Quarterly investment insight August 2020

Australian Listed Automotive Dealerships
Celeste Investment Process at Work

The machine of a dream, such a clean machine
With the pistons a pumpin', and the hubcaps all gleam
When I'm holding your wheel
All I hear is your gear
I'm in love with my car, gotta feel for my automobile
Get a grip on my boy racer roll bar
Such a thrill when your radials squeal
Told my girl I'll have to forget her
Rather buy me a new carburetor
So she made tracks saying this is the end, now
Cars don't talk back they're just four wheeled friends now

'I'm In Love with My Car ' by Queen. Songwriter: Roger Meddows Taylor Lyrics:Copyright Sony ATV Music Publishing LLC

Buying a car is a quintessential physical retail consumer experience. As one of the largest financial commitments, consumers want to understand all the sensory experiences that a car brings, literally kicking the tyres before parting with their cash.

With equities markets melting down from late February to late March, investors became particularly concerned that government induced lock down measures to prevent the spread of Covid-19, meant it would be a very long time before consumers, and for that matter corporates, would buy another car. This resulted in the share prices of listed Australian Automotive Dealerships, Eagers Automotive (APE) and Autosports Group (ASG) falling almost 70% from their February levels, while the decline in broader Australian Small Caps was just over 40%.

With consumers essentially forced to remain at home, investors were of the view that Auto Dealerships would sell far fewer new and used cars, impacting what is known as the front-end of the dealership. Similarly, existing car owners would have their car serviced less frequently, impacting the back-end of the dealership. In more normal times, Auto Dealerships generate quite skinny margins, with the industry average in Australia about 1.5% Profit Before Tax. Given the decline in activity, investors were clearly wondering how APE and ASG were going to pay their staff, landlords, and financiers. Meanwhile, speculation mounted that both companies would require an injection of new equity to see them weather the Covid-19 storm.

As investors in APE and ASG, we at Celeste took the opportunity to reassess our positions based around our investment process. The Celeste process assesses three key pillars of a stock: Business Model, Accounts and Board & Management.

APE and ASG are the leading Auto Dealerships in Australia. APE is the largest by market share, serving all parts of the market, with a particular strength in the Volume segment.

ASG has a significant presence in the Prestige and Luxury segments. Through the cycle, these companies deliver margins well in excess of the industry average. They have extremely strong relationships with their suppliers and financiers (the Original Equipment Manufacturers), their landlords and their staff.

Both companies are also run and overseen by seasoned industry veterans, who individually have decades of industry experience and significant shareholdings in their individual companies. As such, we expected the experience of the Boards and Management teams, that have navigated many cycles, would provide considered and reasoned stewardship through the crisis. We expected the Boards and Management teams to value the existing equity in the business and as such find other methods to support the balance sheet. We expected they would resist the undue influence of those calling for an injection of equity.

Based on our reassessment of APE and ASG, we reached a number of conclusions that led us to increase the portfolio weighting in both stocks.

In the very short term, we concurred with concerns that lower levels of Auto related activity would severely impact the profitability of both companies. However, we expected the management teams of both companies would act decisively to offset this decline in revenue. We expected both companies to leverage their superior relationship with their OEM suppliers and financiers, to provide inventory support, marketing support and bonus payment support. We expected landlords to provide rent relief, at least in line with sales volumes, and we expected difficult decisions to be made around staffing levels.

More importantly, as long-term investors, we expected the economic ramifications of Covid-19 to drive significant structural change in the Australian Auto Dealership industry. Foremost, we expected new and used car sales would be depressed for a number of years, remaining well below peak levels achieved towards the beginning of 2018. As a result, a number of subscale and unprofitable dealerships would eventually depart the industry, primarily via handing back dealership agreements to OEMs and potentially via M&A. On the back of this, we expected APE and ASG to garner meaningfully more market share of a smaller industry revenue pie.

Unsurprisingly, new car sales volumes fell dramatically in April, down 48% compared to April 2019, with less than half the number of cars sold, almost 43,000, than March 2020. This reflected, at the time, stringent lock down measures nationally.

In May however, the speed with which green shoots emerged across virtually all aspects of the auto industry positively surprised. Beginning with car owners taking the opportunity to service their cars whilst being at home, it evolved into many more people choosing a car over public transport as they slowly returned to work, driving a spike in used car sales.

By June, with the first round of lockdown restrictions broadly lifted and aided by fiscal stimulus policies, such as early access to Superannuation and instant asset write-offs for businesses, the green shoots blossomed. New car sales were down only 6% compared to June 2019, with around 110,000 cars sold versus 60,000 in May. At the same time, used car prices lifted as demand materially outstripped supply and service remained robust and durable.

When APE held their delayed AGM at the end of July, the CEO noted in his presentation a number of key financial statistics. Normalised profit before tax was $40m and better than expectation, while corporate net debt had been reduced by over $300m to just $8m in the first 6 months of the year. In our view however, the standout number was permanent cost reductions of $78m, resulting from initiatives taken in the final 3 months of the financial year. This reflected many of the expectations we had set for our investment thesis to be met, albeit in an impressively short time frame.

As a result of better than anticipated Auto related activity and aggressive cost reduction initiatives, the share prices of APE and ASG have recovered more quickly than the broader Australian Small Caps market, up 199% and 139% respectively from their March lows versus the market which has risen 47%.

Despite the improvement in the Auto sector since April, the data will be volatile in the short term, with rolling lock down measures, such as that being witnessed in Victoria at present, momentarily impacting sales and service revenues. However, given the experience of the past few months, we think investors will be more sober in their assessment of the Boards' and Management teams' stewardship at both APE and ASG as they continue to manage their business well and take advantage of the structural changes in the auto industry that are being accelerated by Covid-19.

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