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Car Dealership Market Review

Summer 2021

The advanced world is recovering rapidly from the unprecedented pandemic shock in 2020. Despite this, economic performance has exceeded even the most optimistic forecasts so far this year. This rapid recovery is now expected to continue in the second half of 2021 and throughout 2022. The UK is expected to surpass its pre-pandemic level of GDP by the first quarter of next year at the latest. Unprecedented monetary and fiscal policy support and excess savings by households are expected to power an upswing well beyond the return to pre-pandemic levels of activity from the demand side.

The pent-up demand is driving a major bounce in spending on many services and consumer items, including cars. This surge in demand has been so strong that supply bottlenecks have become apparent and could be the key restraint to growth. This increase in demand is coming at an invisible cost. Inflation has picked up and whilst in the UK, RPI figures from July have seen the headline inflation rate falling to the Government's 2% target, after an increase of 3% in the year the June, the Bank of England expects inflation to rise to 4% by the end of the year. Demand in particular has increased for second-hand cars as people seek alternatives to public transport, accentuated by a global shortage of semi-conductors affecting the supply of new cars and driving consumers to the used car market. In response to this the Bank of England appears wary of altering the unprecedented low interest rate introduced in an attempt to stabilise the economy at the height of the pandemic and is continuing its programme of quantitative easing.

New car registrations in June were up 28% on the same month last year when most dealerships reopened after the first lockdown. Consumer confidence is reported to be *"steady"* by the Society of motor Manufacturers and Traders (SMMT) but as already noted, the global semi-conductor shortage is impacting on vehicle supply. The SMMT report that compared with the previous decade average, monthly registrations were down -16.4% and half-year new car registrations were down -26.8% when compared with the 10-year average. The SMMT's forecast for 2021 new car sales is 1.86 million, which could now prove optimistic given the semi-conductor shortage. This compares with the 2010/2019 average of c.2.3 million new car sales per annum. In parallel Cox Automotive has modelled a mid-level forecast of 6.81 million used car registrations in 2021.

Mike Allen from Zeus Capital reports that there are five themes shaping the car dealership sector in the short to medium term. These are digital sales trends, electrification, the *"agency"* model, vehicle supply and the economic outlook. He states that *"the dealer groups have shown a great deal of resilience and flexibility throughout the Covid-19 pandemic – we expect them to continue to adapt and work closely with OEMs as the industry evolves"*.

Many of the Original Equipment Manufacturers (OEMs – the car manufacturers) are reviewing their new car sales strategies and considering the opportunities for direct sales to customers using the dealer network as their delivery conduit.

A number of manufacturers are considering introducing the 'agency' model in respect of the sale of new vehicles. Mercedes-Benz and Volkswagen in particular are consulting with dealers on this. The process does potentially offer benefits to dealers requiring lower investment in stock and increasing returns on capital employed. Several brands are looking at online direct sales and for example, Volvo plans to sell only EVs by 2030 and shift all sales online, with fixed prices. Their aim is to simplify the buying process and reduce the number of steps in buying a car, removing the price negotiation in dealerships

There is a lot of activity around EVs at the moment, but the charging infrastructure provision looks precariously balanced. According to the SMMT, EVs and hybrids made up 10.7% of the total new car registrations in 2020, up from 3.1% in 2019. This trend has continued in 2021, representing 14.5% of the total market, up 7.7% on 2020. However, the market is threatened by insufficient charging infrastructure. A recent SMMT report stated that 1.7 million public charge points will be required by 2030 and 2.8 million by 2035, compared to around 20,000 public charging locations in the UK currently. A recent survey by CACI said that some 42% of the UK consumers believe their next car will be an EV. However, mass adoption of EVs is unlikely to happen by 2030 based on the current rate. Rapid charger availability remains the biggest constraint.

The immediate future though is challenged by supply shortages. There is currently severe disruption caused by a shortage in semi-conductors. This is an increasingly important component in the electronic systems in vehicles. Manufacturers including Volkswagen, Nissan, Honda, Ford, JLR, and Volvo have all said they will be forced to cut vehicle production. So far in 2021 we have only seen a limited impact of these supply shortages on new vehicle sales in UK, but it is expected to be a different picture in the second half.

The closure of dealerships throughout several lockdowns has encouraged customers to do more of the car buying journey online. Covid-19 accelerated dealer development and use of the internet digital sales tools. Now dealers are offering a more flexible omnichannel approach providing a full choice to consumers in how they wish to complete their sales journey. Those dealers that develop a comprehensive "*bricks and clicks*" strategy, are expected to out-perform over the coming years. Whilst the pandemic has engendered an increase in digital selling, car buyers increasingly require the flexibility to mix online and in-person interactions.

The last 18 months has seen a number of digital retailers enter the used car market, companies such as Cazoo, Cinch and Carzam aim to capture a share of the c.8 million used vehicles sold each year in the UK. However, the incumbent UK motor dealers have adapted their online solutions and now offer a similar online customer proposition to that of the disruptor brands.

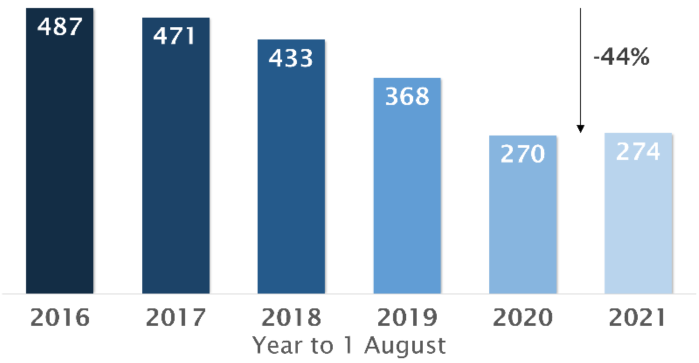
Used car demand and residual values remain strong. Demand factors such as consumers buying used instead of new vehicles, combined with supply shortages, have driven up prices. In June used car prices increased by 4.8%. Aftersales continue to remain a lucrative area of business for car dealers and the most recent data from the DVLA shows that the average age of cars in the UK has crept up to 8.6 years at the end of 2020. This is bolstering dealers' profits and is offsetting the impact of volume reductions.

Recent trading updates from the quoted dealers suggest that record first-half 2021 performances are expected with robust demand and increasing used car values driving up margins. Dealer group performance has been strong. Pendragon have reported that profit before tax for the first half of 2021 is expected to around £30 million and before tax for the full year is expected to sit around £45 - £60 million. Lookers' 2020 accounts show that despite a 23% drop in revenue, profit rose from £5.4 million to £15.5 million. The company expects half 1 2021 underlying profit before tax to finish at around £50 million, compared to a £36.1 million underlying loss last year. Inchcape's half 1's results for 2021 showed a revenue increase of 30% and profit rising 468%. Vertu has reported strong trading performance and it's six month period ending 31 August 2021 is expected to post profits of more than £40 million.

There are less new dealerships or refurbishments being built as evidenced by the decline in planning applications for car dealership activities. There were 487 applications in 2016 and 274 in 2020, a 44% decline. This reaction is reflective of the wider industry's structural and geo-political background; the influences of improved vehicle connectivity, the introduction to shared/subscription services, Electric Vehicles (EVs), and the shift towards autonomous driving capability alongside Brexit, tariff controls, and currency (£:euro) fluctuation all playing their part in moving the shape of the market along.

PLANNING APPLICATIONS SINCE 2016

(Source:: EG Radius)



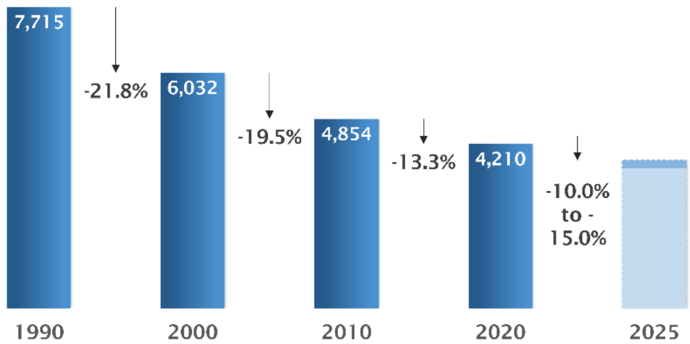
We have noticed a decline in OEMs new site search activity as they manage network consolidation and market area adjustments. This suggests that the car dealership property stock is starting to stabilise around current numbers, and highlights the attractions to dealers of holding property to secure the best franchising opportunities.

We are anticipating future changes in the size and shape of dealerships in response to these evolving car sales and aftersales developments. Showroom space is less likely to grow and may get smaller, and indeed more multi franchising and/or high ticket used cars coming inside showrooms beckons. Workshops will largely stay the same size and adjust to service EVs. We expect some reduction in the size of dealerships, particularly the built area; and we hear colloquial evidence that smaller dealerships are more profitable. We also expect to see less compound space for new vehicle storage, and overall lower premises costs as a % of business cost as buildings either get smaller or house more operations. We expect a greater focus on used cars and their space and pre delivery & inspection (PDI) requirements.

We have recently concluded a survey of car dealers and OEMs seeking their thoughts on the impact of digitalisation on the number of dealerships in the UK through to 2025. The initial responses suggest a reduction of around 10-15%, much less than some forecasters, which may often confuse dealer group consolidation with dealership property numbers. Based on NFDA data the actual decline in the number of dealerships since 2010 has been 13.2%, the previous 10 years 19.5%, and the 10 years before that 21.8%, and so the data suggests the rate of decline is slowing rather than increasing.

DEALERSHIP NUMBERS 1990-2025

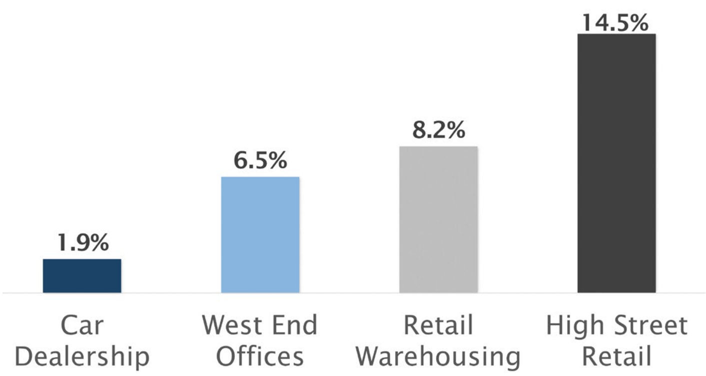
(Sources: APC, National Franchised Dealer Association)



In all distribution functions physical provision is required, what Robert Forrester CEO at Vertu Motors PLC (5th largest dealer group in the UK) has described as *"bricks and clicks"*. There has been and will continue to be some natural shrinkage in the number of outlets; e.g., Honda, and Vauxhall have been closing dealerships, however information gleaned from our database (recording 14,775 car dealership property transactions since 1995 covering 9,919 properties) identifies only 83 out of an estimated stock of 4,210 dealerships (NFDA) are currently available and on the market; a surprisingly small number representing a negligible 1.9% sector vacancy level. This compares with 14.5% High Street Retail (1 in 7) (British Retail Consortium), 8.2% for Retail Warehousing (Trevor Wood Associates), West End Offices at 6.5% (Savills), and Industrial at 4% but in places down to 2.35% (Savills).

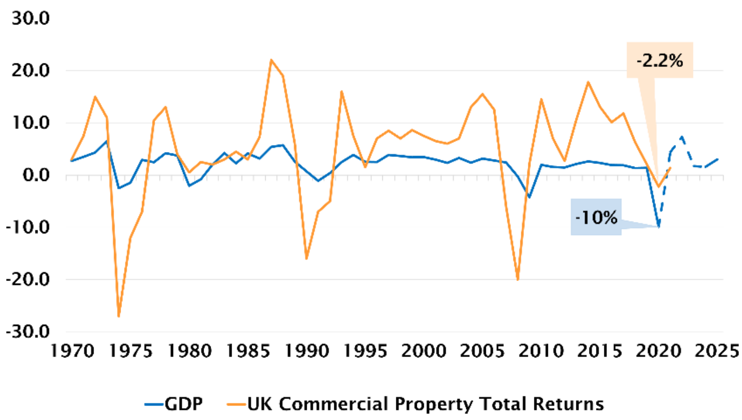
COMPARATIVE COMMERCIAL PROPERTY SECTOR VACANCY RATES

(Sources: APC, British Retail Consortium, Savills, Trevor Wood Associates)



UK COMMERCIAL PROPERTY TOTAL RETURNS AGAINST GDP

(Sources: BPF, CBRE, IPO, OBR, Savills)



The threat to the number of dealership outlets has been over-stated. Activity from growth brands and new entrants; e.g., Kia, MG, Volvo, Cazoo, Tesla, carshop, and Motorpoint have quickly been absorbing surplus stock, together with some adjustment to existing franchise representation i.e., adoption of authorised repairer status, and interest in disaggregation (i.e., aftersales and used car sales sites only).

Property performance is best measured by assessing Total Return (a measurement of Capital Growth and Income (rent), with income (rent) typically representing the major growth generator, and so reductions in income will accelerate the rate of asset value decline for investors). Past performance analysis shows 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. However, in 2020 when GDP fell 10% Commercial Property Total Return fell only 2.2%, reflecting the strength of the Industrial and Distribution sector, which car dealerships are increasingly mirroring in their functionality.

Capital Values bottomed out in 2019 and the resilience of the car dealer sector with them paying their rents has seen Capital Values rising back towards pre-Referendum levels and indeed July saw the first across the board rebound in Capital Values in all commercial property sectors since December 2014 at 1%, and Total Returns at 1.4% (and 2.3% for Industrial) according to CBRE.

Property is key to Dealers. Dealerships provide the "last mile solution" in the unfolding distribution functionality of dealerships, which the direct new car sales or "Agency" model being explored by some OEM's will serve to enhance. Property underpins many Dealers' Balance Sheets and has performed comparatively well during recent times and remains set to continue this trend

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