

# Lookers

H1 trading update

## Used-car trading impacts in Q2

Lookers has confirmed that trading in Q219 has become more difficult following a positive Q119 performance. While new car markets remain challenged mainly by Brexit uncertainty, the main trading issue has been in used cars as residual values fell through the quarter. The shares have also been affected by a formal Financial Conduct Authority (FCA) investigation into selling processes on regulated activities. Together with a £5.6m adjustment to underlying FY19 PBT due to a change to the treatment of intangible amortisation, our estimates are substantially revised. We now expect an adjusted FY19e PBT of £40.8m, leaving the shares trading on a FY19e P/E of just 5.5x. We assume the dividend is maintained in FY19 with cover of 2.0x, which may provide support, but we will review this after the board's decision with the interim results on 14 August.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/17	4,696.3	68.4	14.14	3.89	3.2	8.6
12/18	4,879.5	67.3	14.03	4.08	3.2	9.0
12/19e	4,882.1	40.8	8.22	4.08	5.5	9.0
12/20e	5,038.7	42.7	8.60	4.20	5.2	9.3

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

## Trading conditions worsened in Q2

While Brexit uncertainty continues to undermine the confidence of both business and retail car buyers in new vehicle markets, it was deteriorating performance in used-car markets that led to management reducing its H119 underlying PBT expectation to £32m, an £11m fall from H118. However, some of the fall relates to lower property profits than had been expected. What has had a severe impact is a progressive decline in used-car residual values from April to June, we estimate of around 9%. We feel this has been exacerbated by some specific destocking issues at peers, but with significant used-car inventory not only has there been a reduction in margins as prices fell but also an impact from stock write-downs. These factors could stabilise and the market may recover, but we do not assume this at present. As previously announced, the company is also adjusting underlying PBT to include intangible amortisation, which will reduce profit for FY19 by c £5.6m. Lookers has also announced that Robin Gregson, the CFO since May 2009, is to be succeeded by Mark Raban, former CFO of Marshall Motor Holdings.

## FCA investigation a new overhang

The unexpected news regarding regulated activities has hurt sentiment. The FCA is to launch a formal investigation into the company's selling process from January 2016 to June 2019.

## Valuation: Rating does not allow for any recovery

The very low rating of the stock on depressed profitability does not allow for any improvement in car markets. However, the FCA situation could have financial consequences. We await additional comments on the outlook at the interims.

Automotive retail

24 July 2019

**Price** 45.4p  
**Market cap** £177m

Net debt (£m) at 31 December 2018	86.9
Shares in issue	389.1m
Free float	83.4%
Code	LOOK
Primary exchange	LSE
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	(30.9)	(50.4)	(57.2)
Rel (local)	(32.2)	(50.5)	(56.3)
52-week high/low	111.60p	42.50p	

### 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

H119 results	14 August 2019
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## Trading update and earnings revisions

### Earnings revisions

We have reduced our out-of-date FY19 earnings estimates to reflect three factors: alignment with market expectations following FY18 results and the Q119 trading update (a reduction of c £7m), the latest trading update (-£14m) and the adjustment to presentation of adjusted PBT in FY19 after charging amortisation on internally generated intangible assets, which is expected to reduce underlying PBT by around £5.6m. We have made no allowance for the potential outcome of the FCA investigation as there is no clarity or certainty as to what may be involved.

As result, our FY19 PBT forecast is reduced to £40.8m, a reduction of 39% with our FY19 EPS reduced by 40% to 8.2p. We now expect the dividend to be held given the lower profitability with more limited growth in FY20 as cover levels start to be rebuilt. We introduce FY20 estimates for the first time but at present only forecast modest recovery, although we do expect relatively stable car market conditions, which should limit stock losses on used-car inventory.

**Exhibit 1: Earnings estimates revisions**

Year to December (£m)	2018e	2018		2019e			2020e
	Prior	Actual	% change	Prior	New	% change	New
New	2,446.8	2,394.8	-2.1%	2,412.6	2,400.5	-0.5%	2,463.4
Used	1,873.0	1,939.4	3.5%	1,891.7	1,920.0	1.5%	1,996.8
Aftersales	429.2	433.3	0.9%	429.2	446.3	4.0%	459.7
Leasing	86.4	112.0	29.6%	90.7	115.4	27.2%	118.8
Sales	4,835.4	4,879.5	0.9%	4,824.2	4,882.1	1.2%	5,038.7
EBITDA	105.2	99.9	-5.0%	103.3	79.7	-22.8%	82.9
Underlying EBITA	84.3	85.6	1.5%	82.8	59.4	-28.3%	61.9
Underlying PBT	67.7	67.3	-0.6%	66.4	40.8	-38.6%	42.7
EPS - underlying continuing (p)	13.7	14.0	2.4%	13.7	8.2	-39.8%	8.6
DPS (p)	4.08	4.08	-0.1%	4.17	4.08	-2.1%	4.20
Net debt / (cash)	66.7	86.9	30.4%	57.3	90.8	58.5%	70.2

Source: Lookers, Edison Investment Research

### H119 pre-close trading update

On 12 July 2019 the company issued a trading statement that indicated a deterioration in trading performance in Q219. Having traded robustly in challenging new and used-car markets through 2018 and the Q119, pressure increased as the second quarter progressed, notably in used car markets as used car residual values progressively weakened. The impact is a combination of lower trading margins on used-car revenues as well the necessity to write-down used-car inventory values, which we estimate at around a £4.5m loss.

Q1 saw positive trading, but with new-car sales down 4.6% y-o-y in Q219, the used car deterioration and continued cost inflation pressures, management now says H1 underlying profit before tax is expected to show an £11m deterioration to c £32m, from £43m in H118.

In terms of H219 outlook, we expect Brexit uncertainty to persist and weigh on buyer confidence in both retail and business new-car markets. While used-car markets may be affected by some additional transient factors as a destocking phase is worked through, we feel the market demand is relatively favourably underpinned and that residuals should stabilise when this has completed. However, we are not forecasting any major recovery. Aftersales growth should continue.

## Financials

FY18 year-end net debt of £86.9m (FY17 £97.8m) was around £20m higher than we anticipated due to acquisition spend of around £12.3m and a working capital increase of £10.1m, with a reduction in creditors more than offsetting modestly lower inventories and a fall in debtors. The sale and leaseback proceeds deferred from the prior year of £35.1m were achieved and capex started to reduce from the very high levels seen previously. This will fall further in FY20 as the investment programme in updating dealership sites largely draws to a close this year. Free cash flow should improve by around £20m as capex falls to around £5m of maintenance tangible capex, with a similar level of intangible R&D investment compared to an aggregate £27m last year and £46m in 2017.

In December 2018, the company took the opportunity to refinance early. The term loan of £75m and the revolving credit facility (RCF) of £150m that expired in March 2020 have been replaced by an RCF with five banks totalling £250m with a term to March 2022 and an option to extend to March 2023. There is also the potential to increase the facility by £50m to fund acquisitions.

From H119 Lookers will alter its presentation of adjusted PBT numbers. Previously it had calculated adjusted PBT before all intangible amortisation, which has been £5.6m in each of the last two years and is generally what we would do with purchase priced allocation intangibles (those bought on acquisition). However, this includes the element of internally generated intangible capex in the form of software development spend, currently around £8m a year. Normally amortised over seven years, we estimate it now accounts for most of the annual intangible amortisation and in the future the adjusted PBT will be presented after this charge. We have adjusted our model and presentation but will confirm the details after seeing the interim restatement. The change will move internally generated intangible amortisation from the exceptional line in our financial summary table to the intangible amortisation line. There is no change to cashflows.

The reduction will also reduce dividend cover but this would still be above 2.0x on our estimates, assuming maintenance of the payment this year and a modest improvement as cash flow recovers in FY20. The yield for investors appears well supported at present, but given the high yield we will review this assumption after the interims on 14 August 2019.

## FCA investigation

As disclosed in the Note 23 of the FY18 annual report on contingent liabilities in the FY18 report and accounts, during 2018 the board became aware of certain matters requiring review in relation to the group's regulated activities. Following an independent review and working closely with the regulator, the directors subsequently developed a remedial plan to improve processes and some investment seems likely to be required. Management says it will update on that at the interims.

As announced on 25 June 2019, the FCA has now said it intends to carry out a formal investigation into Lookers' sales processes from 1 January 2016 to 13 June 2019. The outcome of the FCA investigation and any potential penalties remain unclear at present.

## Management succession

The company had already indicated that a search for a new chairman was in process to comply with best practice on corporate governance with respect to length of service. That continues but on 5 July the company announced that CFO Robin Gregson, who joined Lookers in May 2009, would be succeeded by Mark Raban. Formerly the CFO of Marshall Motor Holdings, Mark helped guide the group through both its IPO in 2015 and the subsequent transformational acquisition of Ridgeway in May 2016.

**Exhibit 2: Financial summary**

	£m	2017	2018	2019e	2020e
Year end 31 December		IFRS	IFRS	IFRS	IFRS
<b>PROFIT &amp; LOSS</b>					
Revenue		4,696.3	4,879.5	4,882.1	5,038.7
Cost of Sales		(4,192.2)	(4,364.0)	(4,374.4)	(4,514.7)
Gross Profit		504.1	515.5	507.7	524.0
EBITDA		99.2	99.9	79.7	82.9
Operating Profit (before amort. and except.)		84.7	85.6	65.1	67.5
Intangible Amortisation		0.0	0.0	(5.7)	(5.7)
Exceptionals		(10.0)	(14.2)	(4.0)	(4.0)
Other		0.0	0.0	0.0	0.0
Operating Profit		74.7	71.4	55.4	57.8
Net Interest		(16.3)	(18.3)	(18.6)	(19.2)
Profit Before Tax (norm)		68.4	67.3	40.8	42.7
Profit Before Tax (FRS 3)		58.4	53.1	36.8	38.7
Tax		(10.5)	(9.6)	(7.0)	(7.3)
Profit After Tax (norm)		57.9	57.7	33.5	35.0
Profit After Tax (FRS 3)		47.9	43.5	29.9	31.4
Average Number of Shares Outstanding (m)		397.3	393.4	389.2	389.2
EPS		14.57	14.67	8.60	9.00
EPS - normalised fully diluted (p)		14.14	14.03	8.22	8.60
EPS - (IFRS) (p)		12.06	11.06	7.67	8.07
Dividend per share (p)		3.89	4.08	4.08	4.20
Gross Margin (%)		10.7	10.6	10.4	10.4
EBITDA Margin (%)		2.1	2.0	1.6	1.6
Operating Margin (before GW and except.) (%)		1.8	1.8	1.3	1.3
<b>BALANCE SHEET</b>					
Fixed Assets		563.2	581.7	595.7	594.8
Intangible Assets		221.2	230.8	230.1	229.4
Tangible Assets		342.0	350.9	365.6	365.4
Investments		0.0	0.0	0.0	0.0
Current Assets		1,332.4	1,313.8	1,325.7	1,367.4
Stocks		984.1	1,027.7	1,025.2	1,037.0
Debtors		303.0	233.7	236.1	246.1
Cash		45.3	44.4	64.4	84.4
Other		0.0	8.0	0.0	0.0
Current Liabilities		(1,247.7)	(1,239.2)	(1,224.9)	(1,251.6)
Creditors		(1,228.1)	(1,236.6)	(1,224.9)	(1,251.6)
Short term borrowings		(19.6)	(2.6)	0.0	0.0
Long Term Liabilities		(262.9)	(257.0)	(283.2)	(282.3)
Long term borrowings		(123.5)	(128.7)	(155.2)	(154.6)
Other long term liabilities		(139.4)	(128.3)	(128.0)	(127.7)
Net Assets		385.0	399.3	413.3	428.3
<b>CASH FLOW</b>					
Operating Cash Flow		65.9	80.8	71.6	82.7
Net Interest		(17.6)	(16.3)	(18.3)	(18.6)
Tax		(10.5)	(9.6)	(7.0)	(7.3)
Capex		(54.2)	(33.6)	(34.3)	(20.1)
Acquisitions/disposals		(1.3)	(13.7)	0.0	0.0
Financing		0.0	(9.3)	0.0	0.0
Dividends		(15.0)	(15.6)	(16.0)	(16.1)
Other		9.0	28.2	0.0	0.0
Net Cash Flow		(23.7)	10.9	(3.9)	20.6
Opening net debt/(cash)		74.1	97.8	86.9	90.8
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)		97.8	86.9	90.8	70.2

Source: Company reports; Edison Investment Research estimates

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