EDISON

Lookers

Strategic review/
FY21 update

Normal service has been resumed

Automotive retail

Lookers now expects to deliver a record profit performance in FY21 with adjusted profit before tax (PBT) ahead of market consensus expectations of c £82m. We increase our FY21 PBT estimate by 5% to £86.0m although caution remains around FY22 where our is estimate broadly unchanged. The operational environment appears to have returned to normal following the internal issues that have dogged the company since 2019. That is reflected in the unveiling of a major review of the group to position it for the long-term challenges and opportunities developing in the UK automotive market. The resumption of the dividend and a FY22 P/E of just 7.1x look undemanding considering the recent crystallisation of value elsewhere in the sector.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/19	4,807	4.0	0.81	1.48	91.4	2.0
12/20	3,700	14.1	2.92	0.00	31.2	0.0
12/21e	4,331	86.0	17.36	2.00	4.3	2.7
12/22e	4,528	51.4	10.36	3.30	7.1	4.5

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

Positive trading momentum continued through Q421

Lookers should deliver a record earnings performance in FY21 following a strong Q421 trading performance. Management now expects adjusted PBT to exceed market consensus expectations of c £82m and we increase our estimate to £86.0m (from £81.8m). As previously announced, Lookers has repaid all of its FY21 furlough receipts of £4.1m and has now decided to repay non-essential retail sector COVID-19 grants received of £1.9m in FY22. The balance sheet remains strong, with year-end adjusted net cash of c £8.0m (FY20 £40.7m net debt). The board has indicated its intention to restart dividends with FY21 results on 13 April 2022.

Review heralds return to investing for growth

The refreshed board commenced a major review in October 2021 to improve the operational performance and address long-term market trends including changes in consumer behaviour, electrification, the competitive landscape, OEM relationships, new technologies and regulation. The company has identified six pillars to leverage its strong existing position: continued operational optimisation, investing in new technology and digitalisation, expanding the OEM relationships to include new partners and agency models, increasing used vehicle penetration, developing new Aftersales revenue streams and leveraging its Corporate Leasing and Fleet activity.

Valuation: Starting to reflect recovery and growth

While FY22 has started with a strong order bank, management remains cautious about the vehicle supply issues as the volume/margin trade off should probably start to wane as new vehicle supply improves during FY22 and inflationary cost pressures increase. We still anticipate a strong performance when compared to pre-pandemic FY19 trading and we would expect the FY22 P/E multiple to expand as the resumption of a sustainable growth strategy is executed.

10 January 2022

Price	**74p**
Market cap	**£289m**

Adjusted net cash (£m) at 30 December 2021 (excluding lease liabilities)	c 8.0
Shares in issue	390.5m
Free float	79%
Code	LOOK
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	28.3	15.5	251.9
Rel (local)	26.2	9.8	220.5
52-week high/low		74p	21p

Business description

Lookers is one of the largest UK motor vehicle retailers, with its new car operations supported by the strength of used and aftersales activities. It now operates 153 franchises, representing 33 marques from 100 sites around the UK and Ireland, with strong regional presences in Northern Ireland, Scotland, the Southeast and across northern England.

Next events

FY21 results	13 April 2022

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Revisions to earnings estimates

In line with its peers, trading continues to be driven by the favourable mix of higher margins in new and used car segments as supply shortages constrained vehicle availability. Used car prices rose from April 2021 onwards and currently remain high although volumes are being increasingly constrained, falling by 14% in Q421. New car unit sales rose 2% and aftersales revenues grew by 7.1% in Q421.

We expect the improved margin performance to generate adjusted PBT of £86.0m in FY21, 5% ahead of our previous estimate. While year-end adjusted net cash (before lease liabilities) of c £8m is lower than we expected, mainly due to tax payments during Q421, it still represents a significant strengthening compared to the FY20 adjusted net debt position of 40.7m.

Caution remains around margin levels in FY22 and the resultant trading performance as the supply constraints should progressively moderate and inflationary issues are compounding. While we maintain our FY22 trading expectations, the lower than expected opening cash levels and higher growth investment following the business review leave net interest slightly higher, reducing adjusted PBT and EPS by just over 1%.

Exhibit 1: Lookers earnings revisions

Year to December (£m)	**2021e**	**2021e**		**2022e**	**2022e**	
	Prior	**New**	***% change***	**Prior**	**New**	***% change***
New	1,961.5	1,961.5	*0.0%*	2,094.4	2,094.4	*0.0%*
Used	2,188.3	2,188.3	*0.0%*	2,232.1	2,232.1	*0.0%*
Aftersales	429.9	429.9	*0.0%*	442.8	442.8	*0.0%*
Leasing	160.3	160.3	*0.0%*	165.1	165.1	*0.0%*
Intra-group	-409.1	-409.1	*0.0%*	-406.3	-406.3	*0.0%*
Sales	4,330.9	4,330.9	*0.0%*	4,528.0	4,528.0	*0.0%*
EBITDA	**176.1**	**180.6**	***2.5%***	**150.4**	**150.4**	***0.0%***
Underlying EBITA	116.2	120.7	*3.9%*	86.4	86.4	*0.0%*
Underlying OPBIT	110.8	115.3	*4.0%*	81.1	81.1	*0.0%*
Underlying PBT	**81.8**	**86.0**	***5.2%***	**52.1**	**51.4**	***-1.4%***
EPS – underlying continuing (p)	**16.51**	**17.36**	***5.2%***	**10.51**	**10.36**	***-1.4%***
DPS (p)	2.00	2.00	*0.0%*	3.30	3.30	
Net debt/(cash)	(23.2)	(8.5)	*-63.3%*	(7.3)	16.9	*-331.6%*

Source: Edison Investment Research estimates

In March 2020, as part of its COVID-19 related cash management initiatives Lookers suspended dividend payments. Following the repayment of all CJRS (Coronavirus Job Retention Scheme) receipts and COVID-19 grants relating to 2021, the financial position of the group remains strong. The revised capital allocation policy is intended to provide a balance between investing in the business and returns to shareholders, while retaining financial discipline. If current trading conditions are maintained, Lookers expects to resume payments when it publishes its 2021 financial statements.

Review of the group to underpin future growth potential

With the board refreshed during the pandemic following the regulatory and fraud issues, a review of the group is a natural progression as the resumption of more normal trading was established once the legacy issues were resolved. The company has now revealed that review process commenced in October 2021 and has unveiled the initial outcomes with more detail to be presented with the FY21 results on 13 April 2022.

While the strategy of the right brands in the right locations with excellent service remains at its core the board has established six pillars to support and maximise revenue and profit opportunities and deliver new initiatives for growth. These are

- **Operational optimisation:** in addition to portfolio optimisation of the dealerships the core of the strategy remains the focus on improving organic growth of the existing operations. The harmonisation and simplification of operational processes, systems and structures to improve financial performance and efficiency in several key areas should see initial benefits in FY22 according to management. It also expects the continued expansion of financial products as an opportunity to improve profitability and customer retention as the pandemic wanes.
- **Investments in technology and digitisation:** supporting the operational improvement and key to its implementation, Lookers is to increase its investment in technology to improve the customer experience and management of customer relationships, reducing the cost to serve and driving further working capital benefits. As well as addressing the omnichannel experience for customers, the spend includes funds to harmonise and standardise its DMS (Dealer Management Systems) in 2022, allowing it to build improved data analytics and a new sales platform.
- **Expanding OEM relationships:** while maintaining financial discipline the group intends to deepen and expand its OEM relationships to grow market penetration with both existing and new brand partners. It should also seek to adapt to and exploit opportunities arising from the introduction of agency models in place of the traditional franchise agreements. in December 2021 Daimler Benz (Lookers has 14 dealerships) announced it is moving to such a model in the UK. Lookers gained agency experience in 2021 as it commenced its expanding relationship with Polestar. The board also sees investment in new brand partners as key to growth.
- **Increasing used vehicle penetration:** the development of used car market penetration has been a key element of strategy for many years, which to a degree has positioned Lookers well to cope with the extraordinary market conditions that prevailed through 2021. However, the board believes that the used vehicle market presents further significant growth opportunities, highlighted by the success of several recent new market entrants. The existing multi-franchise standalone used car infrastructure is to be extended and expanded using technology and investment in dedicated used car facilities including servicing operations. It intends to provide a competitive offering to the operations and services of the new entrants and expects to drive significant used car volume growth from FY22.
- **Developing aftersales revenue streams:** as we have previously noted the transition to EV is accelerating and will require adaptation investment in the high margin Aftersales operations of the UK franchise dealers. Lookers intends to develop and implement new products and services to protect market share and increase penetration to drive revenue growth. Again, it has identified opportunities to develop and bring in house opportunities in the growing cosmetic repair market which are currently directed to third-party operators.
- **Leveraging corporate leasing and fleet capabilities:** the corporate leasing sector is still regarded as an important and complementary market by Lookers with more stable, predictable revenue streams, as well as new subscription-based product opportunities. In FY22 it intends to consolidate and grow its existing operations and to introduce new products and services for its corporate customers.

The establishment of a framework for the future development of the group, addressing the emergence of competitive threats and challenges within its markets, appears to indicate that Lookers is back, competing to deliver its ambition to be the preeminent UK automotive retail and services group.

Valuation

Although the pandemic-induced supply chain and operational challenges remain, the new strategy indicates to us that Lookers has starting to operate normally once more following the internal shocks of the fraud and FCA investigations, which are now resolved.

The new strategy should serve to improve the quality of earnings by increasing and stabilising profitability and cash flow. It should also prepare Lookers for the transition to electric vehicles (EVs) and the likely shift to agency models, reducing working capital requirements in the longer term and again making earnings more predictable as transaction fees are fixed. A change in capital allocation should be required as used car market investment and revamped workshops for EV servicing will be needed. The changes may finally be a catalyst for starting to reduce the cyclical discount applied to car retailers by the market especially given the improved performances of the larger dealership groups through the last two major downturns of the financial crisis and the ongoing COVID-19 pandemic.

Recent market transactions imply that there is potentially significant value to be crystallised in the sector.

Applying our normal capped DCF valuation whereby we use a forecast period of six years, then cap terminal growth at zero with normalised working capital and capex/depreciation returns a value of 132p per share currently. Historically, we would have applied a discount to this to reflect cyclicality but should the cash flow performance become more stable under the new strategy we would expect that level to be more attainable. The sensitivity to WACC and the terminal growth rate of our DCF calculation is shown in the table below.

Exhibit 2: Capped DCF sensitivity analysis to WACC and terminal growth rate (p/share)

WACC	6.0%	7.0%	7.9%	8.0%	9.0%	10.0%
Terminal growth rate						
0%	210	163	**132**	128	101	80
1%	212	165	133	129	102	81
2%	215	167	135	131	104	82
3%	217	168	137	133	105	83

Source: Edison Investment Research estimates

The capital allocation policy of the group should allow selective M&A to support the new strategy as well as the resumption of dividend payments to shareholders. Management has indicated it expects to make a payment for FY21 when it announces results on 13 April 2022.

Exhibit 3: Financial summary

£m	2019	2020	2021e	2022e
Year end 31 December	IFRS	IFRS	IFRS	IFRS
PROFIT & LOSS				
Revenue	4,806.5	3,699.9	4,330.9	4,528.0
Cost of Sales	(4,293.4)	(3,288.9)	(3,803.4)	(4,020.9)
Gross Profit	513.1	411.0	527.4	507.1
EBITDA	95.3	99.0	180.6	150.4
Operating Profit (before amort. and except.)	43.0	47.8	120.7	86.4
Intangible Amortisation	(6.1)	(4.8)	(5.4)	(5.4)
Exceptionals	(49.7)	(12.1)	0.4	0.0
Other	(2.3)	(1.6)	(1.5)	(1.5)
Operating Profit	(15.1)	29.3	114.2	79.6
Net Interest	(24.3)	(21.2)	(22.0)	(22.3)
Profit Before Tax (norm)	4.0	14.1	86.0	51.4
Profit Before Tax (FRS 3)	(45.7)	2.0	86.4	51.4
Tax	3.9	(6.1)	(16.4)	(9.8)
Profit After Tax (norm)	3.2	11.4	69.6	41.7
Profit After Tax (FRS 3)	(41.8)	(4.1)	70.0	41.7
Average Number of Shares Outstanding (m)	389.2	390.1	391.0	391.8
EPS (p)	0.82	2.92	17.81	10.63
EPS - normalised fully diluted (p)	0.81	2.92	17.36	10.36
EPS - (IFRS) (p)	(10.74)	(1.05)	17.89	10.63
Dividend per share (p)	1.48	0.00	2.00	3.30
Gross Margin (%)	10.7	11.1	12.2	11.2
EBITDA Margin (%)	2.0	2.7	4.2	3.3
Operating Margin (before GW and except.) (%)	0.9	1.3	2.8	1.9
BALANCE SHEET				
Fixed Assets	744.3	707.6	695.1	692.6
Intangible Assets	196.1	190.1	188.7	193.4
Tangible Assets	429.2	399.9	392.6	388.6
Right of use asset	119.0	117.6	113.8	110.7
Investments	0.0	0.0	0.0	0.0
Current Assets	1,326.9	1,067.0	1,239.4	1,351.5
Stocks	956.5	655.2	779.6	860.3
Debtors	200.3	154.7	180.4	190.9
Cash	150.3	243.0	263.0	283.0
Other	19.8	14.1	16.5	17.3
Current Liabilities	(1,380.9)	(1,028.7)	(1,039.8)	(1,076.3)
Creditors	(1,261.5)	(911.8)	(1,039.8)	(1,076.3)
Short term borrowings	(119.4)	(116.9)	0.0	0.0
Long Term Liabilities	(379.7)	(463.5)	(550.2)	(594.6)
Long term borrowings	(90.4)	(166.8)	(254.5)	(299.9)
Lease liabilities	(146.9)	(144.4)	(144.4)	(144.4)
Other long term liabilities	(142.4)	(152.3)	(151.3)	(150.3)
Net Assets	310.6	282.4	344.5	373.2
CASH FLOW				
Operating Cash Flow	93.5	68.2	107.7	53.5
Net Interest	(18.4)	(24.3)	(21.2)	(22.0)
Tax	3.9	(6.1)	(16.4)	(9.8)
Capex	(53.7)	(16.8)	(21.3)	(34.9)
Acquisitions/disposals	0.0	0.0	0.0	0.0
Financing	0.1	0.0	0.0	0.0
Dividends	(15.9)	0.0	0.0	(12.1)
Other	16.9	(2.2)	0.4	0.0
Net Cash Flow	26.4	18.8	49.2	(25.4)
Opening net debt/(cash)	85.9	59.5	40.7	(8.5)
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)	59.5	40.7	(8.5)	16.9
Net financial Liabilities	206.4	185.1	135.9	161.3

Source: Company reports; Edison Investment Research estimates

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