RESEARCH

Knight Frank

AUTOMOTIVE

CAPITAL MARKETS **2016/17**

HIGHLIGHTS

Surge in high profile M&A activity; the most active 12 months for more than a decade with no sign of abating

Solid property fundamentals and strong rental growth will see Automotive investment perform well in the post-Brexit environment

Highly defensive stock with low vacancy rates, but investment opportunities constrained by a dominance of owner-occupied property

WHAT IS AUTOMOTIVE PROPERTY?

The sector is typically characterised by three asset types: car dealerships, petrol filling stations and services areas. Of these, car dealerships account for over 50% of the automotive investment market, and as such is the focus of this research.

"Average dealership lot sizes have increased significantly; ten years ago the typical investment lot size was £2-£5m however the £7-£10m bracket is now well populated."

The term also covers other 'roadside' assets including, for example, convenience retailing, fast food, tyre and exhaust centres, truck stops and car parks.

Automotive investment landscape

Before the millennium, attracting mainstream investment funds to automotive property, including car dealerships, was difficult. Back then the nature of the stock was far removed from the impressive purpose-built 'brand centres' that typify the landscape today. Investors increasingly appreciate the positive investment credentials of these assets, including the prominent locations, high quality of build (at significant cost) and attractive large plot sizes.

Over recent years, the car dealership investment market has gone from strength to strength; Q1 2016 saw prime yields compress to c. NIY 4.5% as investors demonstrated strong appetite, lured by purpose-built facilities, long leases, strong covenants, regular tenant investment and inflation-linked rent profiles. These are robust and defensive investments; even through the toughest times, the sector was resilient, and investors saw clearly the high regard and support that Government affords this key sector of the economy, with initiatives such as the Scrappage Scheme. Employing over 800,000 people in the UK, the critical importance of the motor industry to the economy cannot be overstated.

Average dealership lot sizes have increased significantly; ten years ago the typical investment lot size was £2-£5m however the £7-£10m bracket is now well populated. Assets (and portfolios) in excess of £10m are becoming more common and look set to continue as premium brands in particular stipulate the need for ever larger facilities on the back of four years of rising new car registrations.

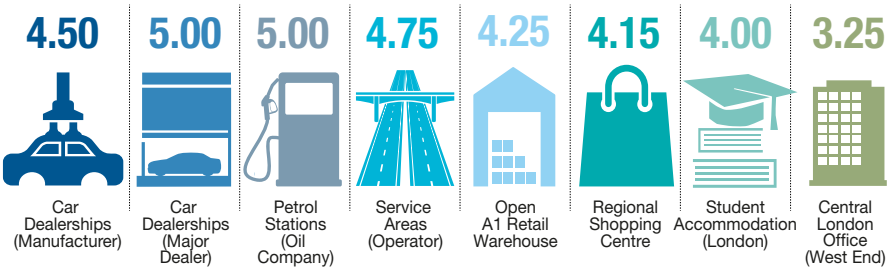
Notwithstanding the above, the somewhat unexpected Referendum result, and initial political fall-out has naturally caused some uncertainty in the market, which has led to a slowing of investment activity in H2 2016, noting that transaction volumes were also surpressed in the immediate lead up to the vote.

What is clear is that in uncertain times there is a 'flight to quality' and this has doubtless been evident in the Automotive sector, with four of the six largest investment deals in 2016 (Figure 1) comprising prime stock let on long leases to secure covenants. As a result

FIGURE 1
Largest automotive investment deals of 2016

Asset	Location	Covenant	Price	Yield	Agents
Glaze Portfolio	Bradford / York	Various	Confidential	-	CBRE/Knight Frank
Land Rover, Honda, Mazda	Birmingham	Lancaster Plc.	£17.00m	4.75%	GVA/Knight Frank
Ford Commercial	Dagenham	Ford Retail	£6.62m	4.57%	Knight Frank/Rapleys
Nissan	Bristol	Nissan GB	£6.03m	4.58%	APC/Knight Frank
Ford	Bristol	Ford Retail	£5.85m	4.85%	Savills/Knight Frank
Ford	Bromley	Bristol Street Motors	£5.50m	5.80%	Michael Elliot / Springer Nicholas

FIGURE 2
Prime yields (%) by sector (as at Q3 2016)



Source: Knight Frank Automotive/IPD

all have traded well inside NIY 5%. Indeed, prime yields have held strong (Figure 2), but values for more secondary stock have drifted.

M&A activity and potential covenant windfall

One measure of the health of the UK automotive market is the level of business-to-business transactions. In this regard, Figure 4 shows a significant number of key transactions over the last 12 months. We calculate there has been over £500m of corporate acquisition activity making it the most active 12 months for over a decade.

Major UK based groups such as Lookers, Group 1, Vertu, Jardine, Sytner and Marshalls have all been acquisitive along with foreign dealers, such as Lei Shing Hong ("LSH") – the world's largest Mercedes retailer – entering the UK. Knight Frank Automotive has provided advice on a number of these transactions, including LSH's first UK acquisition, and US-based Group 1's focus on the UK for its growth strategy.

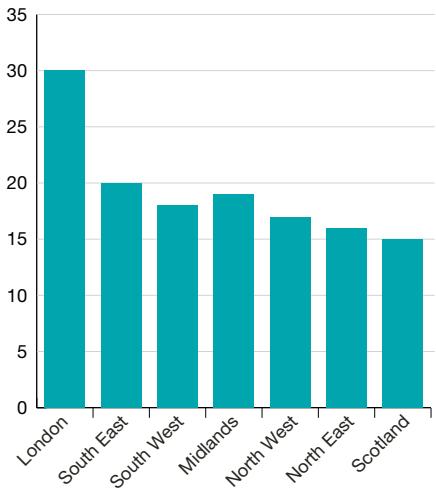
Certainly we envisage this trend continuing as profit margins for smaller groups come under pressure and exacting Corporate Identity requirements give rise to the need for regular capital investment in dealerships, or even relocations and new builds, which many of the smaller groups are unable to finance. This trend has been – and will continue to be – a major appeal to investors who have benefitted from significant covenant windfalls and overnight enhancement in capital values, as smaller regional covenants are acquired by major corporate entities.

Strong automotive rental growth

Investors are looking to diversify their portfolios with the inclusion of 'alternative' assets, and as such the prime automotive investments that do become available are typically in high demand. However, it is the more secondary assets that can provide great opportunities for savvy investors.

Whilst prime yields may not compress much further, there is value to be had in more secondary stock, perhaps with open market reviews, given our view that

FIGURE 3
Prime Automotive Rents (£ per sq ft)



Source: Knight Frank Automotive

The Spirit Portfolio – Knight Frank Automotive Investment Disposal (September 2016)

FIGURE 4
Largest corporate acquisitions in the last 12 months

Purchaser	Vendor	Reported Price
Marshall Motor Holdings	Ridgeway Group	£106.9m
Lookers	Benfield Motor Group	£87.5m
Lookers	Drayton Group	£55.4m
Lookers	Knights Group	£27.2m
Vertu Motors	Greenoaks	£21.9m
Vertu Motors	Gordon Lamb	£18.7m
Group 1 Automotive	Spire Automotive	Undisclosed
Jardine Motors Group	Colliers Motor Group	Undisclosed
Sytner Group	Clare James Automotive	Undisclosed
Lei Shing Hong	Mercedes Benz Retail	Undisclosed

Source: Knight Frank Automotive

in the short to medium term rental growth will be strong having been suppressed for an extended period, despite dealers' operational profits rising.

We anticipate average automotive rental growth of 4-5% per annum over the next 3 years which compares favourably to the 2.53% per annum growth anticipated across All Property. *(Source: IPF Consensus Forecasts, May 2016).*

Where is the profit?

The motor retail industry may be seeing a levelling in new car registrations, but a slight lessening of pressure on new car targets may in fact allow retailers to improve profit margins.

The car dealership sector is fundamentally anchored in retailing. The customer experience is key to the success of the industry and public perception is most accurately measured in the showroom and on the forecourts; the dealers' shop window for new and used cars respectively.

However, whilst new car sales are undeniably a key part of the market, typically comprising around 30% (Figure 5) of a dealership's gross profit contribution, the margins from this part of the business are small by contrast with the servicing side of the industry. MOTs, routine servicing and repair work generate the highest contribution (35%) for dealers, and by far the greatest margins, with groups on average driving profitability of over 50%. By contrast, car sales (new and used) margins are typically below 10%.

Other major profit streams for dealerships include the sale of finance and warranty packages stapled to car sales, together with trade parts sales, fleet business and vehicle hire – these are collated below under 'Other' and collectively contribute a healthy profit margin (30%), notwithstanding these being relatively small contributors to overall profit.

As such, the dealership operating model is far more sophisticated and robust than merely the 'margin in the metal', with profits less sensitive to pure car sales than one might imagine. The modern dealership is a diverse centre of business activity, with turnover across a broad range of profit centres.

The road ahead

The automotive investment market is curtailed by a severe lack of investments on offer. Our research indicates that approximately 75% of franchised UK dealerships are held freehold (Figure 6), with 25% leased. This high percentage of freehold stock is synonymous with the wider Automotive sector where approximately 77% of stock is owner-occupied. We anticipate that as investors continue to demand

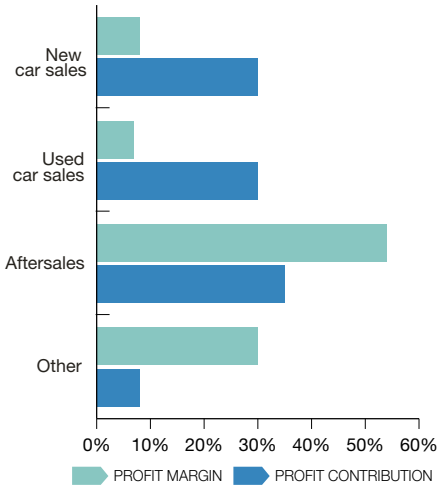
BREXIT – IMPACT ON AUTOMOTIVE INVESTMENT

The unexpected 'leave' vote in the UK Referendum on membership of the European Union has caused considerable consternation across the property market. Much of the concern has centred on the rapid rate of redemptions in the commercial property retail funds managed by a number of the largest Institutional investors. Whilst the majority of these funds held significant cash reserves the scale and speed of withdrawals left funds with little choice but to 'gate' redemptions.

In effect this meant that unit holders were barred from selling their holdings until a later date. These funds are now in the process of an orderly disposal of some of their property holdings to liquidate and return funds to investors as they reopen. Whilst some micro markets will be directly affected (when we know what the actual effect of the vote is – which may still be some way off) the underlying fundamentals are largely as they were pre referendum.

UK based vehicle producers have committed to a post-Brexit UK and assembly activities should be unaffected so long as tariff-free automotive trading is agreed as expected.

FIGURE 5
Profit contribution and margin



Source: Knight Frank Automotive

Land Rover Birmingham – Knight Frank Automotive Investment Purchase (June 2016)

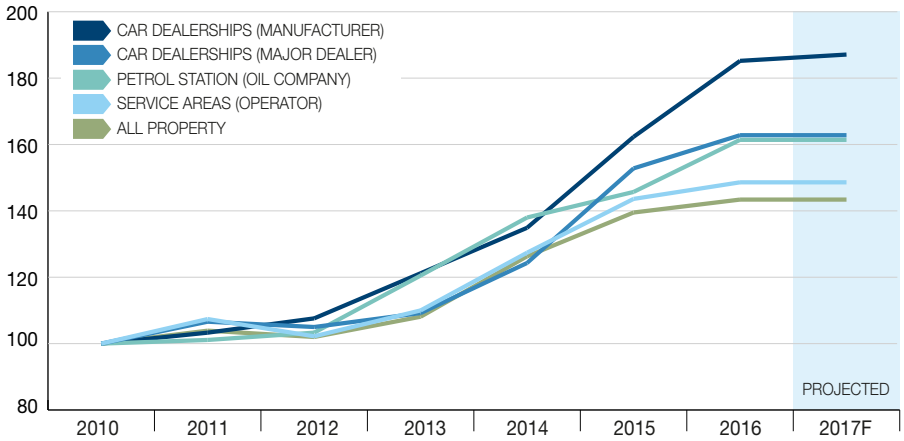
automotive assets for their portfolios, the occupational market will respond by creating further leasehold stock.

In our last research piece Automotive Capital Markets 2015/6, released Q3 2015, we predicted a number of high profile corporate acquisitions, and this has certainly been witnessed. We expect this M&A activity to continue at a pace over the coming 12-24 months, spearheaded by UK majors and overseas corporates.

Another key theme on this horizon is the rise of 'ultra-low emission' vehicles, with sales volumes rising during 2016, reflecting an increase of over 500% on 2014. With all major manufacturers developing new low emission models, this trend looks set to continue.

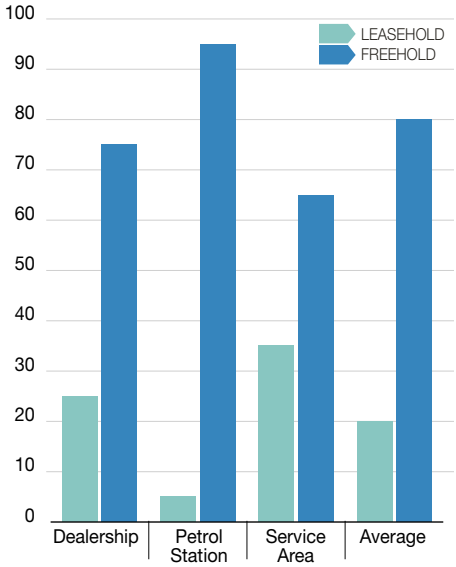
Elsewhere, the shortage of prime investment stock coupled with heightened investor understanding and demand has some major automotive retailers actively undertaking or appraising sale and leaseback. After all, the prime stock that is already held by the funds is rarely traded, as it is difficult to replace; so any 'new' stock is likely to come from sale and leaseback on new developments or existing modern facilities, and in some cases lease restructuring on prime investments. Equally from dealer groups' perspectives, M&A activity can quickly tip the scales in favour of freehold assets, with sale and leaseback able to address this imbalance whilst also releasing capital to invest in / upgrade the facilities or finance further acquisitions.

FIGURE 7
Knight Frank automotive property indices



Source: Knight Frank Automotive, IPD

FIGURE 6
Leasehold vs. freehold ownership



Source: Knight Frank Automotive

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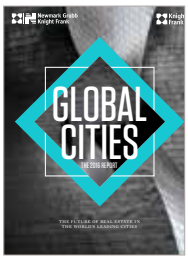

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