

Vertu Motors: Higher car prices are here to stay

Company:	Vertu Motors (VTU LN)	Market Cap:	£234mio
Industry:	Car dealership	Net current assets:	£50mio
Country:	UK	Revenue:	£4,000mio
Date:	28 th March 2022	Net Income:	£60mio (1.5%)
Dividend:	1% (4.75% incl. share buybacks)	Free Cash Flow:	£100mio (2.5%)
Entry:	£232mio	Target market cap:	£325mio

Introduction

I have begun monitoring the car dealership industry since last summer when Marshall Motors reported record interim results. Back then I believed the squeeze in margins is temporary due to supply chains being constrained and could quickly revert. I was wrong. Gross average margins per car have increased by over 50% for Vertu Motors throughout the 2nd half of 2021¹. Supply has not recovered and with Russia's invasion of Ukraine and Covid cases rising in China, the supply chain now faces another perfect storm.

How car dealerships make money

The car dealership model differs between new and used cars:

New cars

New cars are consignment stock, which means they are provided by the Original Equipment Manufacturer (OEM), i.e. Volkswagen, Toyota, etc. and go straight on the balance sheet of the dealership. Usually, the dealership and the OEMs have a bonus scheme in place, which motivates the dealership to take on more stock and sell it quickly. After 60-90 days the dealership then needs to finance the stock paying 4% or 5% to the OEM in interest.

¹ <https://investors.vertumotors.com/custom/104234.pdf>

Used cars

Used cars are generally financed by banks via asset backed loans (@90% loan to value) at rates of around 6% and often treated as working capital. Vertu Motors is one of the few dealers that does not recognize the used cars as working capital and instead lists it as used car debt, which is more conservative.

On the balance sheet this will be reflected as inventories & receivables on the current asset side and trade and other payables on the current liability side. In the case of Vertu Motors' interim report of 2021, inventories declined by £85mio, receivables by £23mio, while trade and other payables declined by £130mio y-o-y. If this trend were to be continued, running the balances down to zero, this alone would add over £80mio in equity to Vertu Motors, or a 25% increase in book value.

Supply/demand imbalance

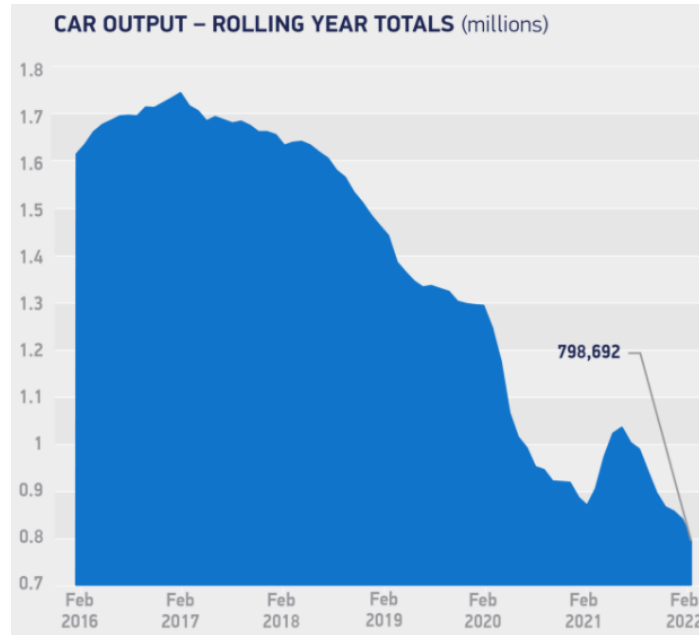
The lower the supply of cars, the higher the turnover and the less dealers need to pay for financing, enabling price hikes. Vertu Motors has increased its gross margins per vehicle from an average of £1,210 to £1,846 over the last year. This has helped to more than offset the lower sales and cleaned up their balance sheet moving to a net current asset position. Two months into 2022 and new car supply continues to lag, down by over 35% y-o-y for the UK market – this is even before the Ukraine invasion amid the chip shortage. Now, we face a shortage of wire harnesses on top of the chip shortage...

UK New Car Manufacturing had its weakest February production since 2009

UK New Car Manufacturing	Feb-21	Feb-22	% change	YTD 2021	YTD 2022	% change
Total	105,008	61,657	-41%	191,060	130,447	-32%
Home	17,689	10,871	-39%	34,381	22,415	-35%
Export	87,319	50,786	-42%	156,679	108,032	-31%
% export	83%	82%		82%	83%	

Source: SMMT

UK New Car Manufacturing continues to decline



Source: SMMT

Valuation imbalance

The actual reason why I began investing in Vertu Motors was down to its cheap valuation compared to its peers and the large amount of M&A activity in the sector. First, Marshall Motors was taken over by Constellation Automotive Group (owner of webuyanycar, BCA and Cinch) for £323mio in 2021. Then, the very same Constellation Automotive Group bought a 19.9% stake in Lookers for a valuation of £400mio this year. Last week, Pendragon received a takeover bid by Hedin (car dealer in Europe) for nearly £400mio as well, which got rejected – Pendragon should have a valuation premium due to the Pinewood software they sell to other dealers. Last Wednesday, Autotrader bought the leasing firm Autorama for £200mio. And finally, insiders have also started buying shares in Inchcape recently. In this sense, Vertu Motors really stands out in terms of its relatively cheap valuation of £240mio market cap, which is around £100mio below its competitors, especially in light of the heavy M&A activity in the sector. Even if Vertu Motors is not taken over, the contracts the OEMs have in place with Vertu's competitors that are being taken over might become invalid with a takeover and this gives Vertu Motors the opportunity to step in and gain market share.

Vertu Motors is valued the cheapest amongst its direct UK peers

Company	Dealerships	Car brands	Revenues in mio £	Market cap in mio £	Profit before tax expectation in mio £	Market cap/PBT	Net current assets in mio £	Long term borrowings
Vertu Motors	159	35	4,000	240	75	3.20	35	55
Lookers	150	32	4,300	350	82	4.27	-62	51
Pendragon	146	21	3,600	365	80	4.56	-155	74
Marshall Motors	162	27	2,650	325	50+	6.50	-22	4

Source: 2021 Interim reports (Revenues annualised), Google Finance as of 22nd March

Other competitors

Other UK competitors	Specialisation	Market cap in mio £
Inchcape	Global car dealer	2,670
Autotrader	Online only car dealer	6,030
Motorpoint	Online only car dealer	260
Cazoo	Online only car dealer	1,600

Source: 2021 Interim reports, Google Finance as of 22nd March

Hidden value opportunity

Besides the valuation imbalance, the sector overall has potentially some hidden value on the books when it comes to the leases and freeholds of the dealership properties. The pandemic has caused a massive demand in online deliveries, which has led to a shortage of storage/logistics facilities. Depending on where these large car dealership showrooms are located, they could turn into a valuable logistics asset instead. Just today Lookers announced to have sold a property with a 20-year lease in London Battersea for £28mio cash, while being valued at only £10.3mio on their books². Vertu Motors has nearly £250mio in property and long-leaseholds at book value compared to Lookers having £290mio.

Headwinds for the industry

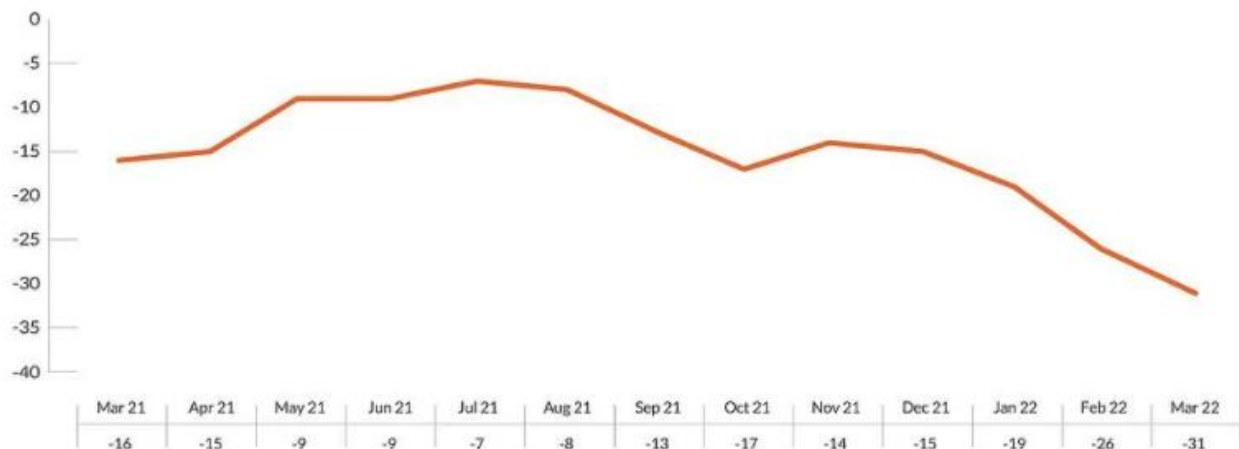
Input inflation is everywhere. For car dealerships this is mostly energy costs/utility bills and wages. Vertu Motors have flagged an increase of £26.3mio in their cost base compared to pre-Pandemic FY20, with underlying core group expenses up 5.2% at £6.4mio. Pendragon recently noted during their analyst call

² <https://www.londonstockexchange.com/news-article/LOOK/sale-and-leaseback-of-battersea-property/15385573>

that at GBp 600 a therm natural gas, the impact on energy costs would be £3-4mio. This appears all miniscule, especially in light of 50% gross margin increases. However, the industry agrees that record profit margins of last year won't be maintained forever and this is somewhat reflected in valuations generally. The shift towards Electric Vehicles (EVs) might also lead to lower servicing margins, as the main problem will be the life of the battery, which in turn might lead to lower used EV car sales as well. Overall, the higher input cost and the shift towards EVs appear to be manageable and Vertu Motors remains the most attractively valued car dealership in the UK. In fact, I see EVs as an opportunity as we might have higher used petrol car sales due to the transition, since the car depreciates faster and consumers would rather buy a relatively cheaper used car than a new car with the view of potentially not being able to sell it later on amid the transition. The biggest risk I see is rather a potential recession, which is reflected in UK consumer confidence declining. For this reason, I am looking to add another investment that should perform no matter what consumer confidence says, acting as a hedge. When looking at US auto inventory/sales, which is facing worse supply constraints than the UK, the market continues to look red hot!



Index Score March 2021 – March 2022

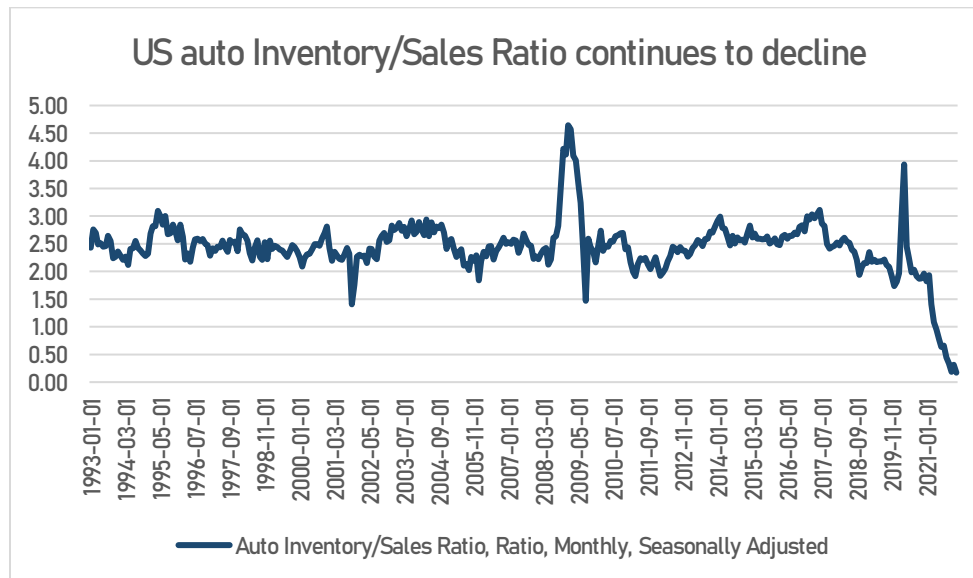


Source: GfK Consumer Confidence Barometer (March 2022)

UK Consumer Confidence March 2022 declines to level last seen in October/November 2020

UK Consumer Confidence March 2022	Change	March 2022	February 2022	January 2022	March 2021
Overall Index Score	-5	-31	-26	-19	-16
Personal Financial Situation over last 12 months	-2	-13	-11	-6	-2
Personal Financial Situation over next 12 months	-4	-18	-14	-2	10
General Economic Situation over last 12 months	-1	-51	-50	-47	-60
General Economic Situation over next 12 months	-6	-49	-43	-32	-17
Major Purchase Index	-9	-24	-15	-10	-11
Savings Index	4	18	14	15	21

Source: GfK Consumer Confidence Barometer (March 2022)



Source: FRED St. Louis Fed



Legal Disclaimer

The contents of this publication have been prepared solely for the purpose of providing information about AozoraStep Capital LLP and the services and products it offers, which are targeted for professional investors only. The opinions and views expressed are those of AozoraStep, may change without notice and should not be construed as investment, tax, legal or other advice. AozoraStep does not guarantee the completeness and accuracy of the information provided and all content can become out of date. Products or services mentioned on this site are subject to legal and regulatory requirements in applicable jurisdictions and may not be available in all jurisdictions. Accordingly persons are required to inform themselves and observe any such restrictions. In respect to investments described on this website, past performance is not a guide to future performance. The value of investments and the income of any financial instruments mentioned on this website may fall as well as rise and may have tax consequences. The performance of AozoraStep is based on a personal track record and audited by Sedulo for the time period Q1 2019 - Q1 2021 only with further audits being done on an occasional basis. AozoraStep Capital LLP is currently not authorized by the FCA, but is in the process of authorization. AozoraStep Capital LLP is registered in England and Wales with registered number OC436835. Registered Office: 57 Lansdowne House, Berkeley Square, London W1J 6ER, United Kingdom. Reproduction or distribution of any materials obtained in this presentation or linking to this presentation without written permission is prohibited.