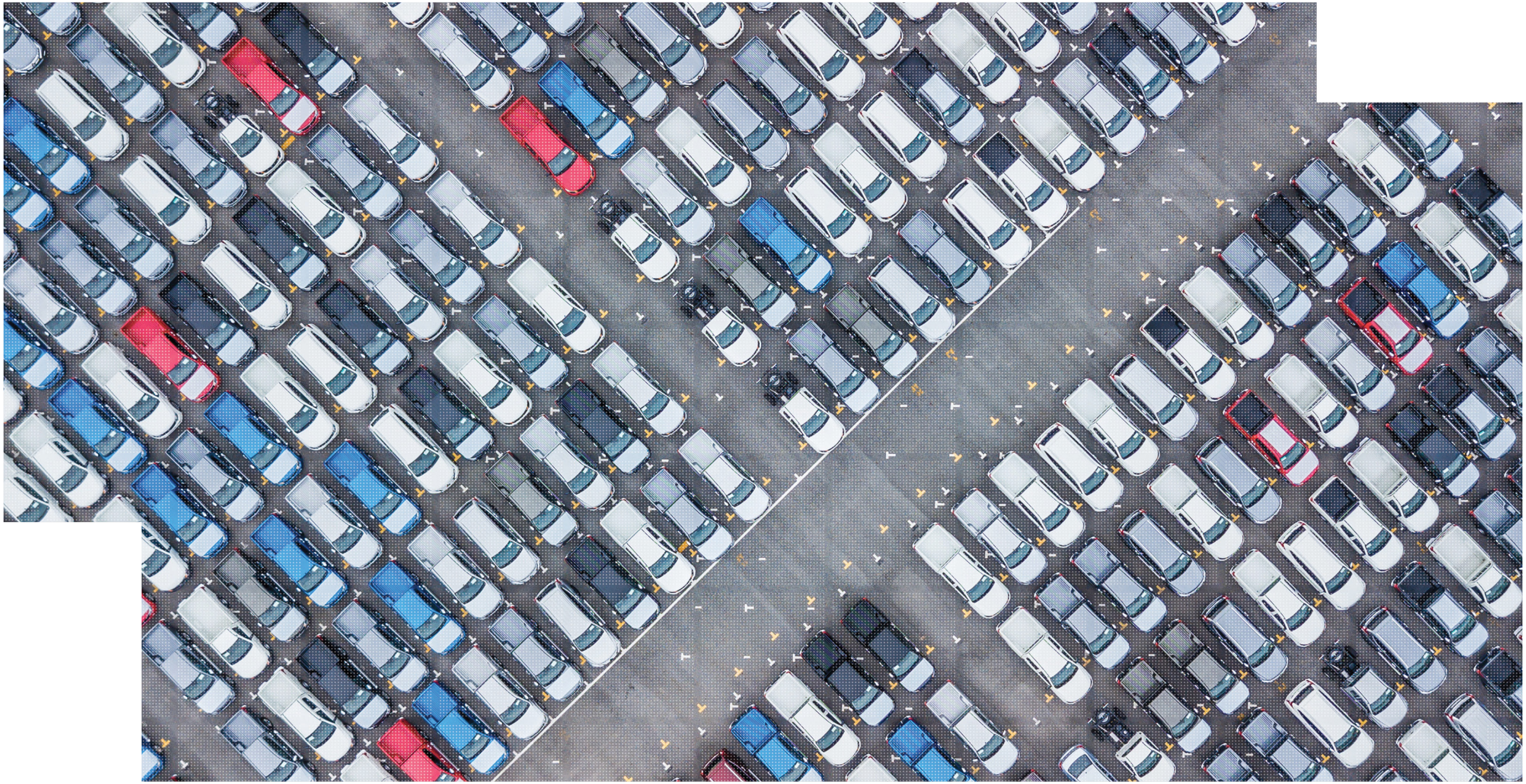


Motor vehicle dealerships

An industry in flux

KordaMentha
Restructuring

September 2019

Key takeaways

New car sales are down, month on month, for 16 consecutive months since April 2018[1]. 2019 sales are down 8% on 2018. This is not news to you, or to industry participants, but market wide trends are far from the whole story, even if this downturn reverses in the near term; challenges, options and opportunities warrant a deeper dive, so read on!

01

Declining sales and tail revenue

16 consecutive months of declining sales – revenue streams start with new car sales – selling margin, finance and insurance, servicing, dealer fitted accessories: no sale, no tail revenue.

02

Brand is everything

New car dealers are typically exposed to one or two brands, with limited options to change brands in the short term, and no immediate influence on product. If a dealer's brand range is not resonating with the market, there is little that can be done. Brand is absolutely key to identify dealer distress, current or coming.

03

Premises are specialised; the dealership model is changing

Improvements are specialised and can't readily be repurposed for traditional industrial or retail uses. A move toward shopping centre, high street and convenience locations has commenced, challenging property values in dealership strongholds. The wholesale to public, mega outlet, warehouse second hand model is growing, challenging used car revenues for traditional dealers.

04

Consumer and technological change

Consumer behaviour is in transition. Consumers are looking for a more convenient 'retail' experience, and brands are responding accordingly, challenging the current dealership model. Technology is changing behaviours through on demand services (ride-sharing, car-sharing), electric vehicle and driver-assistance/autonomous vehicles, which are expected to further depress new car sales.

Introduction

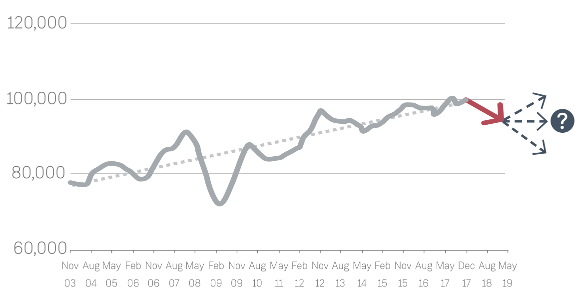
The long-term upward trend of new car sales has reversed. Is this a blip, or are we at an inflection point driven by societal and technological change? Dealers who have over-capitalised on new premises, and new entrants in outer metropolitan areas, are especially vulnerable.

Trend

New car sales in Australia have exhibited a long-term upward trend, driven by population growth, robust economic conditions, and geography and urban planning conducive to private transportation. While short-term dips are evident, most notably through a 15 month period during the GFC when sales dropped from c. 90,700 in February 2008 to c. 73,000 in April 2009, the long-term trend is strong.

The present downtrend is only 16 months old, but is now longer than the GFC dip. The absence of a specific macro externality to drive the downward change such as the GFC, and against a backdrop of low interest rates and reasonably robust consumer sentiment (until very recently), suggests that a more significant structural change may be underway.

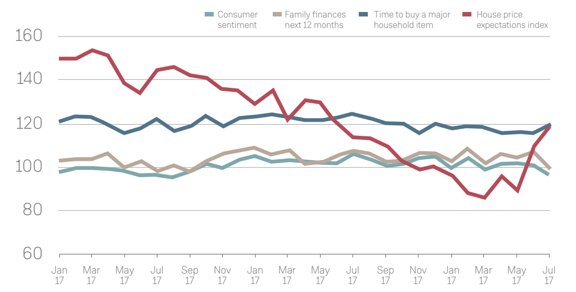
Australia new car sales – long-term trend[2]



Sentiment

- Consumer sentiment is flat but holding.
- The sub-index 'time to buy a major household item' is likewise relatively flat although with a 3.6% increase in July 2019 to rise to its highest level since December 2018 (certainly correlated with house price expectations) we may be seeing some green shoots.
- It seems counterintuitive that this sub-index can hold up concurrently with the longest period of decline in sales in the last 20 plus years, unless there are larger forces at work.

Consumer sentiment[3]



Pressures

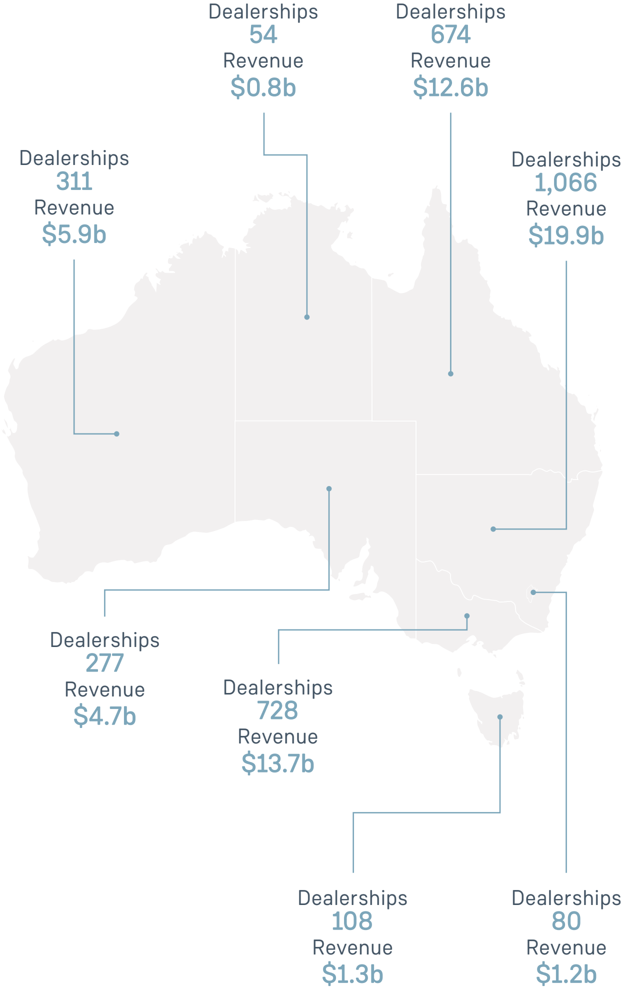
The industry is under pressure from changes in consumer behaviour which increasingly make car ownership more optional, or otherwise decreases the frequency of vehicle replacement (through lower use), including:

- Increased density living closer to city centres, public transport corridors and services reducing reliance on personal vehicles
- The inexorable rise of ridesharing
- Enhanced and expanded delivery services such as Uber Eats, online groceries and Amazon.

While the long-term trend has encouraged investment in the sector, are we approaching an inflection point of significant structural change, driven by societal and technological pressures?

Dealers who have over-capitalised on new premises, and new entrants in outer metropolitan areas are vulnerable. Aggregators are already active in the market seeking outcomes through economies of scale, rationalisation of back office functions, robust systems and controls.

A highly fragmented industry



- There are 3,500 new vehicle dealerships nationally, of which 85% are owned by individual operators or family groups[4].
- Beyond these, the other larger participants include four listed companies:
  - Automotive Holdings Group Ltd (AHG): 115 dealerships
  - A.P. Eagers Ltd: >145 dealerships
  - Autosports Group Ltd: 37 dealerships
  - Motorcycle Holdings Ltd: 31 dealerships, nine accessory retail locations.
- Other larger participants include Suttons Motors Pty Ltd, Paterson Cheney Holdings Pty Ltd, and Autopact Pty Ltd. Each of these groups still only account for a small percentage (<2%) of total market share (by number of dealerships) in their given areas of operation.

Trend and movement

- Market share concentration has remained steady over the past five years but is anticipated to rise through consolidation of existing dealerships.
- The most current example being A.P. Eagers Ltd pressing its takeover of AHG. If successful, the combined group will have 229 new-car dealership locations in Australia, 13 in New Zealand, and 68 new-vehicle truck and bus dealership locations in Australia. The merged entity would have 11.9 per cent of the new-car dealership market in Australia.
- Motorcycle Holdings Ltd continues a path of acquisition, with 31 dealerships and a significant multi-channel accessory retail operation.
- There is a significant imbalance of power between dealers and manufacturers, with typically short-term dealership agreements (1 to 5 years), and ability for manufacturers to unilaterally decline to renew agreements on short notice.
- Manufacturers maintain market power by restriction of the number of dealership points held by any given dealer group.
- Aggregators benefit through economies of scale, rationalisation of back office functions, and the opportunity to put in place robust and sophisticated systems and processes to control costs and margins.
- Consolidation may be tempered by manufacturer restrictions. The outcome of, and any manufacturer response to, the A.P. Eagers Ltd takeover will be of interest.

Real estate considerations

Real estate strategy diverges depending on whether the dealership premises are owned or leased. Opportunities and challenges exist for both owned and leased premises.

Challenges to traditional model

- Digital disruption and consumer trends are working against the traditional dealership model.
- Consumer behaviour is changing. Consumers are looking for a more convenient ‘retail’ experience. Brands and dealers are responding accordingly, for example:
  - Mercedes Me store in Collins Street, Melbourne
  - Genesis in Pitt Street Mall, Sydney
  - CarZoos in Westfields, Brisbane
  - A.P. Eagers Ltd reported plans to move into ‘mini auto malls’.
- Similar trends can be seen in South-East Asia and worldwide.
- These responses from brands and dealers are consistent with the proposition that large format destination dealerships are being supplanted. Specialty car showrooms and dealerships are transitioning to flexible spaces within shopping centres and ground floors of office buildings. Benefits of this approach include:
  - Transition of dealerships from transaction hubs to experience hubs
  - Increased accessibility and exposure to consumers
  - Less intimidating for consumers to browse than traditional dealerships, especially as the approach adopted by staff is largely educational, with no hard sell, and many don’t even transact
  - Shopping centres are constantly looking to broaden their base and mix – new uses, new retailers, and more reasons to visit are critical – and lease agreements reflect this drive.

Real estate implications

- Real estate changes will occur across dealerships nationally – whether this is a wholesale shift away from the standard form dealership, or a more nuanced and case-by-case migration to new form premises.
- Planning restrictions on entry by new dealerships.
- Given their often high-profile locations, dealership sites may be suitable for a wide range of retail, commercial or industrial alternative uses.
- Conversely for certain locations, particularly outer metro, a car yard could be the single credible use, meaning a property owner (whether owner-occupier or landlord model) could be ‘all-in’ with the dealership land use regardless.
- Transformation of dealership sites to alternative uses is site specific and dependent on the highest and best use of the underlying land.
- The best case is for a controlled process to manage the tenancy and leasing transition.
- The worst case is for a ‘hard landing’, negatively impacting consumers, dealerships, and property owners.

Owner-operator model

Owned premises present opportunities for change of use, but also have the potential to exacerbate financial stress.

Considerations

Financial

- Holding costs of dealership e.g. loan covenants
- Parent company or owner strategy and risk profile e.g. national strategy, other investments
- Financial outcome of the exit option

Real estate

- Space requirements e.g. potential to lease some of the space to a third party, may be difficult
- Long term strategic plan e.g. potential for future value uplift through re-zoning, redevelopment etc.
- Potential alternative uses of the site, identification of highest and best use
- Appointment of appropriate selling agent and undertaking a successful marketing campaign

Practical

- Timing of exit
- Importance of individual dealership to the dealership network
- Risk and mitigation planning

Options

Retain

- Site needs to be retained to deliver on strategy

Sell

- Site needs to be exited to deliver on strategy

Execution and strategy

Retain:

- Devise leasing strategy for any excess space to earn an income
- Advice on positioning for future sale in the medium to long term e.g. development applications, capital expenditure
- Capital expenditure requirements to refit/refresh to meet changing consumer needs
- Allow dealership to focus on core business

Sell:

- Full market analysis and identification of the likely buyer profile
- Advice on realistic pricing given various alternative uses
- Review of the transaction management strategy to ensure sales are achieved
- Stakeholder management
- Management of settlement risk
- Relocation/shutdown of dealership

Opportunities and considerations

- Throughout the cycle, owner-occupiers have the opportunity to add value to sites through options including:
  - Retention and lease to another dealer
  - Retention and redevelopment to a higher/better use
  - Sale to another dealer or developer
  - Sale and leaseback to free up capital.
- Outer metropolitan dealerships may have limited alternative uses, which may otherwise exacerbate financial stress for an owner-operator.
- Conversely in some councils there has been a limitation on the number of dealerships permitted, especially close to city centres, leading to an increase in value for the properties being sold with an existing dealership
- Changes to the traditional dealership model will also impact the value of existing sites for current use.
- If an owner-operator wants to sell, there is likely to be contamination issues that need to be rectified to maximise value. The owner may not have the liquidity available to rectify the contamination as a result selling properties below market value.
- There are several considerations for an owner-occupied dealership prior to making a decision on whether to retain or sell. Professional advice and ongoing support from a qualified real estate professional is critical.

Leased premises

Considerations for leasehold dealerships are not dissimilar from owner occupied dealerships, however the execution of an exit or renegotiation is vastly different. Leased premises offer scope for negotiation with landlords to move the dial on viability, although as with any other retailer, ad-hoc 'trench warfare' is occurring on a daily basis between landlords and tenants.

Considerations	Options	Execution and strategy
Financial · Costs associated with lease · Can the lease be renegotiated? · How important is the lease to the landlord (alternative tenants/uses)? · Financial outcome of the exit option **Real Estate** · Space requirements · Rental terms i.e. rent reviews, options to sublet **Practical** · Timing of exit · Importance of individual dealership to the dealership network · Risks, mitigation planning, probability of events	**Retain** · Site needs to be retained to deliver on the strategy. Re-negotiate terms or use as leverage in negotiations	· Full market analysis and identification of landlord weaknesses · Understanding of financial metrics and commercial terms · Engage with advisors and stakeholders are required · Negotiate, document and finalise deals
	Exit · Site needs to be exited to deliver on the strategy · Move to new site, potentially very different premises	· Negotiate end of lease terms e.g. make good clauses, damages for repudiation of lease · Ensure properties are physically exited per plan and/or agreement (avoid damages, cost overruns) · New site selection, fitout, vehicle storage, servicing premises · Transition to new site

Opportunities and considerations

- Occupancy costs and potential lease liabilities are significant considerations when exiting or entering dealership sites.
- Landlords will have similar considerations to owner-occupier dealers around alternative uses.
- For sites with limited alternative uses, landlords are motivated to 'share the pain' with dealers.
- For readily repurposed sites, a landlord may be content to maintain lease terms with the expectation that the lease will break or end.
- The best case is for a controlled process to manage the tenancy and leasing transition.
- The worst case is for a 'hard landing', negatively impacting consumers, dealerships, and property owners.
- Logistics of relocating a dealership to new premises other than a traditional dealership premises are significant. Proper execution is critical, and identifying and linking in vehicle storage and servicing facilities is an additional challenge.

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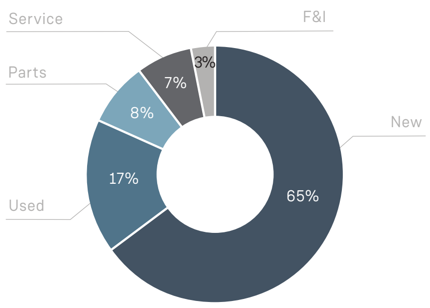
Financial considerations

Dealership revenues are made up of many streams, but most streams stem from a new car sale – selling margin, finance and insurance, servicing, dealer fitted accessories: no sale, no tail revenue.

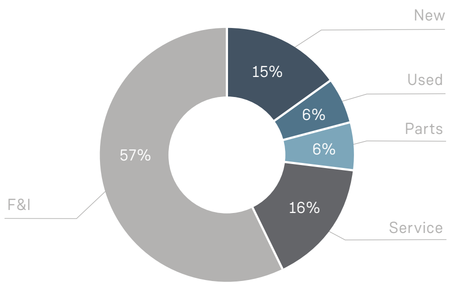
Volume vs margin

- In the background of new car sales volumes continuing to decline, knowing and understanding the contributors to margin has become more integral to operating in what may be the new normal.
- In a highly fragmented market, this is especially so for dealers who:
  - Maintain a 'front-end' bias to their dealership orientation
  - Have historically been volume-driven
  - Have a substantial orientation of their dealership structure skewed towards new car sales, where selling margin (down on average 15% FY16-FY19) and contribution to total dealership net profit (down on average 52% FY16-FY19) continue to decline.
- For these dealers, meeting requirements for manufacturer volume incentives is fundamental to the delivery of sufficient margin.
- Used car sales are challenged by the wholesale to public, mega outlet, warehouse model – another pressure point for dealer revenue streams.
- There is early evidence to suggest the model for many manufacturers is shifting towards a 'one-price' selling approach (i.e. no discount), and away from volume based incentivisation, recognising that the volume-driven approach may be becoming obsolete.
- The contribution to margin from the 'back end' is increasingly central for dealers operating in the 'new normal'. This is particularly so with regulatory changes in finance and insurance beginning to bite.
- Efficient service departments where higher margin revenues are available are becoming increasingly valuable.

Typical contribution to dealership sales



Typical contribution to dealership margin



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Financial considerations

Floor plan finance

- Declining sales and resulting aging of inventory is triggering covenant breaches leading to curtailments and penalty interest under floor plan finance agreements.
- This causes a further drain on dealers' cash or working capital facilities.
- Dealerships are then forced into a cycle of selling inventory below cost to reduce financing costs and further curtailments, causing in turn further liquidity problems.

Auto finance regulatory change

- 90% of all car sales are arranged through finance, with 39% of financing arranged through car dealerships[5], which deliver two potential sources of income:
  - Financial benefits from lenders, including upfront commissions and/or volume bonuses
  - A dealer origination fee charged to the consumer for assisting in the provision of finance.
- Changes to flex commission structures will impact dealer income, and for dealers who heavily rely upon add-ons to complement sales margin, the effects are already being felt.

Warranty claim pressures

- There is increasing pressure by manufacturers on warranty claims, closely tied to longer new car warranties.
- Dealerships are resolving claims for reputational reasons, but being left with the cost.
- Manufacturers are also capping cost contribution to warranty claims putting pressure on service department revenues.

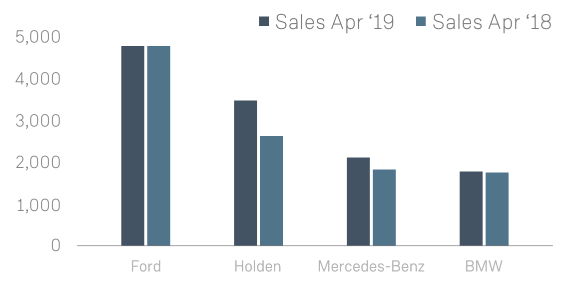
Brand is everything

Brand is key to identifying current or future dealer distress. New car dealers are typically exposed to one or two brands, with limited opportunity to change in the short term, and no immediate influence on product mix. If a brand is not resonating with the market, there is little an individual dealer can do.

Electric vehicle disruption

- Take up of electric vehicles in Australia has been very limited to date, with no more than 1 in 500 (c. 2,000) new car sales being electric vehicles in CY2018. However a swathe of new models and international experience make it clear that a change is coming.
- With driving range increasing, and with the average Australian commute of 16km, it is clear that electric vehicles are now a credible alternative to the internal combustion option for many consumers. While price remains a hurdle – for example the electric version of the Hyundai Kona commands a c. 100% premium against comparable internal combustion models – are we already seeing early adopters holding off on new vehicle purchases in anticipation of increased production volume and advances in technology driving prices down?
- For dealers, will the established manufacturers maintain market share? Or will electric vehicle specialists such as Tesla with its direct sales approach, or new entrants to the Australian market such as Great Wall, take market share in coming years?
- The right choice of brand and strategy will define dealers' outcomes in a period of fundamental change.

Brand examples[6]



Tied to a brand, with limited options

- Dealers often have no option to transition to an alternative brand in the short to medium term – a typical cluster of dealerships will see the key brands already represented.
- Sales by brand in the short to medium term are impacted by many factors:
  - Product mix, new niches, or missing a credible offering in a given sector.
  - Timing of competitor models entering the market can have a profound effect on immediate sales.
  - Change of model not meeting market expectations, e.g. Holden Commodore replacement.
  - Brand issues, e.g. Volkswagen 'dieselgate', or the Subaru two-week factory shutdown January 2019.
- Some immediate examples include:
  - Ford vs Holden, Mercedes vs BMW – Ford and BMW sales are holding up nicely, Holden and Mercedes have declined 24% and 15% respectively – two very different results for comparable brands.
  - Holden sold just 11,825 vehicles in the first three months of 2019 – down from 15,524 in the same period in 2018 – causing its market share drop from 5.3 to 4.4 %. This meant the Toyota Hilux dual-cab outsold the entire Holden range in the month of March 2019 – a deep and sustained slide from Holden, which last lead new car sales in 2002[7].
  - Holden's product range is clearly not resonating with the market, whether retail, fleet or otherwise.

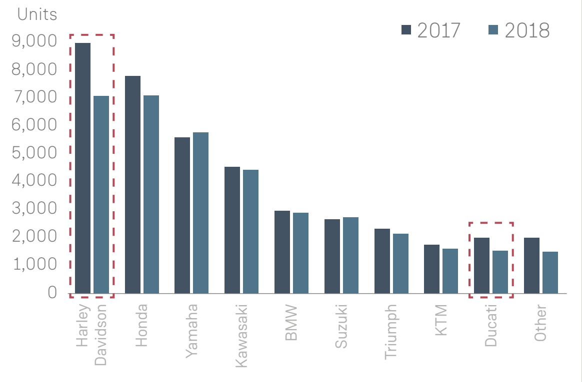
Motorcycle sales

Declining discretionary expenditure is fundamentally changing the motorcycle market landscape. Together with reductions in sales of riding gear and accessories through dealer channels, we see broad stress in the market, and potential for distress for speciality dealers.

Motorcycle specific challenges

- Motorcycles are generally considered a more discretionary purchase than a car, and so are more exposed to changes in macro economic conditions.
- Riding gear and accessory sales continue to move online, reducing what is a higher margin revenue stream for dealers.
- H1 2019 road motorcycle sales were down 17.7% compared to H1 2018.[9]
- As a whole, sales are down c. 30% since 2016.
- Aggregate decline has been most apparent in more discretionary brands/categories, while the more commuter focussed brands held comparatively steady.
- Specialised/prestige brands such as Harley Davidson and Ducati, showed declines of 21% and 23% respectively 2018 vs 2017 and this trend looks to be continuing.
- These brands are at the discretionary end of the market, being more likely to represent the 'Sunday ride', rather than the commute.
- With overall discretionary spending down, it is no surprise to see a substantial drop in discretionary brands.
- We expect to see significant distress in this market, particularly while consumer confidence remains flat.

Sales by brand (road motorcycles)[8]



Financial controls and adjustment to a new normal

The material decline in new car sales is resulting in stress, and distress, across the industry. Dealers and their professional advisors are experts at growth, new sites and positive market conditions. In a declining and difficult market, alternative skill sets are required.

Control systems

- New car sales drive revenue not only from the sale, but from add-ons including:
  - Finance and insurance fees and commissions
  - Dealer fitted accessories
  - Servicing.
- Knowing and understanding margin is critical, and financial and forecasting systems are key.
- Margins on sales are slim, but with high value transactions, nuanced changes can have an immediate and material impact.
- There are varying levels of sophistication in management systems and forecasting evident within the industry, from some best practice end-to-end systems, to ad-hoc spreadsheet-based models.
- While a simple model may work well, it is reliant upon continual update and maintenance by a competent and experienced operator – be it the owner/operator/dealer principal/key staff members which:
  - Takes resources away from the fundamental business
  - Leaves room for error
  - May fail to identify or capture revenue sources and cost drivers.
- Our experience tends towards businesses under stress, which significantly correlates with less automated models and controls.
- Dealer principals are often former sales managers and may not have the background and systems to encourage focus on margin and costs, rather than volumes.
- Helping a business develop and implement a comprehensive and relevant financial management system can provide the critical data to operate effectively and efficiently.

Adjusting to a new normal

- With such a lengthy run of increasing sales, dealers are experts at growth in positive market conditions. Only the most experienced in the industry will have seen any material contractions.
- If this is the 'new normal', very different skills and experience is required, which may include (all while keeping the wheels on in challenging market conditions):
  - Rationalising staff, sites and brands
  - Adjustments to corporate structure
  - Consideration of property options
  - Negotiations with landlords, financiers, suppliers
  - Mitigation planning.
- Taking the first step to seeking advice, and receiving good advice, early in the cycle will determine the end outcome for many dealers.
- Assistance and guidance through this 'new normal' should be sought from professionals experienced in this phase of the cycle to:
  - Review and improve control systems, cost controls, reporting and cash flow
  - Assist with negotiations
  - Provide a commercial and market-wide view of real estate considerations.

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, to ensure alignment of stakeholders on key decisions, leading to the optimal financial and non-financial outcome.

Exit and restructure options

Options are not mutually exclusive

- **Business turnaround** *(People, operations, leases, inventory)*
  - Outcomes: Financial forecast and key personnel review; and Cost cutting initiatives
- **M&A/sale process** *(Whole of business)*
  - Outcomes: Business sale and leases assigned
- **Change of brand/model** *(Move within market)*
  - Outcomes: Negotiation of exit; and/or Implement new brand, residual business adjustment
- **Full exit and wind down** *(People, operations, leases, inventory)*
  - Outcomes: 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 – media release 5 August 2019
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3. Westpac-Melbourne Institute Index of Consumer Sentiment
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