Motor vehicle dealerships

A post-Holden reality check in a COVID-19 environment

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KordaMentha

Key takeaways

In our September 2019 paper, we explored the challenges and opportunities affecting the motor dealership industry. Many of these challenges, for dealers, financiers and landlords will be brought to a head by COVID-19. But this is not just another COVID-19 paper, the challenges for the motor vehicle industry run much deeper, into ever declining sales, an outdated model with dealers continuing to bear risks they can't control, and changes in core consumer behaviour.

01

Sales and revenues continue to decline

March 2020 was the 24th straight month-on-month decline in new car sales. An horrendous COVID-19 impact in April 2020 (48.5%) is an acceleration to that trend.[1]

Long-term declining sales are driven by accelerating societal change; Sales are not going back to 2018 levels; not tomorrow, and potentially not ever.

Revenue streams start with new car sales – selling margin, finance and insurance, servicing, dealer fitted accessories: no sale, no tail revenue.

02

COVID-19 impact has been severe and will persist

With business conditions beyond challenging, declining consumer sentiment, and rising unemployment, the economic impact of COVID-19 is likely to extend well past a cure.

Taxation must rise to fund the extraordinary but necessary level of stimulus, reducing business cash flow and household disposable income in the mid-term, and sales recovery may be 'U-shaped' or worse.

03

Financier support is essential

With high fixed cost structures and extensive inventory finance, financier forbearance and support will be essential.

Against this backdrop, much finance will be secured against inventory at risk of impairment. The risk posed is not just to new car inventories, with an expected influx of underutilised ex-rental cars, together with slower moving existing stock, likely to impact the value of used car inventory.

Challenges for financiers abound; how much support will be required? How long will it last? Will some dealers ever return to profitability?

04

Balance sheet repair is next

While dealerships have on the whole been quick to implement liquidity measures, heavy fixed cost bases and high leverage will see balance sheets erode rapidly.

Restructure of operations, revenue model, and balance sheet will be critical. Financier and brand support will be key to survival.

Key challenges

Brand

Brand is still everything, and dealers are still stuck to a brand.

- In our original paper, we discussed the challenges faced by dealers in being tied to one brand, with limited opportunity to change.
- This 'challenge' sadly materialised in a terminal way for the 185 Holden dealers across Australia in February of this year.
- Perhaps the writing had been on the wall for some time, with General Motors' progressive worldwide exit from right hand drive markets.
- But even if it was, for a Holden dealer in a typical cluster of dealerships with the key brands already represented, limited options were available to pivot to a new brand then, just as they are now.
- Brands that can't invest in a range, don't resonate with consumers, and which require volume sales to provide fair remuneration, will be just another pressure point.
- Dealers must identify if there is a path to profitability with their current brand(s), or scope to renegotiate.

Property

Premises are specialised, repurposing can be difficult.

- Improvements are specialised and can't readily be repurposed for traditional industrial or retail uses.
- Looking to Holden again, each dealership site has a combination of one or more of tenant, owner-operator, landlord and financier.
- In all situations, it remains that someone, be it an owner-operator or a landlord, is holding an expensive piece of real estate that has suddenly become that much less desirable.
- Without a use for the existing improvements or a 'plan b', landowners and financiers will be holding real estate that is effectively land value.
- Outer-metro and regional sites can be the worst affected, although site-specific challenges can present themselves anywhere.

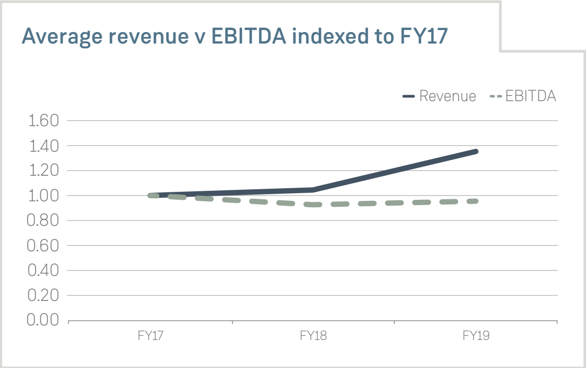
Technological opportunities

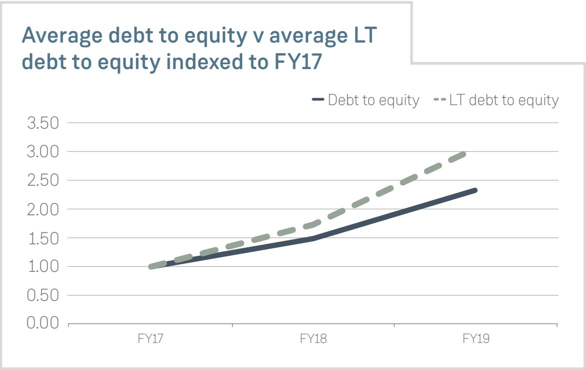
Social distancing dictated an immediate change in interactions. Has this been a catalyst for lasting change?

- In our September 2019 paper, we identified that consumer behaviour is in transition, with consumers looking for a more convenient 'retail' experience.
- Dealers and brands were responding in a measured way but the immediate pressure for change driven by social distancing guidelines, and a step-change increase in consumer preference for non-contact transactions, is providing the impetus for dealers and customers for rapid evolution.
- Hundreds of car dealers across Australia are reported to have rolled out 'contactless' technology for sales, quotes and finance applications, even going as far as connecting to customers via video demonstrations.
- It remains to be seen what will resonate with consumers and makes financial sense long-term, but it is certain that we are not going back to the 2019 ways any time soon.

Spotlight – ASX listed dealerships

To combat declining new car sales, listed dealer groups have continued to grow revenues through dealer acquisitions which have largely been funded by debt. Whilst revenues have grown, profitability has remained flat. An extraordinary acquisition opportunity now presents for groups with capital available.





Growth through acquisition, but profitability remains low

- Average revenue for the listed dealers has grown 35% relative to FY17, largely as a result of dealer acquisition. The most recent notable example being AP Eagers acquisition of Automotive Holdings Group earlier this year.
- Whilst total revenues have grown, profitability remains low with average EBITDA for the listed dealers declining by 5% relative to FY17.

Balance sheets are highly leveraged

- Debt to equity ratios for the listed dealers have more than doubled since FY17. This is largely as a result of expansion, with floorplan financing arrangements for increased inventory accounting for a significant portion of the increased debt.
- Notably however, long-term debt to equity ratios have increased at a greater rate than total debt across the same period, indicating the mix of long-term debt as a source of financing for both operations and expansion is increasing.

COVID-19 will bring forward liquidity challenges

- The sharp decline in retail foot traffic brought on by social distancing measures and general loss of consumer confidence will see new car sales for the large dealer groups heavily impacted.
- The sharp decline in sales will drive cash shortfalls in an environment where operating cash flows are reduced against limited movement of fixed costs of leased premises and financing.

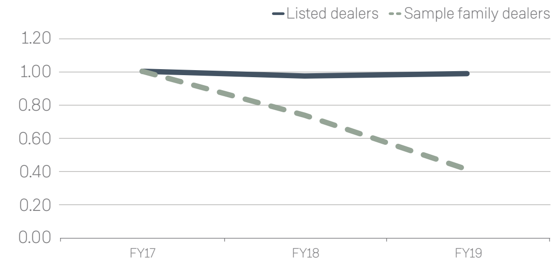
Restructuring may complement short term liquidity measures

- The listed dealers have responded quickly to the crisis by implementing various liquidity measures such as standing down employees, requesting rent free periods and reducing planned dividends.
- These measures will provide short term relief, however restructuring may be required to provide balance sheet restoration and ensure ongoing viability.
- An extraordinary acquisition opportunity presents for groups with capital available.

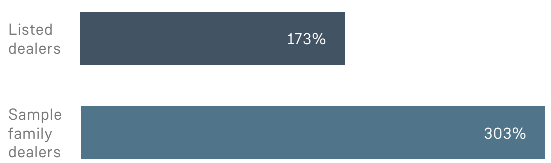
Spotlight – Family owned dealerships

An analysis of a sample of family owned multi-brand dealers highlights a contrast in profitability and risk for these operations relative to the listed dealers. Whilst these businesses face the same challenges ahead, they have higher leverage, limited access to capital, and lack economies of scale critical to expanding razor-thin margins.

Average EBITDA margin indexed to FY17



Average debt to equity in FY19



Efficiency lost through lack of scale

- Compared to the listed dealers, the sample family dealers have experienced a significant decline in profitability relative to FY17 as revenues remain flat.
- The relative performance of the listed dealers highlights the synergies and economies of scale being achieved by large groups through superior market power, lower systems costs, and back-office rationalisation.

Smaller operations are carrying higher leverage

- Average debt to equity ratios of the sample family dealers in FY19 was 303% vs 173% for the listed dealers.
- Unlike the listed dealers however, term facilities are often secured by mortgages over property held within the family owned dealership corporate structures.

Limited liquidity to withstand COVID-19 challenges

- Cash reserves across the sample family owned dealerships were minimal relative to fixed operating costs. For most of the family owned dealerships, steady state operating cash burn (subject to forbearances, government rebates and cost-cutting initiatives) would likely absorb cash reserves within a month.
- Given the high level of existing leverage, access to additional capital will likely depend on the liquidity of upstream entities in the corporate structure.

Success of hibernation strategies appears dependant on landlord and lender support

- Due to the low levels of liquidity and limited access to additional capital, the ability of the sample family owned dealerships to withstand the downturn is dependant on successful negotiation of lease arrangements with third party lessors where applicable, in addition to restructuring of lending arrangements.
- Additional liquidity measures such as postponing dividend payments, standing down employees and making use of government support are a necessity.

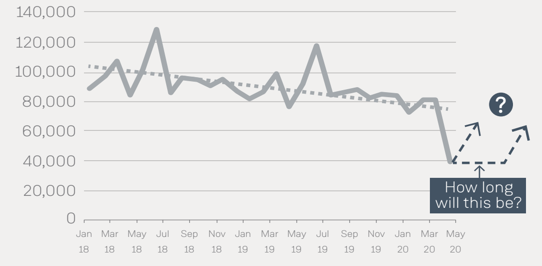
Combating sales decline and brand opportunities

The market has changed, fundamentally and structurally, how can dealers adapt and survive in the short term?

Challenges

Moody's Investor Service suggests global car sales will be down 20% in 2020, with an 11.5% increase in 2021[2]. Sales and tail revenues are not going back to 2018 levels, not tomorrow, and potentially not ever.

Monthly sales[3]



Brand is still everything, dealers are still stuck to a brand, and are exposed to risks outside of their control.

Potential for an industry shift toward agency model could lead to significant rationalisation of networks to fewer, smaller dealerships; challenges for financiers providing floor plan finance, and even for continuing dealers if finance and insurance revenues are compromised.

Mitigants

Know the margins, shake out the cash, squeeze the costs

- Knowing and understanding the contributors to margin has become even more integral to continued business through the recovery cycle, and into the mid-term at least – good systems, well-used, with useful reporting that is acted on, are key.
- Prioritise cash flow now, ensure the business has the skillset to identify and act decisively to:
  - access stimulus payments (Jobkeeper if available, ATO cash flow boost, state based payroll tax relief)
  - rationalise staff, sites and brands as required
  - consider property options
  - negotiate with landlords, financiers, suppliers.
- If the business does not hold required skillsets, taking the first step to seeking advice, and receiving good advice, early in the cycle will determine the end outcome for many dealers.

Opportunity

Extraordinary times bring extraordinary opportunities

- Brands that are willing and able to support dealers now and in the future are, and will be, gold.
- Support best comes in the form of a popular range, together with a balanced dealer remuneration structure.
- There are signs of a shift to an agency model for dealerships, and intimations that this shift could be progressively widely adopted if seen as successful. Potentially an opportunity for dealers offered an agency, yet another challenge for those who are not.
- In the interim there's never been a better time to revisit dealer remuneration structures.
- Do the returned Chinese brands form the next pool of opportunity for dealers struggling with a declining established brand?
- Is it time to revisit an approach from a larger group? Is it time to explore an acquisition?

Understanding consumer behaviour

The current sales crunch is a further (big) dip on a steady downward trend. Having survived 2020 with brand, financier and landlord support, dealer considerations should move to ongoing challenges.

Challenges

Lower driving rates among younger demographics are a lead indicator for a continuation of a downward sales trend.

Car ownership is becoming more optional as public transport, ride sharing and delivery services reduce the need to use a car, and car-share services reduce the need to own one.

Consumer behaviour has evolved to a point where shopping for a car online is entirely the new norm, with a showroom visit only once the buyer is well down the path.

Mitigants

Re-evaluate and identify what is valuable to your customers

- Identify what matters to your customers, what makes them buy from you? Right now that might be video demonstration and a non-contact handover.
- Restoration of conditions to '2019 normal' is unlikely to be next month – embrace the opportunity to sell differently, and ultimately more efficiently.
- Is customer service from demonstration, to sale, to after sales service everything it could be? Is this an opportunity to differentiate?
- Refresh websites, improve and broaden content, offer flexible communications, take the opportunity to upskill salespeople. Availability and ease of use of content is key, particularly with younger demographics.

Opportunity

Does social distancing provide an opportunity?

- It's certainly too early to tell what long-term behavioural changes COVID-19 may drive.
- A pause in the move away from private transport may be one of them.
- If not to the extent of individual car ownership, then potentially driving preference towards Uber, Ola, DiDi rather than the bus – is there an opportunity in sales to this market?
- For similar reasons, are there opportunities in sales to car share providers, both established and emerging?
- Will the Blinker model of dealership based car share be the next wave?

Real estate considerations

Owners of dealership premises are often the forgotten stakeholder. Premises are specialised, difficult to repurpose, and now suddenly, that bit less valuable. Immediate considerations include cash flows for serviceability; longer term considerations are more fundamental.

Challenges

Dealership premises are suddenly that bit less valuable, serviceability is immediately in question.

- In our September 2019 paper, we discussed the challenges of the standard dealership premises, and these challenges are now exacerbated.
- With the demise of Holden, there is now one less major brand representative pressing for space in each dealership precinct; this alone should be cause for concern for owners of sub-prime premises.
- Cash flows from owner/operator dealers are declining, squeezing free cash flow to meet repayment obligations.
- For leased premises, rental deferrals are legislated; for those eligible this is an immediate hit to landlord income and yield, adding to general uncertainty going forward and potentially a material re-set to valuations.

Considerations

Owner-operators

- Is this the highest and best use of the land? What options do I have e.g. sale and leaseback or am I in the right location for the long-term viability of my business?
- Are the reduced (cash) holding costs of an owned premise subsidising the dealership?
- Engage with financiers early if forbearance could be required, and approach with a credible plan – engage professional assistance as required.

Landlords

- Is the dealer seeking forbearance and/or rent relief?
- What does this mean for any mortgage payment? Does this in turn mean a need to approach your financier?
- What is the dealer bridging to? Is there an underlying profitable business? A commercial mindset now is imperative. Would you both be better served by coming to an agreement to terminate now?

Lessees

- Start any discussion on forbearance and rent-relief early, be aware of threshold.
- Have a credible plan and proposal, backed with some science – engage professional assistance as required.
- If a return to profitability in the short to short-medium-term is not credibly forecast, would you be better served by ending the arrangement now?
- Have the conversation sooner rather than later, but be strategic.

Planning and options

In our experience, it is critical to assess all options and estimate the likely outcomes, prior to embarking on a restructuring process, thereby ensuring alignment of stakeholders on key decisions, leading to the optimal financial and non-financial outcome.

Exit and restructure options

Options are not mutually exclusive

Exit and restructure options	Outcomes
Business turnaround *(People, operations, leases, inventory)*	Financial forecast and key personnel review and Cost cutting initiatives
M&A/sale process *(Whole of business)*	Business sale and leases assigned
Change of brand/model *(Move within market)*	Negotiation of exit and/or Implement new brand, residual business adjustment
Full exit and wind down *(People, operations, leases, inventory)*	Solvent exit (including real estate) and Insolvency process (partial or full)

Key elements to consider during the options assessment

- Corporate and leasing structure
- Cash trading profit/losses
- Seasonality and timing of exit
- Parent company or owner strategy and risk profile (e.g.: global strategy, other investments)
- Estimate financial outcome of the available exit options (probability and range of financial outcomes)
- Understand risks, mitigation planning, probability of events
- Develop a robust Plan B, C, D ...
- Understand optionality – how long can you maintain the option to pursue backup plans?
- Management composition

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Endnotes

1. Federal Chamber of Automotive Industries https://www.fcai.com.au/news/index/view/news/622
2. Battered car makers set for sales slump https://www.afr.com/companies/manufacturing/battered-car-makers-set-for-sales-slump-20200514-p54ss0
3. Australian Bureau of Statistics – Sales of New Motor Vehicles, Australia (cat. no. 9314.0)/Federal Chamber of Automotive Industries - https://www.fcai.com.au/news/index/view/news/622

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