Zeus Capital

UK Motor Retail Industry –November 2018

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Overview

- Overview
- New car market
- Brexit scenarios
- Used car market demand dynamics
- Used car market supply dynamics
- International dynamics
- Macro economic indicators
- Valuation considerations
- Q&A

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Introduction

The purpose of my presentation is to give an update of our current thoughts for the used car market in 2019

- **Market conditions remain tough**, with business and political uncertainty reducing buyer confidence.
- New car registrations declined -3%, (-1% in private) for October and currently **-6.5% YTD**
- **Used car market robust** with both volumes and values up across the market
- **Sterling uncertainty is impacting new car supply**, which we believe will create a more robust environment for residual values further down the line.
- Rising levels of car finance has generated increased regulatory scrutiny with the **FCA currently reviewing the motor finance market**.
- **Balance sheet strength remains generally robust** across the sector and we envisage further consolidation as smaller operators become more distressed.
- **We remain cautious in our outlook**. We have downgraded our forecasts across the board and see scope for further downside risk to earnings but believe these are priced in at current share price levels given asset backing and historically low valuations.

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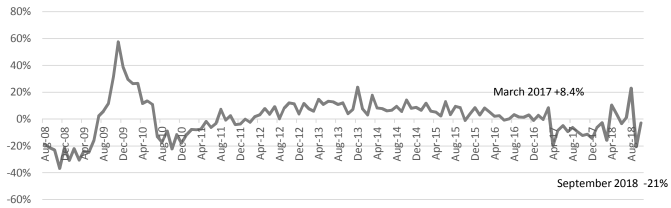
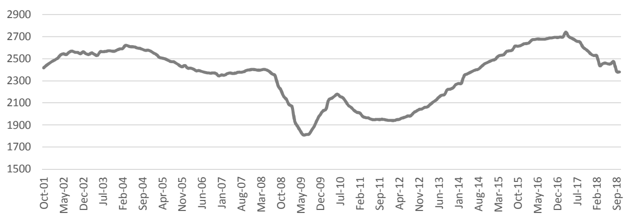
New car registrations remain weak driven by supply

- New car registrations were down 2.9% in October which was a better performance than we had anticipated.
- The declines follows a 20.5% decline in September and a 12.2% decline in October 2017.
- This data demonstrates the decline has reduced since September (which was -20.5%) albeit the supply pressures we flagged in our recent sector note remains visible in this data with Audi (-52.7%).
- Looking at August, September and October together vs last year, registration over the 3 month period were down 11.2%.

UK new car registrations YoY%



12 month rolling new car registrations



Source: SMMT

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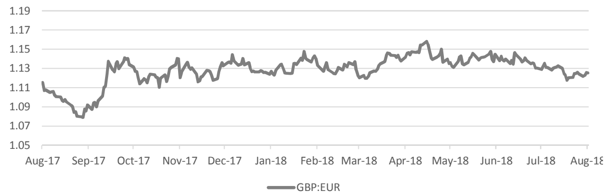
Sterling devaluation and new car pricing

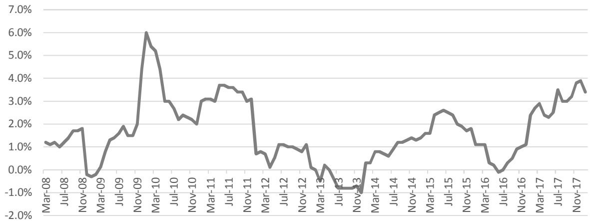
- The UK car market is a net importer of vehicles with 2.7 million cars registered in 2016 versus 1.7 million units produced by UK manufactures, of which c.80% were exported.
- Sterling's sharp depreciation following the Brexit vote in June 2016 has created margin pressure for overseas manufacturers.
- Price inflation on new cars has risen in recent months, currently running at 3% - 4%.
- In the context of the significant fall in sterling, further incremental price rises are possible.

GBP to EUR exchange rate



Source: Bloomberg

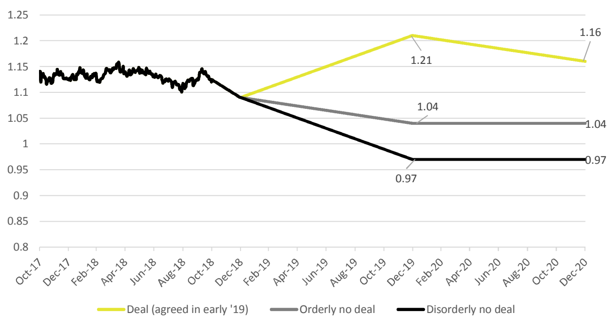
UK CPI on new cars YoY%*



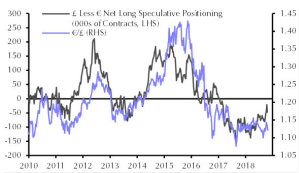
Source: Bloomberg
*Data taken from ONS CPI basket of goods

Brexit scenarios

- The pound has fallen by almost 10% against the US dollar over the past five months leaving it at around $1.30.
- According to Capital Economics the weakness of Sterling is largely being driven by Brexit uncertainty, evidenced by increased demand for Sterling put options.
- Capital Economics base case forecast assumes an '11th hour' deal is struck, pushing Sterling up to 1.21 vs the €.
- Forecasts available on Bloomberg for 2019 range from a low of 1.04 £/€ to a high of 1.23 £/€ based on 80 different contributors. The key driving factor in the various forecasts is the outcome of Brexit negotiations.



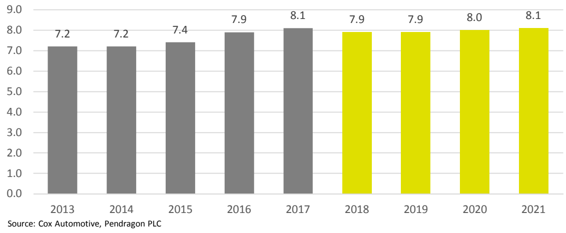
€/£ End-year forecasts	2018	2019	2020
Deal (agreed in early '19)	1.09	1.21	1.16
Orderly No Deal	1.09	1.04	1.04
Disorderly No Deal	1.09	0.97	0.97



Used car market will remain in focus

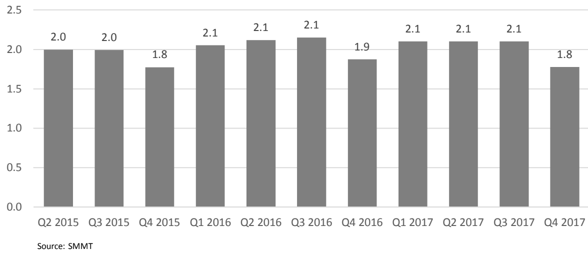
- Relative to the new car market, the used market has proven to be relatively robust.
- Both franchised and independent dealers have focused on this area as a source of profitability.
- Latest data from Cox Automotive suggest the used car market will decline in 2018 by 3.7% (compared to the 4.1% expected in the new market), forecasting a market of 7.9 million transactions
- The impact of WLTP will take longer to be seen in the used market and is ultimately more difficult to predict. Reduced supply could help margins in the short run but an extended period of low supply makes sourcing quality stock difficult, resulting in lower volumes and profits in the used business.
- The weakness in the new car market and current supply issues represents a longer-term risk for the used market in our view.

Used car market volume



Source: Cox Automotive, Pendragon PLC

Quarterly used car sales volumes

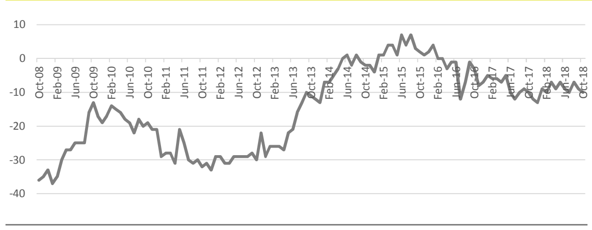


Source: SMMT

Used car market – demand dynamics

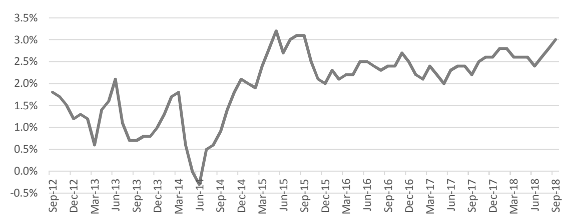
- According to Capital Economics, real spending growth should pick up from a likely 1.6% this year, to around 2.0% by 2020., assuming a Brexit deal is agreed.
- In contrast, if there were a “no deal” Brexit, Capital Economics estimate a hit of between 1 and 3ppts to consumer spending growth in 2019, depending on the scenario.
- Capital Economics expect sales of most consumer goods and services look set to benefit from an acceleration in real wage growth if the Government secures a Brexit transition period.
- Demand has been strong in the used car market with growth in volumes through 2018.
- Overall we believe that while there are inherent risks for the consumer outlook (political uncertainty, tightening monetary policy etc.) the potential for continued growth in incomes should continue to drive robust demand.

UK consumer confidence



Source: Gfk, Bloomberg

UK Earnings growth YoY% (3m MA)



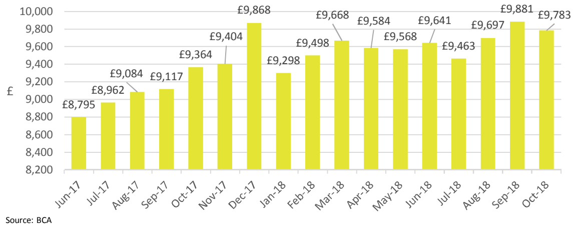
Source: Gfk, Bloomberg

Source: Bloomberg

Used car market – supply side dynamics

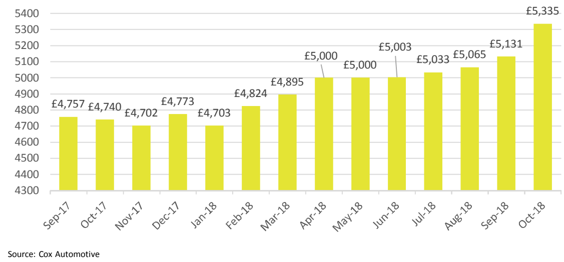
- WLTP and other supply issues are now feeding through to the used market. This is having a positive impact on residual values.
- The latest BCA auction data on used car auction values were declined 1.0% in October albeit this was up 4.5% yoy and was accompanied by an increase in he average mileage from 48,145 to 49,047.
- Average dealer part-exchange values improved sharply at BCA in October, rising by £204 (4%) to £5,335.
- Year-on-year values were ahead by £595, representing a 12.5% increase over the 12-month period with age decreasing from 88.42 to 87.30 months and mileage falling from 70,593 to 68,147.

Used car auction values



Source: BCA

Dealer part exchange values



Source: Cox Automotive

H1 themes from the listed dealers

Marshall Motor Holdings

H1 results – highlights

- Lfl retail sales down 5.9%
- Lfl used unit sales broadly flat, revenue up 5.2%, gross margin up 37 bps to 7.2%
- Lfl aftersales up 3.2%
- Net underlying operating expenses down 0.3%
- Continuing gross margin maintained at 11.5%

Trading update 14th November

- "growth in our used car volumes and margins given supply constraints in the new car market, combined with further revenue growth achieved in aftersales, has given us more confidence over the expected outcome for the year"

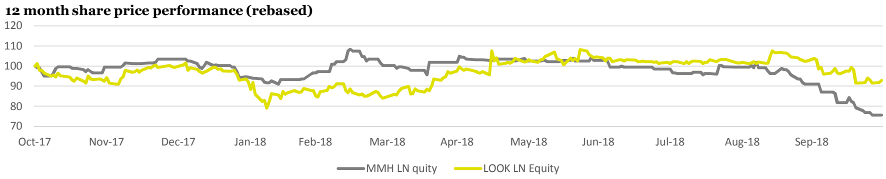
Lookers PLC

Q3 IMS – highlights

- Turnover and volumes of new cars reduced by 7%
- Total gross profit from new cars reduced by 5%;
- New car margins and profit per unit were higher than the prior year.
- Turnover of used cars has increased by 10%
- Gross profit from used cars increased by 10% during the period with improved margins per unit.

"The used car market continues to be buoyant and values have remained stable and predictable in the period. Used cars contributed 27% of total gross profit and are an important and successful part of our business, delivering additional growth in both volumes and gross profit"

12 month share price performance (rebased)



H1 themes from the listed dealers

Vertu Motors PLC

H1 results – highlights

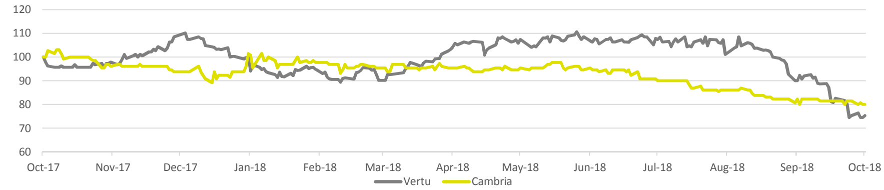
- Revenues of £1.56bn (2017 H1: £1.45bn) representing growth of 7.9%
- Group gross margin of 10.7% (2017 H1: 11.0%)
- Adjusted operating profit of £19.4m (2017 H1: £21.4m)
- Adjusted profit before tax of £18.1m (2017 H1: £20.9m)
- Profit before tax of £17.3m (2017 H1: £24.2m)
- Period end net debt of £8.7m (2017 H1: net cash £20.8m)
- Freehold and long leasehold property portfolio: £202.9m (2017 H1: £175.0m)
- Tangible net assets per share 45.9p (2017 H1: 44.5p)

Cambria Automobiles PLC

Pre close trading update– highlights

- The Group's adjusted profit for the 11 months to 31 July 2018 is behind that achieved in the prior year.
- The trading performance is down 6.4% year on year with the reduced new car performance partially offset by improvements in used cars and aftersales.
- Used vehicle sales continued to perform well and whilst unit sales were down 6.6%, the marginal reduction in units has been more than offset by improved profit retention with gross profit per unit on both a total and like-for-like basis continuing to increase significantly

12 month share price performance (rebased)



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H1 themes from the listed dealers

AutoTrader PLC

H1 results – highlights

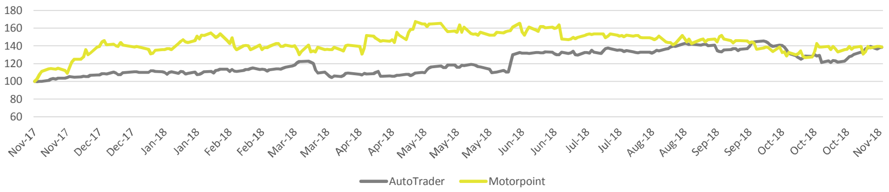
- Revenue up 7% to £176.8 million (H1 2018: £165.0 million)
- Average Revenue Per Retailer forecourt ('ARPR') per month up £152 to £1,826 (H1 2018: £1,674), driven by product and price growth
- New car market remains under pressure but used car transactions look to be stabilising
- Operating profit up 10% to £120.6 million (H1 2018 restated: £109.9 million) resulting in Operating profit margin of 68% (H1 2018 restated: 67%)
- Profit before tax up 9% to £114.5 million (H1 2018 restated: £105.3 million)

Motorpoint PLC

Pre close trading update– highlights

- Profit before tax and exceptional items up 32.5% to £20.8m (FY17: £15.7m)
- Profit before tax up 70.9% to £20.0m (FY17: £11.7m)
- Adjusted basic earnings per share up 32.3% to 16.8p (FY17: 12.7p)
- Cash flow from operations up £12.8m to £20.2m (FY17: £7.4m)
- Operating cash conversion of 94.8% (FY17: 57.4%)
- Proposed final dividend of 4.6 pence per share (FY17: 2.9p) which would give a full year dividend of 6.6 pence (FY17: 4.2p) an increase of 57.1%
- Revenue increased 20.6% to £991.2m (FY17: £822.0m)

12 month share price performance (rebased)



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Dealer profitability

	Rolling 12 months September 2018	Rolling 12 months September 2017	Benchmark
Net profit as a % sales	0.91%	1.03%	3.0%
Overhead absorption	52.8%	53.2%	80.0%
Used:New sales	1.48:1	1.3:1	1.5:1
Vehicle sales expenses as a % gross	66.5%	66.3%	50.0%
Sales per executive	153	157	150
Used vehicle stockturn	57.1	57.7	45.0
Return on used car investment	86.9%	88.6%	100.0%
Overall labour efficience	84.9%	83.7%	100.0%
Service gross profit % on labour	74.9%	74.9%	75.0%
Service Expenses as a % gross profit	62.6%	61.1%	40.0%
Hours per retail job card	1.52	1.51	2.5
Parts gross profit %	22.4%	22.5%	23.0%
Parts expenses as a % goss	43.0%	41.3%	40.0%
Parts stockturn	7.1	6.1	8.0

International dynamics

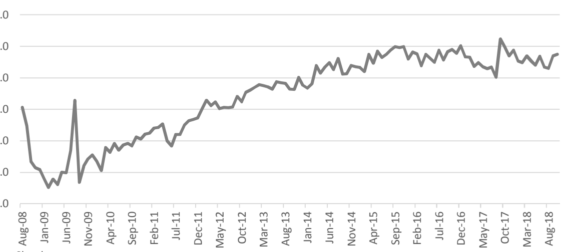
US Dynamics

- US cycle typically 12-18 months ahead of UK.
- The seasonally adjusted, annualized sales rate for October came in at 17.59 million.
- October marked the eighth month in 2018 the annualized pace of sales has topped 17 million.
- U.S. auto sales in 2018 have now risen 0.5 percent through October but analysts still expect the second-half slowdown to continue.

European Dynamics

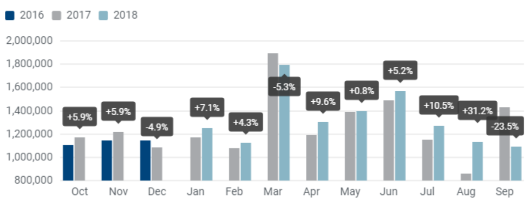
- New car registrations dropped 23.5% across Europe in September.
- Over the first nine months of 2018, EU demand for passenger cars remained positive (+2.5%), in line with growth expectations for this year. Looking at the five biggest markets, demand went up in Spain (+11.7%), France (+6.5%) and Germany (+2.4%), while car sales contracted in Italy (-2.8%) and in the United Kingdom (-7.5%).

US vehicle sales – Seasonally adjusted annual rate



Source: Bloomberg

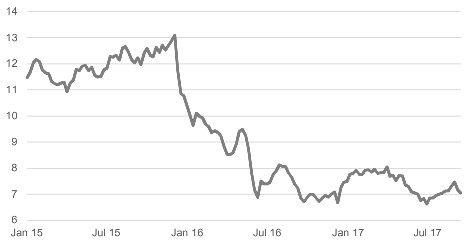
European vehicle registrations YoY%



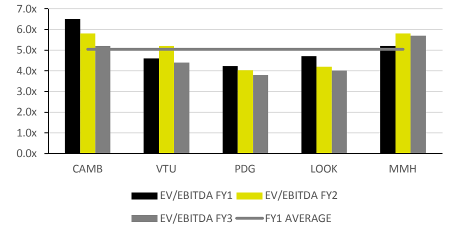
Source: ACEA

PLC Valuation snapshot

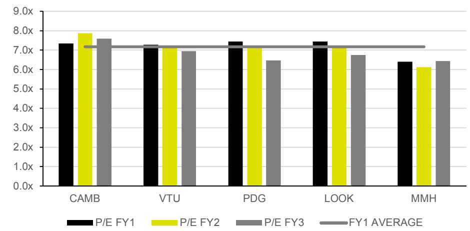
Average FY1 P/E



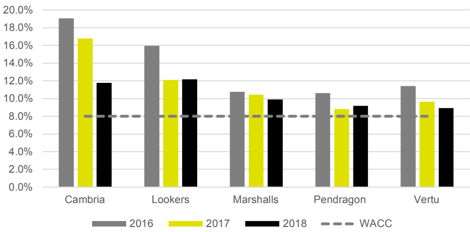
EV/EBITDA multiples



P/E multiples



ROCE analysis

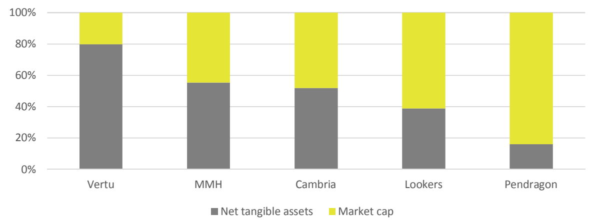


Source: Zeus Capital estimates, Bloomberg

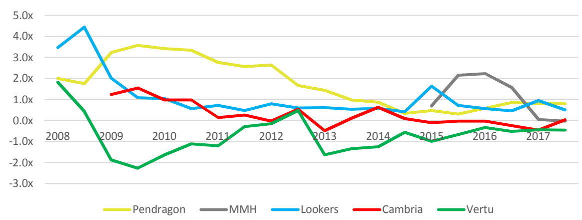
Balance sheet strength

- Balance sheets remain robust across the sector.
- Listed dealers have significantly deleveraged over the past decade – average net debt to EBITDA down from 2.4x in 2008 to 0.2x according to latest reported figures.
- Vertu, Cambria and MMH all have net cash positions according to latest reported figures.
- Vertu, Pendragon and Lookers have been returning cash to shareholders through share repurchases
- Valuations are underpinned by net tangible assets on balance sheet.
- We believe we will see consolidation across the sector as the large listed groups utilise their balance sheet capacity and take advantage of opportunities to acquire smaller groups.

Net tangible assets vs. market cap



Net debt/EBITDA



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5 Key conclusions

1. Consumer environment will remain challenging in 2018/2019
2. Used car market proving robust – listed dealers achieving growth in used car profits
3. WLTP creating potential for supply issues in new market, expected to continue to Q1 2019
4. Supply issues in new pushing residual values up
5. Improving FCF yields likely to become catalyst for share price improvements
6. Balance sheets of large dealers remain robust – we expect further consolidation