making property work for business

The immediate future for car dealership property – Spring 2021

Reports of the demise of bricks and mortar car dealerships are greatly exaggerated. Car dealerships in particular both in function and location can readily evolve; witness Tesla and Cazoo transiting into former dealerships, and on top of that other uses are biting at the heels.

Volvo have been reported to want to move to selling new cars entirely on-line, but on closer investigation what they intend is to originate sales online and close them at the dealerships. Original Equipment Manufacturers (OEMs) are wedded to dealers remaining the principal distribution conduit, and that is the key word, Distribution, as dealers move away from conventional 'retailing' and morph into distribution and tech companies. For example Inchcape have relisted on the London Stock Exchange and are now classified as "Business Support Service", having previously been "Speciality Retail", and Cazoo are expected to move to an IPO, rated as a Tech stock.

What are the implications for the future?

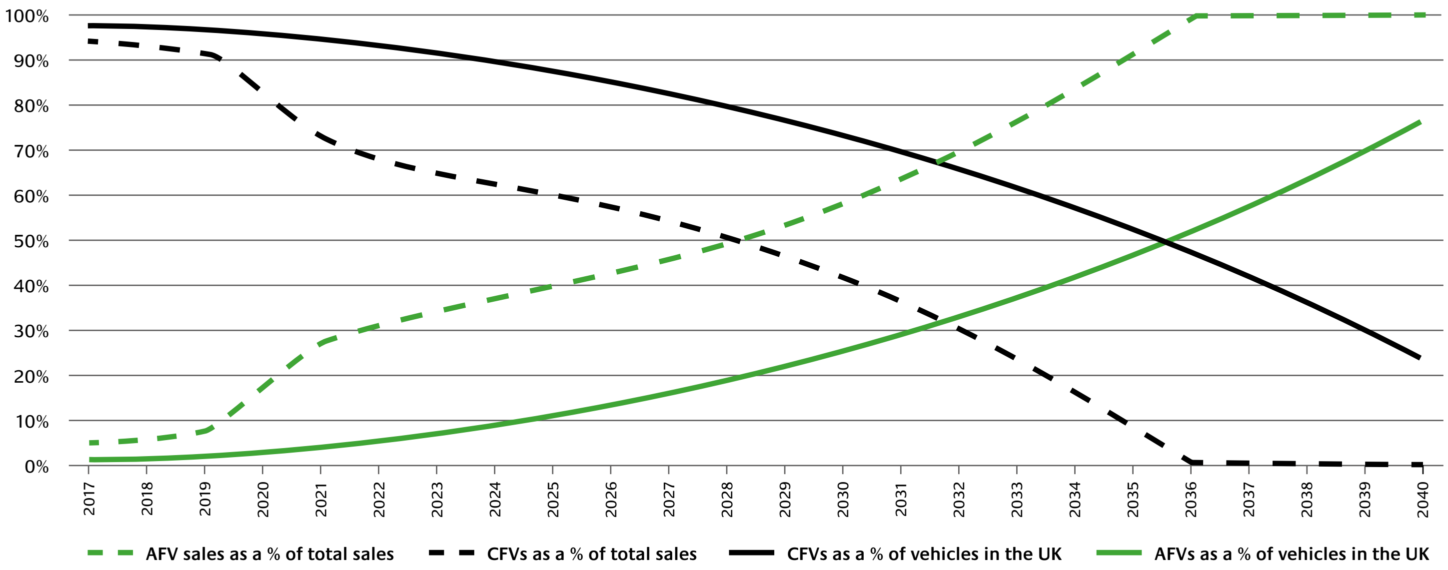
Dealing firstly with Brexit, we are seeing impending problems with satisfying the Rules of Origin Regulations which in particular affect battery production. This is resulting in many European countries, including the UK, looking to establish their own battery giga-factories to address future supply problems. We can expect weak economic growth as we move out of the lockdowns, there are already significant border control issues restricting imports and exports, and Brexit implications have squeezed the availability of finance for dealers.

Brexit though has been occluded by the Covid-19 pandemic. However, with the significant impact of vaccines we are starting to see hope for the freedom to travel and, with that, expected rises in consumer confidence and subsequent rises in consumer spending, which in turn feeds into economic recovery. The Bank of England's Chief Economist, Andy Haldane, back in February talked about the economic "coiled spring", ready to bounce back strongly when the pandemic is over. Household balance sheets are strong with low debt. Consumers, therefore, have cash to spend. With limited foreign travel opportunities in the immediate future, their attention could well turn to cars.

Supply of new vehicles has proven challenging during lockdown and further accentuated by a semiconductor chip shortage. New car pricing has effectively risen as dealers have been able to secure fuller margins and across various segments within the used car markets, pricing has actually at times increased. This is all indicative of a supply-side squeeze, rather than any lack of demand. The pandemic has seen cars become more important to consumers wanting to have their own space and in the short term, increases in stay-vacations and car journeys is a reasonable expectation. The large open spaces that car dealerships are able to offer, both externally and internally, can easily satisfy social distancing requirements. Overall, we see that the pandemic has effectively acted as an accelerator of structural changes sweeping through the motor industry.

This leads on to the core CASE dynamic as outlined by Mike Allen at Zeus Capital (Connectively, Autonomy, Shared/Subscription and Electric). There are around 100 electric vehicle offerings available now or shortly which has stimulated significant growth in EV sales and adaption. Covid 19 has accelerated EV take-up and OEMs are going electric in a big way, for example Jaguar have recently announced plans to go all electric. The emissions benefits are well publicised, however enormous investment in infrastructure is required to provide the necessary charging points. The Government has announced bold plans for the ban of

AFV UPTAKE & CFV DECLINE



petrol and diesel cars by 2030 and hybrids by 2035. This does not mean that of the approximately 39.7 million vehicles on the road that by 2030 or indeed 2035 they will all be electric vehicles. Take-up over the last year or so has improved significantly and, considering the extended range of EVs available, we have adjusted our January 2018 projections for the number of AFV sales in 2030 from 24% to 58% and by 2035, from 54% to 93%. This means that in 2030, 26% of vehicles on the road will be AFVs and by 2035, 49%. We think it will take until 2040 to achieve 100% new car AFV sales but even then, 22% of vehicles on the road will be combustion engines. While take-up now is expected to be quick, within a relatively short period of a year or two, we expect the pace to slow down to allow the infrastructure provision to catch up.

The internet is another conduit for dealers to reach out more easily to their customers to generate enquiries and to overall improve the 'mouse to house' journey. The digital showroom is always open, and the internet provides pricing transparency with websites like Carwow leading the way. Customers now undertake 80% of the buying journey online and during the recent lockdown new car sales have been running at 60% of normal activity, even with showrooms closed. As the economy and the World reopens, we can also expect to see an extension of the mobility services being pioneered by OEMs and tech companies prior to the pandemic, such as improved autonomy, smart-roads, and a widening of subscription services offering customers flexibility for car usage.

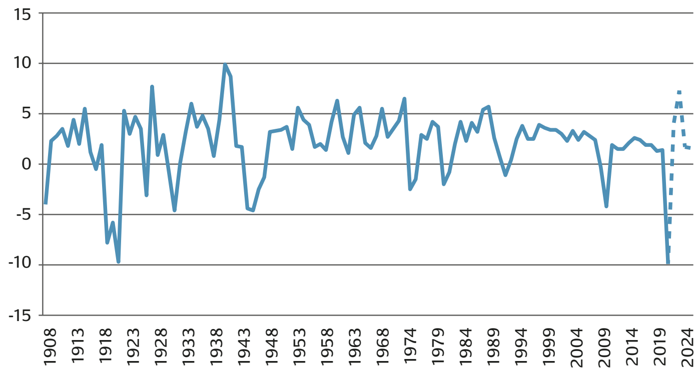
What does this mean for car dealership property?

Turning to the bricks and mortar story: dealers have paid their rents, and as a result investors have developed a new respect for the industry, albeit the investor profile has shifted towards private investors and property companies who have the dexterity and responsiveness to recognise the robust distribution credentials of the sector. The larger financial institutions are hampered by the reported classification of car dealerships as retail assets by the world's leading property performance index, MSCI. Car dealerships offer a strong Industrial functionality and as the CASE-motivated structural changes permeate throughout the industry, the distribution function of dealers and their real estate assets will only be enhanced.

Dealership property is flexible and we are already seeing an increase in the aftersales and distribution utilisation of real estate and a shrinking of the traditional showroom. Whilst the buildings' adaptability is often not an impediment, this does need to be amalgamated with changing OEM standards, and overcoming town planning obstacles, when compared to the freedom of the internet. Nonetheless, the two work in harmony together.

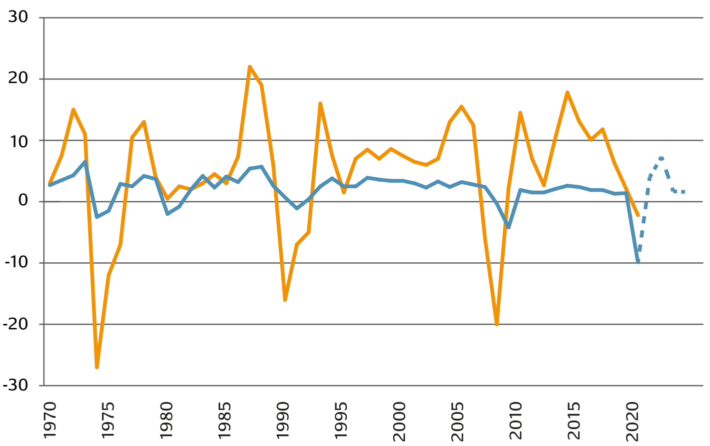
Albeit we are living in uncertain times, the property market moves in a typical peak and trough fashion. The slide opposite measures GDP from almost the turn of the last century and shows the peak and troughs of economic performance, reflecting dramatic events such as the world wars and the Spanish flu pandemic, which lasted almost 36 months from January 1918 to December 1920.

GDP (Source: OBR)

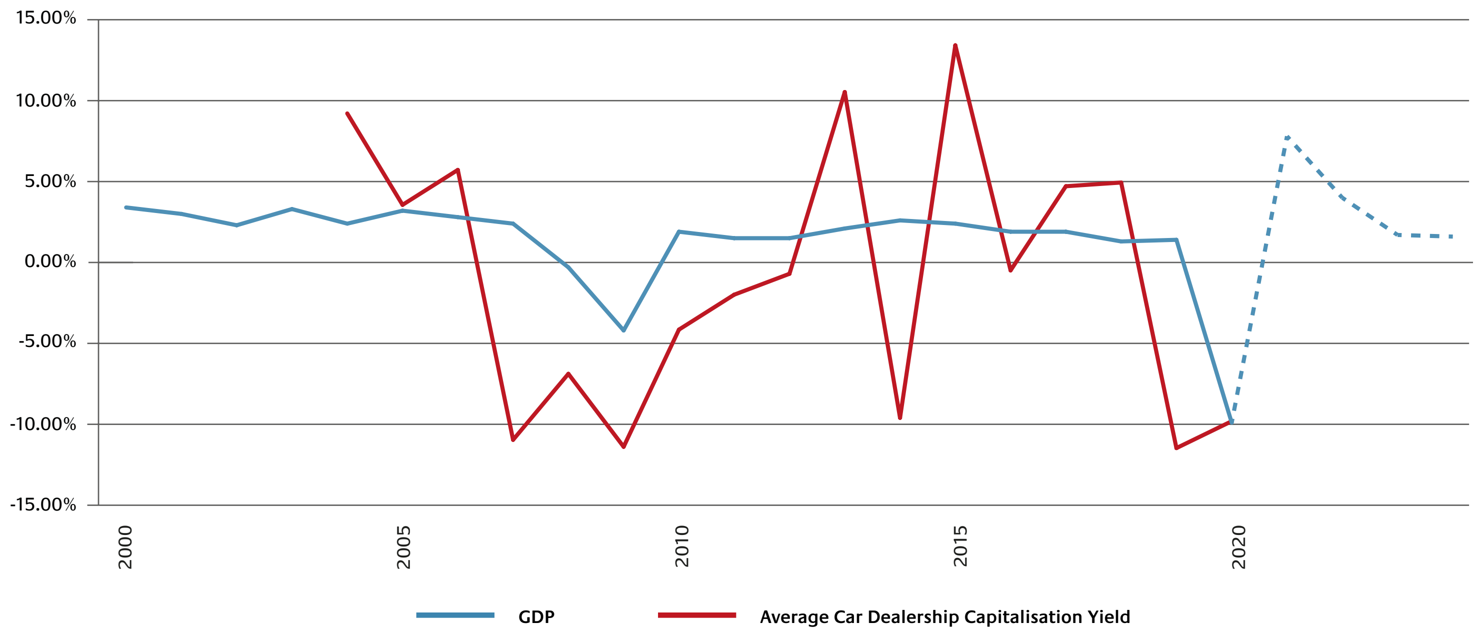


The graph below demonstrates that from past performance analysis, property does not directly follow GDP movements, but is rather a GDP multiplier. Property performance over the last 50 years has tracked the direction of GDP movement, but more aggressively i.e., there are deeper troughs and higher peaks. As such, property is more volatile than GDP. Total Return is a measurement of capital growth and income (rent).

UK COMMERCIAL PROPERTY TOTAL RETURNS AGAINST GDP
(Sources: OBR, CBRE, IPD, BPF, Savills)



GDP vs AVERAGE CAR DEALERSHIP CAPITALISATION YIELD



In the graph above we have used APC's investment yield (capitalisation rate) as a proxy for car dealership pricing and plotted the direction of travel alongside the Government's own GDP projections.

Car dealership investments' solid performance during the pandemic has seen robust value retention easing only 4% when compared to the wider commercial property pricing declines of 7% – 10%. Since Summer 2020 we have see noticeable improvements in pricing and more investor interest in the sector which we expect to result in further pricing compression for what can be best described as survivor stock. When compared to broader economic uncertainty, its comparative attractive Yield makes the right dealership investment a good place for investors to be.

Customers will still demand the dealership experience

Car dealerships are uniquely characterised by their ability to combine 'ecommerce' and 'bricks and mortar' and it remains important to disengage their association with the performance of the Retail Property Market and unlock value through their distribution characteristics. In the next 12 months, we expect dealerships continue to expand their digital journey between dealer and customer with physical dealerships evolving in function and location over time, particularly as consideration is given to how moving to EVs will affect the usage of space.

Disclaimer

The views expressed in this bulletin are those of the author Bill Bexson and are from personal research and experience and intended as opinion only.

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