Vertu Motors

FY17 results

Responding to the challenge

Retail (automotive)

Vertu Motors has produced another solid set of figures, supported by a series of key investments to strengthen the medium-term outlook. Trading in the new car market has become more challenging, but the key used car and aftermarket operations continue to progress consistently.

Year end	Revenue (£bn)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
02/16	2.42	27.4	6.31	1.30	7.6	2.7
02/17	2.82	31.5	6.43	1.40	7.5	2.9
02/18e	2.90	34.0	6.79	1.50	7.1	3.1
02/19e	3.00	35.5	7.08	1.60	6.8	3.3

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Another good year

Vertu's FY17 results are at the upper end of market expectations, showing revenue up by 16.5% to £2.82bn and adjusted PBT by 15.0% to £31.5m; dilution from a £35m (gross) equity fund-raising restricted the rise in adjusted diluted EPS to just 1.9%. The dividend was lifted by 7.7% to 1.4p. While UK new car registrations were at record levels, trading conditions became more challenging from Q1 onwards, especially following the Brexit vote, which led to weaker sterling and rising new car prices. The group's key used car and aftermarket operations (71.5% of gross profit) performed impressively, delivering a 20% increase in profits.

Investment of almost £80m

Investment continued apace, with net capex and acquisition expenditure over the year of £28.6m and £50.6m. Capex is indicated at £37.5m in the current year, while management continues to assess acquisition opportunities that meet strict internal criteria in terms of quality, location and potential ROC. Meanwhile, there has been management strengthening ahead of the next stage of growth, while new initiatives to reach and retain new customers continue to emerge. Conditions in the new car market may become more challenging, but the impact of management action, especially in recent acquisitions, leaves us confident about the immediate and longer-term prospects. We are leaving our current year adjusted PBT forecast of £34.0m unchanged and introduce an estimate of £35.5m for FY19.

Strong balance sheet

Last year's investment programme was largely financed by cash generated from operations and the above mentioned fund-raising; net funds were reduced over the year from £23.1m to £21.0m. Unused facilities of some £60m are available to support the group's continuing ambitious capex and acquisition programme.

Valuation: Quality in an undervalued sector

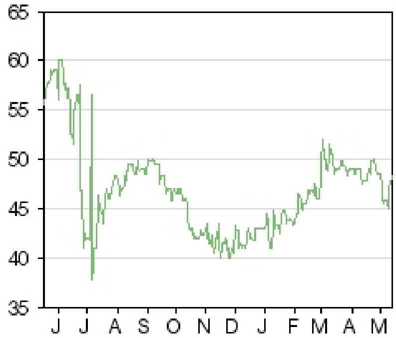
Vertu's rating of 7.1x CY17 prospective earnings is at a small discount to the 7.9x average of the other UK motor distributors and little more than half the 13.9x rating of the FTSE General Retailers index. This discount reflects neither the defensive qualities of motor retailing nor the group's consistent record and growth potential.

15 May 2017

Price	**48.25p**
Market cap	**£192m**

Net cash (£m) at end February 2017	21.0
Shares in issue	397.3m
Free float	97%
Code	VTU
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.6	6.0	(16.8)
Rel (local)	0.3	2.9	(31.4)
52-week high/low		60.0p	37.8p

Business description

Vertu Motors is the sixth largest UK motor vehicle retailer. Established in 2006, it is expanding through the completion and subsequent development of a series of acquisitions, initially in volume cars, but now including the premium segment of the market.

Next events

AGM	July 2017

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Edison profile page

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Adjusted PBT up 15%

Vertu Motors sustained its impressive rate of progress in the year to February 2017. Like-for-like group revenues were up by 4.4%, with the group delivering sound profits progress in all four core parts of the business: new cars, fleet/light commercial, used cars and aftermarket. Unlike in recent years, there was a modest widening of gross margins; with little change in the mix of business, there was a determination not to chase less profitable sales, especially in the more challenging new car market. Costs as a percentage of revenue rose slightly because of increased investment in the next stage of growth, but remained firmly under control; operating margins edged up from 1.18% to 1.20%. Underlying pre-tax profits of £31.5 were 15% above the £27.4m of the previous year and also ahead of our £30.5m estimate. Reflecting dilution from the £35m equity placing during the year, adjusted diluted EPS rose by just 1.9% to 6.43p; the dividend is lifted by 7.7% to 1.4p, covered 4.7 times.

The momentum of acquisitions and new openings continued, with group net investment of £79.2m. Principal acquisitions involved the introduction of Mercedes Benz (Reading, Slough, Ascot) to the group and the extension of the Jaguar Land Rover network in Yorkshire. The group also secured its first Toyota representation and added to its Nissan and Skoda coverage. In addition, there were several major relocations and franchise upgrades as part of the previously reported medium-term investment programme; the ongoing review of operations again led to a number of disposals, closures and refranchising of underperforming operations.

These developments were largely financed by a £35m (gross) equity placing and a strong cash flow. At February 2016, Vertu had net cash of £21.0m, compared with £23.1m 12 months earlier.

Exhibit 1: Results breakdown

Year to February	2017 (£m)	2016 (£m)	Change (%)
Revenue			
New car retail/Motability	909.4	796.5	+14.2
New fleet and commercial	648.7	587.6	+10.4
Used cars	1,037.5	850.2	+22.0
Aftermarket	227.0	189.0	+20.1
Total revenue	**2,822.6**	**2,423.3**	**+16.5**
Gross profit			
New car retail/Motability	68.3	59.3	+15.2
New fleet and commercial	21.1	17.6	+19.9
Used cars	100.7	83.5	+20.6
Aftermarket	123.4	102.9	+19.9
Total gross profit	**313.5**	**263.3**	**+19.1**
Operating profit	**33.8**	**28.6**	**+18.2**
Pre-tax profit	**31.5**	**27.4**	**+15.0**
Gross margins	11.11%	10.86%	
Operating margins	1.20%	1.18%	
Pre-tax margins	1.12%	1.13%	

Source: Vertu Motors preliminary statement. Note: Before intangibles amortisation, share-based payments and exceptional items.

New cars/Motability (21.8% of gross profit)

As was generally predicted across the sector, the new car market remained robust throughout the year, although conditions became progressively more challenging after a strong Q1. While CY16 new car registrations rose to a new record of 2.7m (Source: SMMT), the retail segment slipped back by 1.0%, despite the continued strong support of the OEMs in the form of attractive financial packages and a relatively high level of pre-registration activity by certain retailers seeking to meet demanding OEM targets. In this context, the group delivered 41,525 new retail vehicles, representing a 4.4% advance over the previous year. On a like-for-like basis, however, there was a reduction of 6.4%, with a higher shortfall in H2. Management concentrated on sustaining margins, while meeting OEM targets; the group resisted the urge to chase volume.

There was a nominal reduction in Motability volumes to 11,396 vehicles, including a 4.4% like-for-like reduction; the market slipped by 1.1%. Management indicated that its loss of market share reflected a switch in franchise preference, following OEM price adjustments related to the weakness of sterling. Nevertheless, Vertu retained the Motability Dealer Group of the Year accolade earned in the two previous years.

Margin pressures on retail new car sales continued throughout the year, especially when volumes started to fall away in H2. However, a combination of a higher percentage of specialist vehicle sales and the decision not to chase volume enabled the group to sustain gross margins at 7.4%.

The new retail and Motability sectors both face challenging conditions in the current year. A strong new car performance in March was influenced by VED (vehicle excise duty) changes and was followed by a sharp correction in April. Retail registrations for the first two months of FY18 are reported 7.6% lower at 0.36m – ironically, SMMT upgraded its FY17 registrations forecast at the time of the announcement of the April figures. Significantly, Vertu has indicated segmental gross profits ahead of the corresponding period of the previous year. There is increasing uncertainty in the Motability marketplace, but we still look for another sound result from this segment in FY18.

Fleet and commercial (6.7% of gross profit)

Fleet was the mainstay of the new car market last year, supplying all of the growth in registrations, while the light commercial vehicle (LCV) market rose by a further 1.2%. Vertu performed well in both sectors, although for differing reasons. Fleet car sales were largely unchanged, although falling by 4.2% on a like-for-like basis; the quality of the business again rose considerably, with a fall in the ultra-low-margin daily rental business balanced by the impact of higher volumes of premium vehicles carrying a higher margin. Vertu modestly outperformed the LCV market, lifting volumes on an actual and like-for-like basis. Combined unit sales rose by 1.3% to 35,577 vehicles, but with a higher average unit price and increased overall margins, revenue rose by 10.4% and gross profits by 19.9%.

These trends have continued into the current year, with volume increases in the fleet/LCV segment of the business balancing the shortfall in retail sales. LCV registrations were disappointing in April, but action taken by management to raise the quality of the underlying operations encourages us to view the remainder of the year with optimism.

Used cars (32.1% of gross profit)

Used cars remain fundamental to the development of group profitability – Vertu has a recognised skill base in this area, while the increased sale of service plans increase throughput and efficiency levels in the group's aftermarket operations. The group sold 81,636 used cars last year, representing a 13.9% increase over the previous year; this included a 7.1% like-for-like advance. The size of the overall market was augmented by the growth in self-registrations, but the group again outpaced the 6% market growth indicated by management.

This represents another impressive performance, in the context of the range of sales inducements in the retail new car market, which will have contributed to a number of traditional used car buyers switching to new vehicles. The sourcing of used cars and the inventory profile across the dealership network remain fundamental, with the recovery in the new car market (which began five years ago) still leading to increased vehicle availability.

It has been clear for some time that this increased availability could put pressure on used car margins, but management was confident that its increased emphasis on investment in inventory profiles, a high stockturn and marketing advances would lift volumes and lead to another strong result. Growing involvement of the OEMs in offering PCPs (personal contract plans) on quality used cars is also helping to sustain margins. Gross profit per vehicle increased by 6.6%, while like-for-like gross margins increased by 50bp to 10.6%. Lower margins on recent acquisitions held back overall gross returns (down from 9.8% in FY16 to 9.7% in FY17), but the outlook remains positive.

The current year has started well, with like-for-like margins and volumes for the first two months of the trading year running ahead of last year. We look for a sustained increase in volumes in the coming months and, although we cannot be sure as to the sustainability of the increased margins, we are confident of useful further profits progress.

Aftermarket (39.4% of gross profit)

Although not matching the impressive revenue growth seen elsewhere in the group, the aftermarket operations again performed consistently. Revenues rose by 20.1% to £227m, including useful like-for-like revenue growth in each segment of the business. Gross profit margins (expressed on internal and external revenue) were little changed at 44.6% despite slightly unfavourable changes in the terms of trade in the parts business.

The development of the used car business across the franchises remains fundamental to the development of aftermarket operations. Vertu has been progressively securing increased market share through consistent investment in CRM and the sale of service plans, which has extended the age profile of vehicles going through the group workshops. The proportion of service work on vehicles more than five years old continues to rise, while the number of service plans (excluding OEM-sponsored plans) rose to 104,040 last year, up from 28,895 just four years ago.

Management continues to introduce initiatives to lift aftermarket revenues. Working hours are being extended, where appropriate, to meet a more demanding customer. The recovery in the new car market over the past four years, the more focused motivation of sales teams to sell service plans and the planned targeting of smaller fleet customers, all point to consistent growth being delivered by Vertu's aftermarket operations – both in the immediate future and over the medium term.

Conditions more challenging

From the above comments it is clear that the retail new car market is under pressure. While SMMT forecasts for current year registrations have been nudged higher in recent weeks, a reduction from last year's record still looks likely. We understand from several dealership groups that several OEMs are looking to reduce the number of new vehicles imported to the UK in the coming months, which should help sustain margins, but only the well-managed groups, especially those with investment benefits to accrue, will deliver like-for-like progress in this segment in 2017.

However, more than 70% of gross profits are generated in the used car and aftermarket operations, both of which performed strongly in FY17 and have started the current year positively. Much of the group investment in recent years has been aimed at these segments of the business. Management has been bolstered ahead of the next stage of growth, while there is a clear strategy to respond effectively to the opportunities presented by modern media channels to reach and retain new customers. At the same time, OEM relationships remain fundamental to business development.

Vertu has a pent-up profit momentum in recent acquisitions, which take up to four years to reach their optimum performance. Several businesses acquired during this period are moving ahead, as overall efficiency levels are raised and the used car content builds, with its subsequent impact on aftermarket returns. In addition, several major recent capex projects involving the upgrading and/or relocation of facilities will be moving towards higher returns.

We remain confident about the medium term. The pipeline of potential acquisitions remains extensive, while the group supplemented the available funds in 2016, to respond quickly to opportunities as they arise. Competition for acquisitions has increased in recent months, especially in the premium segment of the market; the weakness of sterling has raised interest from overseas, particularly the US. Vertu has demonstrated an ability to identify and secure deals that meet its demanding quality and returns criteria over the past few years and, with the support of the OEMs, can be expected to continue.

The OEMs are becoming less tolerant of underperforming franchises. The independent retailers (60% of the market) have benefited from benign market conditions for the past three years and are under increasing pressure to commit substantial capital investment to upgrade their dealership facilities. Many of those without family succession in place will be tempted to exit in the near future, especially as trading conditions are becoming more challenging.

Industry dynamics, especially those involving the necessary investment in internet visibility, all point to the industry becoming more focused towards the larger dealership groups over the next two to three years. Vertu should continue at the forefront of this trend.

We have left our FY18 adjusted PBT estimate unchanged at £34.0m, while other analysts have been taking a more cautious line in recent months in response to sterling weakness and consumer spending fears following last year's Brexit vote. We believe that the underlying momentum from recent acquisitions and the continued progress being delivered in used cars and the aftermarket point positively to the immediate future. As the year progresses, we anticipate that the market will take a less cautious line and lift their targets in line with our own. We look to further benefits from recent and current investment plans in the following year and are introducing an adjusted PBT estimate of £35.5m for FY19.

Finances remain strong

The Vertu balance sheet remains strong, with management well able to respond quickly to acquisition opportunities in the market.

Last year's funds flow statement shows £58.1m in cash flow generated from operations, benefiting from a further £16.0m reduction in working capital – year-end inventory levels were again below our estimates. With the outflow related to interest payments (£2.4m), taxation (£5.7m) and dividends (£5.4m) totalling £13.5m, there was a net £44.6m generated to finance investment. The substantial capital (£28.6m) and acquisition (£50.6m) expenditure totalling £79.2m, was largely financed by the operational cashflow and the £32.6m net proceeds of the share placing. Net funds decreased year-on-year by £2.1m from £23.1m to £21.0m.

On the basis of our current estimates, the group will generate just over £46m from operations in the current year, of which up to £15m will be absorbed by tax, interest and dividend payments, leaving in excess of £30m available for investment. With capex indicated at around £37.5m, we anticipate a net cash outflow over the year of up to £10m.

The group balance sheet at February 2017 shows shareholders' funds of £246.4m, equivalent to 62.3p per share; net tangible assets amount to 39.5p per share.

Current banking facilities comprise £68m related to the general financing of the business, including working capital (the balance sheet date tends to be favourable for working capital ratios). In addition, the group has a £40m acquisition facility, which can be extended by a further £30m to facilitate larger deals – the group has drawn £10m of this facility. On this basis there are substantial funds available to support the group's ongoing ambitious acquisition programme.

Exhibit 2: Financial summary

£000s	2013	2014	2015	2016	2017	2018e	2019e
Year end 28 February	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS							
Revenue	1,259,335	1,684,500	2,074,912	2,423,279	2,822,589	2,900,000	3,000,000
Cost of sales	(1,110,254)	(1,492,335)	(1,846,843)	(2,160,000)	(2,509,049)	(2,575,200)	(2,661,000)
Gross profit	149,081	192,165	228,069	263,279	313,540	324,800	339,000
EBITDA	13,281	23,574	28,650	35,451	42,435	45,000	46,600
Operating profit (before GW and except.)	9,139	17,904	22,735	28,648	33,770	36,200	37,600
Intangible amortisation	(291)	(293)	(405)	(558)	(614)	(650)	(650)
Exceptionals	(3,606)	(1,180)	0	0	0	0	0
Other	(99)	(195)	(645)	(911)	(1,082)	(1,150)	(1,150)
Operating profit	5,143	16,236	21,685	27,179	32,074	34,400	35,800
Exceptionals	316	0	0	0	0	0	0
Net interest	(1,081)	(394)	(687)	(1,217)	(2,254)	(2,200)	(2,100)
Profit before tax (norm.)	8,058	17,510	22,048	27,431	31,516	34,000	35,500
Profit before tax (FRS 3)	4,378	15,842	20,998	25,962	29,820	32,200	33,700
Tax	(989)	(3,414)	(4,459)	(5,282)	(5,800)	(6,440)	(6,740)
Profit after tax (norm.)	7,069	14,096	17,589	22,149	25,716	27,560	28,760
Profit after tax (FRS 3)	3,389	12,428	16,539	20,680	24,020	25,760	26,960
Average number of shares outstanding (m)	199	299	340	341	391	398	398
EPS - normalised (p)	3.15	4.69	5.15	6.46	6.54	6.90	7.20
EPS - normalised fully diluted (p)	3.14	4.64	5.06	6.31	6.43	6.79	7.08
EPS - FRS 3 (p)	1.70	4.15	4.87	6.06	6.14	6.47	6.77
Dividend per share (p)	0.70	0.80	1.05	1.30	1.40	1.50	1.60
Gross margin (%)	11.8	11.4	11.0	10.9	11.1	11.2	11.3
EBITDA margin (%)	1.1	1.4	1.4	1.5	1.5	1.6	1.6
Operating margin (before GW and except.) (%)	0.7	1.1	1.1	1.2	1.2	1.2	1.3
BALANCE SHEET							
Fixed assets	129,695	163,810	190,928	227,339	295,542	331,492	350,742
Intangible assets	22,585	44,361	52,772	70,881	96,113	103,313	110,513
Tangible assets	102,932	116,380	135,153	150,361	197,545	226,295	238,345
Pension surplus	4,178	3,069	3,003	6,097	1,884	1,884	1,884
Current assets	301,622	414,371	468,907	638,274	598,860	608,790	641,706
Stocks	250,443	334,452	394,287	530,406	506,470	520,360	538,304
Debtors	43,939	42,971	53,500	63,416	52,545	53,986	55,848
Cash	7,240	36,948	19,254	43,915	39,845	34,444	47,555
Other	0	0	1,866	537	0	0	0
Current liabilities	(300,980)	(400,233)	(470,244)	(641,556)	(624,400)	(641,170)	(663,424)
Creditors	(298,980)	(398,233)	(466,821)	(634,800)	(615,729)	(632,670)	(654,424)
Short-term borrowings	(2,000)	(2,000)	(3,423)	(6,756)	(8,671)	(8,500)	(9,000)
Long-term liabilities	(23,696)	(14,569)	(9,957)	(26,198)	(23,573)	(22,573)	(21,573)
Long-term borrowings	(11,454)	(3,512)	(161)	(14,011)	(10,166)	(10,166)	(10,166)
Other long-term liabilities	(12,242)	(11,057)	(9,796)	(12,187)	(13,407)	(12,407)	(11,407)
Net assets	106,641	163,379	179,634	197,859	246,429	276,539	307,451
CASH FLOW							
Operating cash flow	12,973	47,392	26,113	65,810	58,123	46,450	48,473
Net interest	(1,236)	(521)	(714)	(1,415)	(2,413)	(2,200)	(2,100)
Tax	(1,430)	(2,350)	(4,471)	(7,700)	(5,744)	(6,280)	(6,665)
Capex	(5,510)	(14,447)	(17,161)	(19,657)	(28,598)	(37,500)	(21,000)
Acquisitions/disposals	(13,481)	(37,512)	(16,685)	(25,837)	(50,632)	0	0
Financing	256	47,614	47	200	32,477	0	0
Dividends	(1,296)	(2,526)	(2,895)	(3,923)	(5,353)	(5,700)	(6,098)
Net cash flow	(9,724)	37,650	(15,766)	7,478	(2,140)	(5,230)	12,611
Opening net debt/(cash)	(3,510)	6,214	(31,436)	(15,670)	(23,148)	(21,008)	(15,778)
HP finance leases initiated	0	0	0	0	0	0	0
Other	0	0	0	0	0	0	0
Closing net debt/(cash)	6,214	(31,436)	(15,670)	(23,148)	(21,008)	(15,778)	(28,389)

Source: Company accounts, Edison Investment Research

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