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Car Dealership Market Update April 2020

The car dealership market, like business more generally, is facing an unprecedented level of uncertainty. This challenge will accelerate necessary structural change as we pass through a hard market. With the UK entering "Lockdown" on 24 March new car sales during March dropped a whopping 44.4% (obscuring the seismic overtaking of Ford by Volkswagen as the market leader after 35 years of dominance). There is an expectation that new and used car sales will drop by 90% during April with limited ability to hand over vehicles (sold over the internet).

The question on everybody's lips in the automotive sector is what may happen as we transition from complete "Lockdown" to the new future? There is likely to be a different type of recession than experienced before. Release from "Lockdown" will probably still necessitate "social distancing" until widespread COVID-19 testing can be introduced and may last into 2021. When business switches on demand is expected to reflect remaining restrictions and corporate, individual, and national debt levels. Despite this automotive industry research company Indicata consider that vehicle pricing will largely remain consistent with pre-crisis levels reflecting the reductions in new vehicle production resulting from factory closures, estimated at a 2.5m – 3m unit shortfall in Europe alone, and supply shortages in the used vehicle chain.

As the nation clambers out of the "Lockdown" Government aid will recede leaving companies and individuals exposed to the prevailing market forces, pressurising disposable income and employment opportunities. As the Chancellor said on 8 April he "cannot protect every business". In the meantime, most automotive companies will have experienced damaging revenue starvation which will put pressure on year end viability. The lifeline lies in identifying quick and safe reopening.

Another motor industry analyst, Cazana, is suggesting a market nadir in July reflecting an anticipated low point in business and consumer confidence. However, there is a spring feeling around the Alternative Fuelled Vehicle market, in particular the (solely) Battery Electric Vehicle offer.

Car Dealership Market Update
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As we have reported previously a lead in economic direction can be taken from China where there is evidence that new car sales are bouncing back. China is the obvious country to look to; following the outbreak parts of the country shut down, a large number of factories were closed including many automotive premises and likewise car retailers were ordered to shut and large parts of the population were not only locked down but had little interest in buying cars. During February new car registrations were down 92% year on year but following re-opening according to the International Car Distribution Programme (an organisation that works alongside global car manufacturers) dealers reported trading at 66% of "normal" levels covering new cars, parts, and servicing. During the lockdown internet traffic endured and some dealer activity was aimed at turning this interest into a pipeline for future sales and as a result many dealers focussed on staffing their online sales channels. These sales have been backed by new sales practices such as home delivery and home servicing collection.

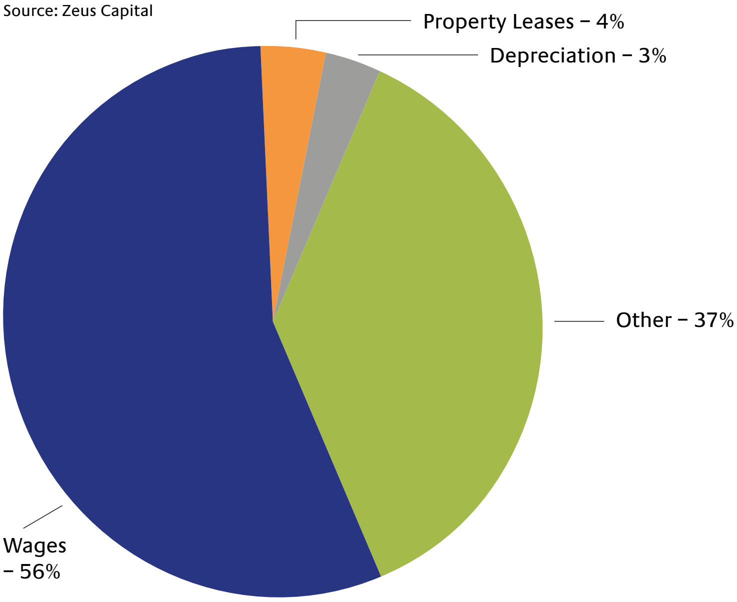
The suggestion is that there is a pipeline of pent-up customer demand. Change, both short and long term, is inevitable as a result of this crisis. The positive reflection is that the UK car industry is crucial to the country, and dealerships remain the conduit between manufacturers and their customers.

Currently companies have many different issues and need to be cost conscious. Those that have been managing their businesses well against a difficult past two or three years will be better positioned to steer through the crisis. Those who have faced spiralling costs and challenges such as pensions, are already damaged entering this crisis. Low interest rates are a double-edged sword, as well as lowering borrowing costs they reduce investment returns and add to pension liabilities. Government measures are helping, but currently new car supply has dried up and there is concern about vehicle stock holding costs. Manufacturers have their role to play in inspiring dealer profitability and creating softer targets for dealers and deferred payment terms once they get going again.

There remains though huge uncertainty and motor dealers face high fixed costs with a potential 95% drop in sales in April volumes due to a suspended supply chain, followed by a drop in customer demand. Cash reserves will be crucial alongside manufacturer support. Addressing costs is another focus area and typicaly wages account for around 60% of a dealer's cost. The second highest is reported to be property (leasehold, freehold, and Business Rates). See sample chart below;

FIGURE 1: SAMPLE DEALERSHIP GROUP PROFILE

Source: Zeus Capital



Dealer groups who can garner strong manufacturer support stand better prospects than others. One thing is certain that exiting this crisis we will all see a different world which will have embedded a greater use of the internet and adaption of mobility services. Amidst the pain there is an opportunity for dealers and their staff to learn new skills and move closer to the 'Clicks & Mortar' model.

Returning to the pressures today, dealerships have closed all their new and used car sales operations. Whilst current regulations would allow workshops, trade parts, car rental, bodyshops, and MOT operations to remain open, dealers will need to reconcile the Health & Safety concerns of customers and staff without complete closure. The industry is seeking

COVID-19 Global Pandemic Timeline

21 DEC 2019 — Chinese Centre for Disease control and Prevention identify first cluster of patients.

31 DEC 2019 — Chinese authorities contact World Health Organisation (WHO) and informs them of 'cases of pneumonia of unknown case'.

2 JAN 2020 — Central Hospital of Wuhan banned staff from discussing the disease publicly.

8 JAN 2020 — Chinese government accepts WHO scientific team assistance.

11 JAN 2020 — First known death.

20 JAN 2020 — WHO confirmed first confirmed cases outside mainland China as occurring in Japan, South Korea and Thailand.

22 JAN 2020 — Public Health England announces move in risk level from 'very low' to 'low'.

30 JAN 2020 — WHO declares global health emergency amid thousands of new cases in China.

4 FEB 2020 — UK directs its citizens to leave China.

20 FEB 2020 — COVID-19 erupts into the public domain.

4 MAR 2020 — Cases of COVID-19 surge.

11 MAR 2020 — Global pandemic declared by WHO.
Chancellor announces £12bn emergency support package.

16 MAR 2020 — First daily Prime Minister's press conference
Government advised against unnecessary travel and workers were "advised" to work from home where possible.

17 MAR 2020 — Government advised against all non-essential travel.
Chancellor unveils £330bn government backed loan package and more than £20bn in tax cuts.

19 MAR 2020 — RICS issued a COVID-19 valuation notification inviting members to consider whether a material uncertainty declaration is now appropriate.

20 MAR 2020 — Government instructed all bars, pubs, restaurants, theatres, cinemas, gyms, cafes, and nightclubs to close and also announced the Furlough Job Retention Scheme.

ways to run these operations, initially for emergency and key worker customers. In time hopefully methods will be devised whereby handover of vehicles and parts can be achieved whilst satisfying social-distancing directions.

Government has introduced a raft of job retention schemes which dealers, alongside many businesses, are utilising. "Furloughing" staff rather than make them redundant has seen wide take up with many dealers and indeed manufacturers reporting furloughing 60%-90% of their staff. There is also a raft of government supported funding accessed via the banking system. After an initial awkward start there are now reports of a more ready response from the banks. Credit checks are required but there has been an easing in the requirement for Directors' personal guarantees for small and medium business company loans. It remains to be seen how effective the banking sector will be in responding to Government initiatives, particularly as it was only a decade ago that they were asked to fulfil similar roles in the face of the global financial crisis

Government tax breaks, in particular VAT deferral, is seen by businesses as extremely helpful. PAYE and NIC deferral are also possible over the next few months by arrangement with HMRC.

Little solace though can be expected at the moment from business interruption insurance policies. Broadly speaking it is not envisaged that many policies will cover COVID-19. The bigger insurance concern is responsibility for vacant properties and valuable stock. Many dealers have been required to move stock from forecourts. Insurers have different requirements for vacant properties compared to occupied ones. Whilst some leniency can be expected in the short term from insurers, to be recovered in the medium to longer term by increased premiums, insurance and security concerns are a spur to some element of property reoccupation.

On a purely property perspective, the Business Rates relief available to car showrooms, amongst many other retail related businesses, is of huge assistance in cost control. Typically, between 80-90% of dealer groups' properties are covered by this relief and overall can be expected to write-off around 33% of property cost over the next twelve months.

Whilst all tenants' attention is now turned towards seeing what help landlords can provide in the way of rent payment relief, consideration needs to be given as to what relief in turn is available to landlords from their banks and others? Such relief could involve relaxation of mortgage capital repayments and interest rate holidays. The Estates Gazette commented on 28 March that "the Government moratorium on evictions is being interpreted by some tenants as an instruction not to pay regardless of ability to pay". Pressure is therefore heaping up on landlords.

General legal sentiment towards escaping from contractual landlord and tenant obligations is not encouraging for tenants. Attention has been focussed on force majeure and frustration provision. Force majeure is likely to require complete prevention of performance of a contract, and frustration would need to demonstrate that performance is not possible and show that no party is considered responsible. According to Guy Featherstonehaugh QC in an article in the Estates Gazette (28 March 2020) "as matters stand, no court has in our experience ever held that a lease has been frustrated"

Key dates in the crisis appear to be 20 February as being the day when COVID-19 erupted into the public domain, followed by the COVID-19 outbreak being declared a global pandemic by the World Health Organisation on 11 March. Another key date was the Government's announcement on 23 March that they will prevent commercial tenants who cannot pay their rent because of the coronavirus from eviction; meaning no business will be forced out of their premises if they miss a payment in the next 3 months. Against this background many landlords and tenants are already having conversations and reaching voluntary arrangements about rental payments due. As such this announcement has drawn a "line in the sand". The Government recognises tenants are still liable for their rent and should pay this as usual, but in the case of financial hardship landlords and tenants are encouraged to put in place a rent payment scheme.

Landlords do have other means of redress for non-payment of rent, and the emphasis is on financial hardship, and so arbitrary decisions by tenants not to pay rent will not be well received by landlords, and nor abide by the spirit of Government guidance. The real focus should be the future June Quarter day payment which will be following a substantial period of dealership closure.

Having regard to the enduring structural pressure on the industry on release from "Lockdown" there will be an urgent need for manufacturers to increase their electric vehicle production to avoid stringent CO_2 emission regulation and fines. Some manufacturers face

COVID-19 Global Pandemic Timeline

23 MAR 2020 — Ministry of Housing, Communities and Local Government announce that car showrooms along with a series of other business and premises must close

Government announce it will prevent commercial tenants who cannot pay their rent due to COVID-19 from facing eviction for 3 months.

Prime Minister announces national movement restrictions.

24 MAR 2020 — Lockdown commences.

25 MAR 2020 — MOT's deferred for 6 months.

27 MAR 2020 — Insolvency regulations were changed with the suspension of the "Wrongful Trading" rules.

28 MAR 2020 — Chancellor announced support for the self employed.

31 MAR 2020 — NHS calls for businesses to support the production and supply of ventilators.

2 APR 2020 — Chancellor claims banks taking advantage of the crisis and that only £145 million of £330 billion government grants and loans had been taken-up.

RICS issued further guidance relating to the use of a material uncertainty clause.

3 APR 2020 — The Purchasing Managers Index Survey shows the service industry has slumped from a reading of 53.2 to 34.5, marking a significant economic contraction.

6 APR 2020 — March car registrations drop 44%.

8 APR 2020 — Chancellor states that he "cannot protect every business".

16 APR 2020 — Lockdown extended for 3 further weeks.

17 APR 2020 — Furloughing extended to end of June.

27 APR 2020 — Chancellor announces further financial help for small firms offering loans "within days" of up to £50,000, 100% backed by Government.

higher challenges than others and, for example, Toyota come out of this looking good. Inflation will also have its influence and the relative strength of sterling will influence car manufacturers' desire to achieve sales in the UK. The used car market remains in focus but there are concerns about margins. Whilst a number of the top dealer groups have strong cash positions there are evolving pressures on the quality of their franchise portfolio and cost. The electric vehicle integration is significantly hindered by the paucity of charging infrastructure, and of course the cheapening of oil. Projections for the next twelve years show substantial retention of combustion engine vehicles on the UK's roads, albeit an aging parc which according to Zeus Capital, will rise from an average age of 9.5 to 11.2 years over the next five years. Such vehicles are likely to require greater maintenance and parts, feeding business to dealer's workshops.

The dealership format has also been evolving and the current crisis will only serve to "fast forward" the process. There is a focus on locations with 'retail pull' to enhance brand awareness and a growing interest in pop-up stores. Physical dealerships still remain essential and the new formats are intended to provide flexibility for dealerships to optimise their coverage. Supported by service factories and used car centres, the trend remains towards disaggregation and an overall reduction in the number of outlets of perhaps up to 30% (according to Grant Thornton). Consolidation will provide a lifeline against cost pressures and the need to maintain margins. Currently the top 10 UK motor retailers account for nearly 50% of total market revenue. The implications of this are that not all closed dealerships and car sales outlets will re-open as this crisis dissipates, and dealership re-opening will most likely be phased across the various functions, starting with vehicle servicing and internet sales.

Already property pricing is correcting. At a Valuation level on 19 March the Royal Institution of Chartered Surveyors issued an alert to the effect that the property market was now entering a period of "material uncertainty", identifying that the exact consequences of the COVI-19 outbreak are unknown; inspecting property may be difficult either through firms' own internal procedures, Government imposed restrictions or unwillingness of occupants to grant access. Access to data such as comparable evidence maybe less freely available and at the valuation date it may be that less weight can be attached to previous market evidence for comparison purposes, to inform opinions of value. The RICS guidance states; "Indeed, the current response to COVID-19 means that we are faced with an unprecedented set of circumstances on which to base a judgement".

This means that current property pricing is likely to demonstrate a greater variance in reliability than under normal market conditions, and reportedly during March will have seen a 2.5 – 5% downwards movement in "Investment" grade property pricing. This pricing compression will continue and widescale re-structuring of leases can be reasonably anticipated. Landlords are already being inundated with requests for rent support, such as paying monthly or even a 3-month rental deferment. With the car dealership world in "Lockdown", the majority of staff furloughed (for a minimum of 3 weeks), no revenue coming in, and the timescale for re-opening in any form uncertain, these requests are evolving into more enduring lease structure changes. The urgency will increase as the June quarter day edges closer and with furloughing programmed to end at the end of June.

Guidance for addressing this innovation can be gleaned from previous retail sector lease re-arrangements, but any rent adjustment is also an existential threat to Landlord's asset values. Agreements are likley to reflect the revenue generating scope of the staggered re-opening of dealership services and consequent tenant affordability/profitability, and offer landlord's down the line asset value recovery. There is a balance to strike with a need to act quickly and decisively to arrest greater risk down the road as the market hardens. A crisis should provide the motivation for restructuring and price risk realignment and not trigger a retrenchment.

The future of dealerships remains essential to Mobility; test drives are still rated as a very important part of the buying process, 14% of annual household's budget is spent on transport, more than housing; internet usage is set to increase, and manufacturers will need to support their dealer networks. Post-crisis, overall, we can expect a more definitive move towards omni-channel retailing and facility disaggregation. In turn the property world has always responded to market evolution and entwining new concepts alongside enduring market fundamentals.

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