EDISON

Lookers

Looking to the future

Half year results

Automobiles & parts

24 August 2018

Along with its peers, in H118 Lookers continued to be challenged by market conditions, which returned to a more normal sequential development but meant that Q1 profitability was lower than in the prior year. With new and used car markets now appearing to have stabilised, management appears confident that the impact of the new vehicle testing regime is likely to be neutral across H218. With a continued focus on operating cost control, H2 profitability should recover strongly to provide a more normal H1:H2 seasonal split than was seen in 2017. As a result, we maintain our PBT and EPS forecasts.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/16	4,088.2	64.9	13.13	3.64	8.2	3.4
12/17	4,696.3	68.4	14.14	3.89	7.6	3.6
12/18e	4,835.4	67.7	13.70	4.08	7.8	3.8
12/19e	4,989.7	70.4	14.47	4.29	7.4	4.0

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

H118 trading reflects a more normal period

Lookers outperformed the UK car markets and delivered a 3% increase in gross profit as used and aftersales improvements outweighed a more subdued new car performance. The prior year included a record Q1 performance as new car sales were pulled forward in advance of changes to UK Vehicle Excise Duty (VED) rates. H217 also saw the collapse in diesel demand which remained depressed in H118, but is now a more stable and manageable element of group performance. A £12m step up in operating expenses reflected investment in people, property and technology, which together with higher interest led to a 14% fall in H118 PBT.

Outperforming as markets stabilise

With the various issues that distorted sequential market progression now established trends, the UK new and used car markets appear to be stabilised at modestly lower levels. Lookers continues to outperform underlying market demand, especially in the Used car segment with a beneficial knock-on effect in the high margin aftersales activity. Used and aftersales currently contribute two thirds of gross profit. The continued focus on growing the ratio of used car sales to new to 2.0x over the next few years should deliver healthy profitable growth. Lookers appears well positioned to take advantage of its strong balance sheet as seasonal trading patterns revert to normality. With net debt/EBITDA towards the lower end of the 0.5x to1.5x target range, and with £165m of undrawn facilities, any appropriate M&A opportunities that arise can be pursued.

Valuation: Sector rating remains depressed

Supported by the buyback, Lookers' rating has recovered in the last six months and now stands towards the top end of the sector. The shares trade on an FY19e P/E of 7.4x based on our estimates, vs the peer group average of 6.8x. A re-rating of the overall sector would appear to require a restoral of economic confidence.

Price 107.2p

Market cap £422m

Net debt (£m) at 30 June 2018	54.5
Shares in issue	394.1m
Free float	80%
Code	LOOK
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	1.1	1.9	(2.6)
Rel (local)	2.2	4.7	(5.2)
52-week high/low		120.00p	82.00p

Business description

Lookers is vying to be the largest UK motor vehicle retailer, with its new car operations supported by the strength of used and aftersales activities. It now operates 155 franchises, representing 32 marques from 100 sites around the UK, with strong regional presences in Northern Ireland, Scotland, the South East and across northern England.

Next events

Q318 update	November 2018

Analysts

Andy Chambers +44 (0)20 3077 5700

Annabel Hewson +44 (0)20 3077 5700

industrials@edisongroup.com

Edison profile page

Lookers is a research client of Edison Investment Research Limited

H118 results

Lookers delivered a solid H118 report against a challenging UK new car backdrop, and in comparison to a period that included a record first quarter. We summarise the key points here:

- Reported H118 group revenues of £2.58bn (H117 £2.46bn) represented growth of 5%, including flat new car revenues.
- Reported H118 gross profit of £271m (+3% vs. H117 £264m) was supported by continued growth in used cars and aftersales businesses.
- Reported H118 adjusted profit before tax of £43.1m (-14.1% vs H117 £50.2m) reflected the tough Q117 comparatives, a higher interest charge as well increased costs from investment in people, technology and property.
- Reported H118 adjusted EPS of 9.07p (H117 10.49p) was down 13.5%.
- Reported H118 dividend per share of 1.48p (H117 1.41p) was an increase of 5.0% in line with our expectations, covered 6.1x by adjusted earnings and reflecting the company's progressive dividend policy. We expect a similar increase in the full year dividend.
- Strong cash conversion with working capital reduced and net debt lowered to £54.5m (H117 £61.9m).
- Share buyback remains ongoing, following the announcement in March of a £10m programme. At 30 June 2018, the company had acquired and cancelled c 3 million shares at a cost of £3.1m.

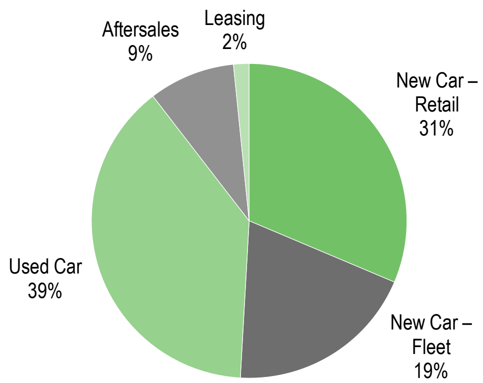
Exhibit 1: Lookers H118 key data

Half year to June £m	H117	H118	% change
Revenues	**2,458.5**	**2,576.5**	**4.8%**
Operating profit (adjusted)	58.1	52.8	-9.1%
Profit before tax (adjusted)	**50.2**	**43.1**	**-14.1%**
Net income (adjusted)	41.6	35.9	-100.0%
EPS (p) (reported)	9.07	9.71	7.1%
EPS (p) (adjusted)	**10.49**	**9.07**	**-13.5%**
DPS (p)	1.41	1.48	5.0%
Net debt	61.9	54.5	-12.0%
Freehold/long leasehold property per share (p)	74	78	5.4%
NAV per share (p)	93	105	12.9%

Source: Company reports

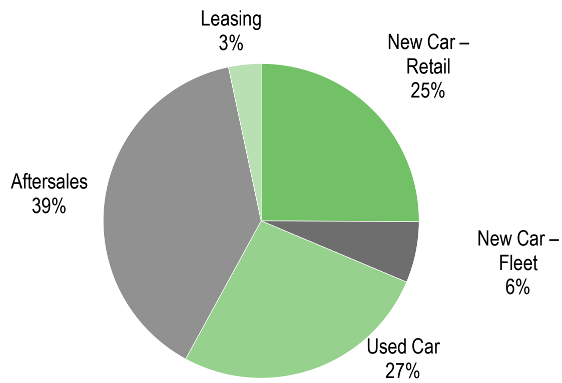
Used car and aftersales segments continue to contribute around two thirds of group profitability, aided by their higher margin business dynamics.

Exhibit 2: H118 revenue by activity



Source: Company reports

Exhibit 3: H118 gross profit by activity



Source: Company reports

New car sales were broadly stable at £1.3bn with a significant 12% increase in used car sales and a healthy 6% improvement from the aftersales segment. Group gross margin was a healthy 10.5% (Q117 10.7%), as a fall in new and used car margins was largely offset by an improvement in the aftersales segment. The small leasing business maintained its gross profit contribution.

Exhibit 4: Lookers H1 divisional analysis

Year-end December	2017			2018	% change	% change
(£m)	H117	H217	FY17	H118	H118 vs H117	H118 vs H217
New car – retail	822	677	1499	808	(2)%	19%
New car – fleet	490	488	978	503	3%	3%
Used car	887	815	1702	996	12%	22%
Aftersales	216	193	409	228	6%	18%
Leasing	44	64	108	41	(7)%	-36%
Group revenues	**2,459**	**2,237**	**4,696**	**2,576**	**5%**	**15%**
Gross profit by segment	-	-	-	-	-	-
New car – retail	71	63	134	68	(4)%	8%
New car – fleet	17	14	31	17	0%	21%
Used car	69	64	133	72	4%	13%
Aftersales	98	91	189	105	7%	15%
Leasing	9	8	17	9	0%	13%
Group gross profit	**264**	**240**	**504**	**271**	**3%**	**13%**
Gross margin	-	-	-	-	-	-
New car – retail	8.6%	9.3%	8.9%	8.4%		
New car – fleet	3.5%	2.9%	3.2%	3.4%		
Used car	7.8%	7.9%	7.8%	7.2%		
Aftersales	45.4%	47.2%	46.2%	46.1%		
Leasing	20.5%	12.5%	15.7%	22.0%		
Group gross margin	**10.7%**	**10.7%**	**10.7%**	**10.5%**		

Source: Company reports

New cars (H118: 51% group sales; 31% group gross profit)

As expected, a decrease in the UK new car market was visible in H118 with a y-o-y decline in registrations of 6.3%. Within that, the retail new car market reduced by 4.9% and the fleet market reduced by 7.3%. The market decline was more pronounced in Q118, given the tougher comparison from the pull forward effect seen in 2017 in advance of changes to VED.

Of the issues that affected the market last year

- VED change was not repeated so the important March/April registration period returned to normal this year.
- The issues related to the use of Personal Contract Purchase (PCP) finance plans appear to have been given a clean bill of health for new car and higher quality used car deals.
- The demonisation of diesel continued to have an adverse impact on new car purchases but the sharp decline in demand in H217 has now stabilised to a degree at lower levels. Residual values have recovered so used profitability for diesels has started to recover.
- Brexit concerns continue to weigh on consumer and business confidence.

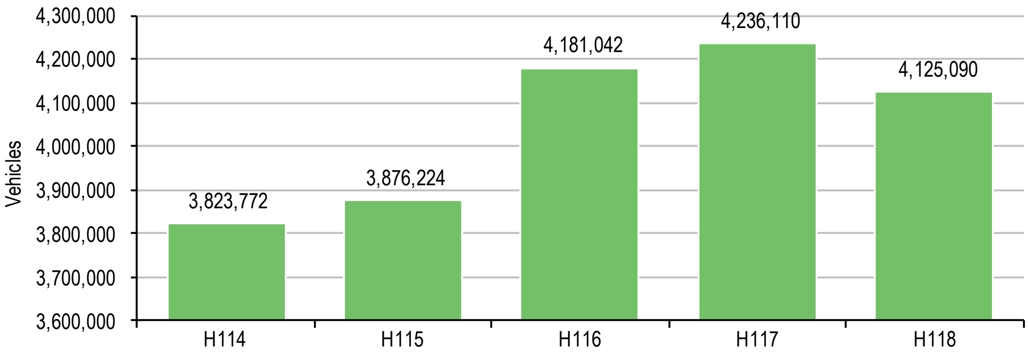
Lookers saw modest sales growth from April and overall kept new car revenues broadly flat on H117. Within this figure, Lookers' new car retail revenues fell 2% y-o-y but grew 19% on a sequential basis from H217. New car fleet turnover increased 3% y-o-y against the market decline of 6%. New car retail gross profit declined by 4%, reflecting the wider market weakness. However, a sensible attitude to maintaining margins kept new car fleet gross profit flat y-o-y.

We discuss the outlook for the UK new car market in detail later on.

Used cars (H118: 39% group sales; 27% group gross profit)

The UK used car market remained relatively more stable during the first half, although a modest 2.6% dip in Q118 was followed by just a 0.4% fall in Q218. Exhibit 5 outlines UK used car H1 transactions, indicating that the market is still at a healthy level.

Exhibit 5: UK used car transactions, six months to June



Source: SMMT

Lookers viewed the H118 used car market as buoyant and once again managed to outperform the market. This was aided by the manufacturer deal it took on in December, but more generally arising from the assertive actions it is taking to accelerate used car sales. Lookers' used car revenues increased by 12% y-o-y and 22% sequentially. Gross profit increased by 4% y-o-y and 13% sequentially. Although the average selling price increased, profit per unit was maintained at the same level. Lookers has driven used car volume growth each year over the last five years and continues to recognise the segment as a significant opportunity and intends to drive growth here.

Aftersales (H118: 9% group sales; 39% group gross profit)

Lookers delivered 6% revenue growth and 7% gross profit growth y-o-y, boosting gross profit margin by 80bp. The company has worked on increasing capacity and retaining customers. The use of PCP finance packages and service plans in both new and used car deals is continuing to encourage customers to use Lookers' dealership facilities. Service plan penetration increased to 39% in H118 having been stable at 38% since 2014 and the number of live service plans is now comfortably above 100k providing an effective annuity for the high margin aftersales business.

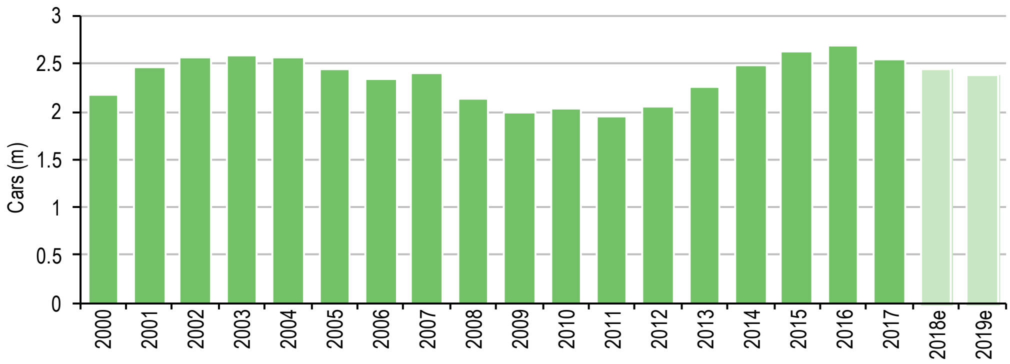
UK car market prospects remain subdued

The SMMT (Society of Motor Manufacturers and Traders) new car registration forecast for 2018 has been revised up fractionally as the year has progressed. The forecast released in early August, which is derived from the average consensus of a panel of forecasters, is now for a decline of 4.1% to 2.436m units from 2.541m in 2017. A further 1.9% decline is anticipated in 2019. New light commercial vehicle (van) sales are expected to fall by 0.8% to 0.359m vehicles this year and remain broadly stable in 2019. Both car and van sales remain at very high levels in historical terms.

The implication of these forecasts is the new car market will see a more moderate fall in sales of c 2% in H218, compared to the 6.3% decline in H1.

While the distortion in the new car market caused by the April 2017 VED changes have now largely worked through the comparisons, the confidence of buyers remains low, both for business and private consumers. This is despite what we would consider are supportive overall economic fundamentals in terms of labour markets and the low interest rate environment. The tarnishing of diesel as a main engine choice, which in our view may be misguided given the improved emissions of Euro 6-compliant diesel engines, continues to defer purchase decisions. Diesel's share of the new car market continued to fall sharply in H118 to 32.3%, down from 47.7% in 2016 and a peak of 50.8% in 2012.

Exhibit 6: UK annual new car registrations (millions) (2000-2019e)



Source: SMMT

We feel the concerns of the FCA regarding the use of PCP plans has been addressed in the main, especially with regards to larger dealerships and new and younger used car sales. The main stumbling block appears to be Brexit, which continues to weigh heavily on the timing of vehicle replacement decisions.

As mentioned, the SMMT forecast has just been modestly improved to a decline of 4.1% in the current year. However, it is unclear how much allowance this makes for what appears to be the potential for significant supply-side disruption in H218 from the introduction of the new vehicle testing regime in Europe, the Worldwide Harmonised Light Vehicle Test Procedure (WLTP). Lookers does not currently believe WLTP will represent a material issue, but it recognises that it has the potential to result in some volatility to the supply of new vehicles. Overall, Lookers continues to view the business implications of the current political climate, Brexit and exchange rates as "Unhelpful." However, management has stated it is happy with FY18 market estimates.

Neutral impact expected by Lookers from WLTP

WLTP is a testing system being introduced in the European Union to measure fuel consumption and CO_2 emissions from passenger cars, as well as pollutant emissions. It follows recent emission testing scandals and is designed to provide more realistic and accurate data. It replaces the previous regime from the 1980s called the NEDC (New European Driving Cycle). The main difference is the NEDC lab test used a theoretical driving cycle, whereas WLTP tests models over a variety of driving conditions, including actual driving data.

For every car type, every engine variant is tested for the lightest and heaviest version. The regime is therefore more complex for manufacturers in terms of the numbers of models to be tested.

Initially coming into force from 1 September 2017, WLTP is to replace NEDC for all vehicles from 1 September 2018. The interim period has been one of transition. Any vehicles produced since 1 June 2018 can only be sold after 1 September 2018 if they are processed under WLTP. Cars produced before this date that are not WLTP tested have a 12-month derogation period for up to 10% of a manufacturer's total sales volumes during which time they can be registered. It appears that some manufacturers may encourage some pre-registration of non-compliant vehicles before the September deadline.

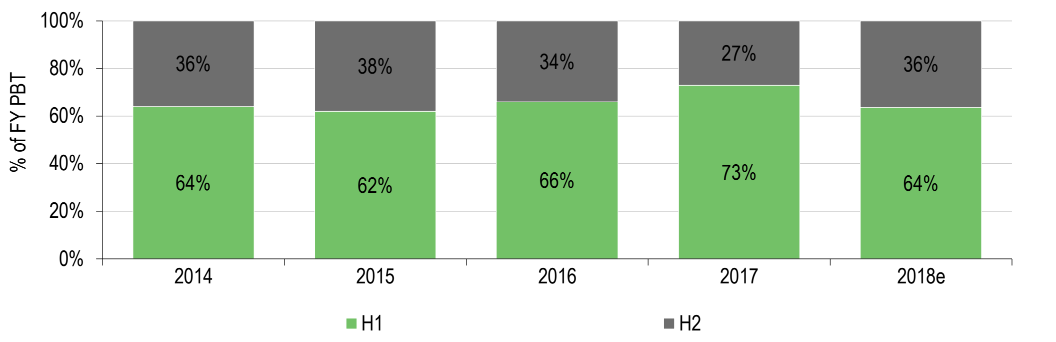
In addition, the supply of compliant new vehicles in the busy September registration month may be abnormally constrained and possibly spread new registrations more evenly through the end of 2018 and even into 2019. With pre-registrations likely to unwind after the deadline, the supply of high quality, nearly new cars could boost used sales but at a likely detriment to margins.

Outlook

Lookers is not expected to be alone in being affected by these factors as WLTP is an industry-wide issue. Clearly the impact for each retailer will likely be dependent on brand mix. Lookers' management feels that the transition to WLTP may distort registrations over the period, boosting August and lowering September and subsequent months, but expect the overall impact on H218 to be relatively neutral. We thus expect to see modestly lower new car revenues year-on-year for Lookers in H218 due to the potential supply-side constraint, strong used car sales and a solid aftersales performance. The overall retail operating margin is likely to remain stable due to the factors affecting both used and new car markets.

Management has indicated that the weak H217 profitability appears to have been an anomaly. An analysis of the contribution to PBT by half year indicates an historic trend of closer to 65% from H1 and 35% from H2. Management believes that notwithstanding WLTP, a reversion to the more normal historic trend in FY18 is highly likely. The impact of the sharp fall in new car diesel sales in the UK and its effect on residual values only really started to affect the market from June 2017. There was therefore a large step down in H217, which led to the lower profit contribution especially from used cars. The split was exacerbated by the record Q1 performance in 2017, due to the distortions caused by the change to VED rates in the UK. As trends and most importantly residual values have now stabilised, management expects a much stronger H2 performance in the current year than in FY17.

Exhibit 7: H1-H2 historic trend analysis and FY18 forecast (Edison)



Source: Company reports, Edison Investment Research

Valuation

Exhibit 8 summarises the auto retail segment on three valuation multiples, using current market consensus forecasts (Bloomberg). We choose to exclude Inchcape from the average comparative multiples due to its very international distribution model, whereas the others have a fundamentally UK footprint like Lookers. We include Inchcape's valuation metrics for information.

Exhibit 8: Peer group key metrics comparison

Company	Year end	Price (p)	Mkt cap (£m)	P/E (x)			EV/EBITDA (x)			Dividend yield (%)		
				Year 1	Year 2	Year 3	Year 1	Year 2	Year 3	Year 1	Year 2	Year 3
Lookers	12/2017	106.0	417.7	7.79	7.41	6.93	4.55	4.36	4.17	3.77%	3.96%	4.15%
Vertu Motors	02/2018	49.7	188.5	9.38	8.02	7.65	4.43	3.96	3.81	3.22%	3.42%	3.82%
Marshall Motor Holdings	12/2017	156.0	121.5	6.53	6.37	6.24	3.11	3.06	2.97	4.23%	4.29%	4.29%
Pendragon	12/2017	26.1	367.2	7.66	6.68	6.20	3.63	3.61	3.47	6.14%	6.14%	6.53%
Cambria Automobiles	08/2017	56.0	56.0	7.47	7.09	6.59	4.55	4.30	4.03	1.79%	1.79%	1.96%
Inchcape	12/2017	704.5	2,924.6	10.86	10.47	10.15	6.78	6.49	6.40	3.92%	4.05%	4.22%
Average ex LOOK & INCH				7.76	7.04	6.67	3.93	3.73	3.57	3.84%	3.91%	4.15%

Source: Bloomberg consensus. Note: Prices at 14 August.

Following the recent share price rise, Lookers now trades at a modest 5% premium to its peer group average. The discount of the auto retailers to the FTSE General Retail sector still appears to be over-discounting Brexit fears. We would expect the gap to close over the next 12 months.

We also note that our capped DCF value is 169p/share. We use six years of cash flow forecast then the terminal value is calculated on a zero growth basis, with working capital normalised to zero and capex equal to depreciation. To further constrain the model we have averaged the terminal cash flow to equate to the average over the forecast period rather than the peak in the terminal forecast year. A calculated WACC of 8.9% derived from a cost of equity of 10% and a pre-tax debt cost of 5% is used to discount the cash flows. The sensitivity of the capped DCF value to assumed terminal growth rates and WACC are shown in the table below

Exhibit 9: Lookers capped DCF sensitivity to WACC and terminal growth rate (p per share)

WACC	7%	8%	9%	10%	11%	12%
Terminal growth rate						
0%	231	195	**168**	145	127	113
1%	233	197	169	147	129	114
2%	235	199	170	148	130	114
3%	237	200	172	149	131	115

Source: Edison Investment Research estimates. Highlighted in bold the valuation obtained with the closest assumptions to the ones used in base case (169p).

Financials

Our EPS estimates do not change although we do expect a slightly different mix of sales and profitability following the interim results. We have increased our new car expectations for sales reflecting the more stable outlook for the UK market, notwithstanding WLTP concerns and continued depressed diesel engine vehicle demand. At the same time the success of the used car initiative so far this year has led us to increase our revenues for that segment, with a consequent modest increase in aftersales.

Exhibit 10: Lookers earnings estimates revisions

Year to December (£m)	2018e			2019e		
	Prior	New	% change	Prior	New	% change
New	2,397.3	2,446.8	2.1%	2,421.3	2,486.0	2.7%
Used	1,804.9	1,873.0	3.8%	1,895.1	1,966.6	3.8%
Aftersales	425.2	429.2	1.0%	442.2	446.4	1.0%
Leasing	116.6	86.4	-25.9%	126.0	90.7	-28.0%
Sales	**4,743.9**	**4,835.4**	**1.9%**	**4,884.5**	**4,989.7**	**2.2%**
EBITDA	**103.8**	**105.2**	**1.4%**	**106.3**	**107.9**	**1.5%**
Underlying EBITA	**83.3**	**84.3**	**1.2%**	**85.7**	**86.8**	**1.3%**
Underlying PBT	**67.7**	**67.7**	**0.0%**	**70.4**	**70.4**	**0.0%**
EPS - underlying continuing (p)	**13.7**	**13.7**	**0.0%**	**14.5**	**14.5**	**0.0%**
DPS (p)	4.08	4.08	0.0%	4.29	4.29	0.0%
Net debt/(cash)	64.1	66.7	4.0%	53.4	56.5	5.8%

Source: Edison Investment Research

However, we expect a higher finance charge for the year, largely reflecting higher interest rates, which offset the increase in group EBITA. As a result, our expectations for PBT, EPS and full year dividend all remain unchanged.

There is a slight increase in our expectation for year end net debt, which reflects modestly higher working capital requirements in support of the increased sales expectation.

The £10m share buyback is continuing with £3.1m spent on repurchases in the first half and management expects the spend to increase in H218. There is no change to our previous assumption in this regard that the buyback is completed by the year end.

Exhibit 11: Financial summary

£m	2016	2017	2018e	2019e
Year end 31 December	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	4,088.2	4,696.3	4,835.4	4,989.7
Cost of Sales	(3,638.7)	(4,192.2)	(4,327.7)	(4,465.8)
Gross Profit	449.5	504.1	507.7	523.9
EBITDA	97.6	105.4	105.2	107.9
Operating Profit (before amort. and except.)	82.5	84.7	84.3	86.8
Intangible Amortisation	0.0	0.0	0.0	0.0
Exceptionals	14.7	(10.0)	(4.5)	(12.1)
Other	0.0	0.0	0.0	0.0
Operating Profit	97.2	74.7	79.8	74.7
Net Interest	(17.6)	(16.3)	(16.6)	(16.4)
Profit Before Tax (norm)	64.9	68.4	67.7	70.4
Profit Before Tax (FRS 3)	79.6	58.4	63.2	58.3
Tax	(7.9)	(10.5)	(12.7)	(11.8)
Profit After Tax (norm)	53.3	57.9	55.5	57.7
Profit After Tax (FRS 3)	71.7	47.9	50.4	46.4
Average Number of Shares Outstanding (m)	396.4	397.3	393.2	386.9
EPS	13.4	14.6	14.1	14.9
EPS - normalised fully diluted (p)	13.13	14.14	13.70	14.47
EPS - (IFRS) (p)	18.1	12.1	12.8	12.0
Dividend per share (p)	3.6	3.9	4.1	4.3
Gross Margin (%)	11.0	10.7	10.5	10.5
EBITDA Margin (%)	2.4	2.2	2.2	2.2
Operating Margin (before GW and except.) (%)	2.0	1.8	1.7	1.7
BALANCE SHEET				
Fixed Assets	536.5	563.2	572.6	596.9
Intangible Assets	217.4	221.2	220.5	219.8
Tangible Assets	319.1	342.0	352.2	377.1
Investments	0.0	0.0	0.0	0.0
Current Assets	1,171.3	1,332.4	1,344.8	1,389.5
Stocks	839.4	984.1	967.1	978.0
Debtors	292.1	303.0	322.4	336.2
Cash	39.8	45.3	55.3	75.3
Other	0.0	0.0	0.0	0.0
Current Liabilities	(1,130.3)	(1,294.2)	(1,251.8)	(1,278.9)
Creditors	(1,105.2)	(1,228.1)	(1,251.8)	(1,278.9)
Short term borrowings	(25.1)	(66.1)	0.0	0.0
Long Term Liabilities	(235.8)	(216.4)	(263.6)	(275.6)
Long term borrowings	(88.8)	(77.0)	(122.0)	(131.8)
Other long term liabilities	(147.0)	(139.4)	(141.6)	(143.8)
Net Assets	341.7	385.0	402.0	431.9
CASH FLOW				
Operating Cash Flow	130.5	65.9	121.9	105.9
Net Interest	(13.8)	(17.6)	(16.3)	(16.6)
Tax	(17.3)	(10.5)	(12.7)	(11.8)
Capex	(45.5)	(54.2)	(51.0)	(51.1)
Acquisitions/disposals	18.9	0.0	0.0	0.0
Financing	0.0	0.0	(10.0)	0.0
Dividends	(13.2)	(15.0)	(15.7)	(16.3)
Other	28.0	7.7	15.0	0.0
Net Cash Flow	87.6	(23.7)	31.1	10.1
Opening net debt/(cash)	161.7	74.1	97.8	66.7
HP finance leases initiated	0.0	0.0	0.0	0.0
Other	0.0	(0.0)	0.0	0.0
Closing net debt/(cash)	74.1	97.8	66.7	56.5

Source: Company reports, Edison Investment Research estimates

Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
295 Madison Avenue, 18th Floor
10017, New York
US

Sydney +61 (0)2 8249 8342
Level 4, Office 1205
95 Pitt Street, Sydney
NSW 2000, Australia