the sector has responded positively to the challenges imposed by the tougher trading climate. Each company has announced its own specific action to reduce costs and raise efficiency levels. These have ranged from the more effective use of management by consolidating the management of adjacent dealerships under one team, right through to the closure of unremunerative or satellite depots. In the main, action has centred on cost centres, rather than profit centres. More specifically, Pendragon has indicated that its software business, Pinewood, is being groomed for sale, while the surrender of a long lease by H R Owen is expected to generate well over 50% of its current group market capitalisation over the next few years. The of the quoted dealership groups are expected to emerge from the recession much leaner and fitter than they were just a few months ago.
- **Balance sheet strength.** Several of the companies have renegotiated their group borrowings over the past 12 months and have significant headroom. City fears seem to relate to covenants allied to interest cover and whether the poor new car market indicated for 2009 may lead to difficulties. On the basis of current City estimates, only Pendragon would appear to be in danger of breaching such a covenant. We suspect that the banks

would consider such a technical breach as an excuse to start restoring their margins, by lifting the rate of interest charged, rather than planning more serious action.

- **Vehicle finance.** A high proportion of vehicles are purchased with debt. Motor dealers tend to gain a commission for introducing business to finance houses. While many buyers will secure their own source of finance, the larger dealership groups can be very competitive because of the amount of business they can generate. When the trading climate deteriorates, private sources of finance can often dry up and the successful dealership will often provide finance on a higher proportion of vehicles sold.
- **Property.** Many motor dealerships occupy large sites, with retail consents. While commercial property markets are subdued at the current time, substantial gains can be made from securing a change of use, either to food retailing, residential or offices and then relocating to a less expensive location.
- **Fragmented market.** Many retail sectors are dominated by a small number of key operators with significant market shares. By contrast, the top 10 motor dealers command little more than 20% of the new car market. The market has been undergoing rationalisation in recent years, with several market leaders acquiring smaller groups, with a view to extending sales territories and securing stronger relationships with their OEM partners. This process still has some way to go, although in current market conditions, buyers will be more discerning. There are considerable benefits to be gained from consolidation in terms of centralising buying power for certain products and services. Meanwhile, the expectations of the OEMs in terms of the quality of facilities have stretched the finances of a number of small family businesses and several acquisition opportunities are emerging in the present trading climate. There is a growing consensus across the industry that number of franchised dealerships will be significantly lower by the time the sector starts to recover, hopefully in 2010.
- **CRM.** Many of the larger groups invest heavily in developing Customer Relations Management systems. Databases are built around the sales and aftermarket operations and used to encourage customers to return to the distributor that sold the car for various services. The media constantly refers to poor experiences by customers in the motor sector, and attention to detail in terms of service quality may secure considerable medium to long term benefits.
- **Multi-franchising.** The leading dealership groups manage franchises for a wide cross section of OEMs. There are always going to be shifts in market share between the various OEMs, related to the timing of new model introductions and/or sales inducements. For most groups it will be a case of swings and roundabouts.

The companies

Below is a brief description of the five main quoted motor dealership groups. Just 10 years ago this list would have been more comprehensive, but as part of the restructuring process, several quoted dealership groups have either been absorbed into other groups or taken private, sometimes involving venture capital funds.

- **Inchcape** – has emerged out of a major international trading group, which rationalised itself into the largest global player in the motor distribution sector. It has for some time had key operations in Europe (UK, Belgium, Greece), the Far East (Hong Kong, Singapore) and Australia, expanding where appropriate by strategic acquisition. In recent years, Inchcape has expanded its reach into Eastern Europe, the Baltic States and Russia, while also developing in China and South America. The group has chosen to work with a restricted list of OEM partners, building a strong local representation in the various territories, occasionally acting as distributor as well as retailer.
- **Pendragon** – is the largest UK motor distributor, with some 300 outlets providing national coverage, plus a small operation in California. The group was floated in 1989 as a distributor of specialist cars, including a strong relationship with BMW. It has grown both organically and through a series of key acquisitions, including CD Brammall, Evans Halshaw and Reg Vardy; it currently represents more than 20 brands. It operates under the Stratstone (specialist cars) and Evans Halshaw (volume cars) brands. The group has experienced difficult conditions over the past two years, struggling to integrate its acquisitions; recent restructuring has involved numerous closures and relocations.
- **Vertu Motors** – is the most recent addition to the list of quoted dealerships, having been established in late 2006 as a vehicle to build a major presence in the volume segment of the UK market. Following four acquisitions, notably that of Bristol Street in March 2007, the group is already established as number 10 in the market and has strong medium-term ambitions, involving investment in acquiring underperforming dealerships and lifting their potential. A highly experienced and motivated team has been assembled, largely comprising former key executives at Reg Vardy, the highly successful volume distributor acquired by Pendragon in early 2006.
- **Lookers** – has an impressive record stretching back over a number of years, with a combination of organic and acquisition based growth. Group philosophy has involved building its representation with its chosen OEM partners, extending the size of individual sales territories and lifting the aftermarket content of revenues. Lookers has national coverage and is stronger in the northern half of the UK; it is also the largest operator in Northern Ireland, spearheaded by a major business in Belfast, where the group represents a comprehensive range of OEMs. It also has a major aftermarket presence, including a unique national distribution business supplying parts at short notice to motor factors.
- **H R Owen** – has undergone major restructuring in recent years and is currently the leading UK distributor of luxury cars. The principal franchise is for Bentley (40% of sales), but the group also acts for Rolls Royce, Ferrari, Maserati, Bugatti, Lamborghini and Alfa Romeo. The main operating base is in central London, although there are also businesses in north London and Manchester. The group also operates used car and aftermarket operations for its key franchises. The restructuring was forced on management by virtue of the high costs associated with operating in the southeast. The group has recently announced the planned surrender of the long-term lease on one of its south London aftermarket operations at a substantial surplus to book values.

Valuation

As demonstrated in Exhibit 1 (page 2), the share prices of all five quoted motor dealership groups have gone into reverse over 2008, especially since mid-year, when the downturn in registrations became clear. While most share prices have rallied from their lowest levels, they are still down by an average 74% from their 2008 high points. In relation to their three-year highs the reverse is even more marked, at 82%.

Such movements are understandable in the context of nervousness across the City, but current price levels are suggesting a far more protracted recovery period than that indicated by recent history. As discussed above, during the severe recessions in the early 1980s and 1990s, new car registrations slipped back sharply, by an aggregate of some 20% over the two worst years, but recovered all the lost ground within two further years and then moved ahead steadily.

Exhibit 3: Motor retailers consensus estimates

Note: normalised earnings before amortisation and exceptional items; Vertu figures to subsequent February. Prices as at 20 Nov 2008

	Price	Mkt Cap	Revenue (historic)	PBT (historic)	P/E	P/E	P/E
	p	£m	£m	£m	2007	2008	2009
Inchcape	46	211	6,057	235.1	1.2	1.5	1.9
Pendragon	5	31	5,060	34.8	1.1	N/A	2.8
Vertu Motors	18	16	677	1.3	11.3	6.3	6.0
Lookers	32	59	1,680	24.5	3.5	4.6	4.8
H R Owen	70	17	184	3.2	5.8	13.2	13.2

Source: London Stock Exchange; Edison Investment Research estimates

There is no consistent pattern to the ratings across the sector, with the City having taken a particularly cautious view of Inchcape and Pendragon, a nervous view of Lookers and Vertu Motors, while H R Owen is being viewed as a special situation.

The problems at **Pendragon** are well chronicled in the media, with a general consensus that it has taken on a massive job in rationalising a number of sizeable acquisitions. Much of the property portfolio has either been divested, with a sale and lease back operation having been undertaken into a joint company. The City is quite nervous about the rentals payable on these properties and the recent indication of an underlying loss for 2008 of £30m suggests that the difficulties are far from overcome. We are optimistic that the group will emerge from its present problems, but this may be in a different form of ownership.

The reverse in the **Inchcape** share price has also been spectacular, but without the same level of external speculation. The recent IMS was reassuring, despite the indication that 2008 and 2009 profits will be below City expectations. We sense fears about the quality of the recent investment in Eastern Europe, while the Australian market is also moving into reverse, following the falls in certain commodity prices. The shares could offer unbelievable value at current levels, but the share price movement hints at something in the background that is not readily visible.

The setbacks in the share prices of both **Lookers** and **Vertu Motors** have also been severe, but in each case there is a management team with a proven long-term record, a sound balance sheet and action already taken to respond to the current difficulties. **On a two to three year view, both companies offer real value with potential for a doubling of the share price from current levels.**

H R Owen is a special situation, buoyed by considerable takeover speculation over the past year, while the recent announcement of the planned early surrender of the lease on its Nine Elms service facility should generate some £10m in cash over the next few years.

We have also taken a brief snapshot of other retailers, simply looking at historic and the next two years prospective earnings. We have not adjusted to quote figures for concurrent trading periods.

Exhibit 4: Other retailers consensus estimates

Note: Consensus estimates. Prices as at 20 Nov 2008

	Price	2008 High	From 2008 High	P/E Hist	P/E 2009e	P/E 2010e
	p	p	%	x	x	x
Morrison	251	319	(21)	12.2	15	13.1
Sainsbury	283	450	(37)	14.4	14.1	13
Tesco	295	472	(38)	12.4	12	10.7
Mothercare	280	425	(34)	8.1	9.3	8.2
W H Smith	327	442	(26)	9	8.5	8
Halfords	240	319	(25)	7.8	8	8
Carpetright	365	879	(58)	5.8	10.1	10
Marks & Spencer	205	561	(63)	5.1	6.8	8.6
Next	970	1,666	(42)	5.8	6.3	6.9
Debenhams	28	104	(73)	2.9	3.3	3.4
Average			(42)	8.4	9.3	9.0

Source: Bloomberg consensus estimates

The message seems to be that either other types of retailer are seen to be either less vulnerable to cyclical downturn or that estimates may have to be adjusted further. Their share prices have come back by 42% from their 2008 high, compared with the 74% average for motor retailers, while prospective ratings are also significantly higher. We recognise that demand for non-durables will be more consistent, but we would suggest that the supermarket groups might also see a shift in demand from higher margin to lower margin products as has been happening in the motor industry.

We acknowledge that each of the above companies has strong brand recognition, but none has a viable aftermarket or used goods market. Moreover, apart from the supermarkets, few can match the quality of freehold and long leasehold portfolios of Lookers and Vertu Motors.

The next 12 months are going to be very tough for motor retailers, but this is more than fully discounted in the relative ratings.

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