

BUY-SELL Q&A

WHERE THE M&A MARKET IS GOING NEXT

Auto retail industry expert predicts the unprecedented dealership consolidation boom will continue, but potential risks such as inflation and the agency model loom on the horizon.

The red hot buy-sell market in automotive retailing continues its torrid pace in 2022, generating record dealership valuations and spurring continued industry consolidation. But how long will this blistering trend continue? And what will happen when vehicle inventory levels normalize and what potential threats and risks lie ahead for dealers? Alan Haig, the founder and president of Haig Partners, a leading auto retail buy-sell advisory firm, offers some valuable insights and perspectives.



Alan Haig

- From 2015 to 2019, new vehicle sales in the United States averaged 17.3M units.
- Due to the Pandemic and subsequent Chipdemic, we lost 2.7M new unit sales in 2020, 2.3M new unit sales in 2021 and are poised to lose an estimated 2.1M units in 2022. The combined lost sales over this three year period is 7.1M units, plus inventories are down about 2 million units, so the total shortfall between production and demand is likely closer to 9 million units.
- It's unclear how much production capacity the original equipment manufacturers (OEMs) have now, given that they're shifting over production lines to electric vehicles (EVs). But let's assume their capacity is 10 percent above the average level produced from 2015 to 2019, so a total of 19.1M units per year.

Q: How does the current buy-sell market compare to where it's been for the past year or so?

A: The buy-sell market remains as strong today as it was last year. And there is an appetite for everything on the menu. We are in regular contact with the biggest consolidators that are looking for large acquisitions. They want to invest billions to expand their networks. And on the other end of the spectrum, we recently received a call from the owner of three independent used vehicle dealerships who's looking to acquire their first franchise. Their target is interesting: an Infiniti store, a brand that the buyer believes is affordable and on the rebound. Along with the robust demand for dealerships, we see an elevated supply of dealerships coming to market. Sellers are attracted by the record high valuations we are seeing today, and some are concerned about potential threats down the road. Strong demand is matched by a large inventory of dealerships for sale. The current environment is special for buyers and sellers.

Q: Where is the buy-sell market headed in 2022 and 2023 – will the good times keep rolling?

A: We believe the buy-sell market will remain healthy for the next year or two. There is significant pent-up demand for new and used units, which should drive profits for dealers for years. As vehicle supply rebounds, margins may retract, but not to pre-pandemic levels. Elevated demand, supported by customers who've been waiting for pricing to normalize, should more than offset margin compression and ensure strong profitability for some time. High profits attract buyers and sellers to the market.

That said, there's a risk of a recession on the horizon. The Federal Reserve is increasing interest rates to try to reduce inflation, which could lead to reduced economic growth or even a shrinking economy. Demand for new and used vehicles could then fall, which would mean that margins and volume would drop, a tough combination that would surely dent dealership profits.

Q: Low vehicle inventories have helped stores generate record profits. Do you expect low inventories to continue through 2022?

A: Many in our industry wonder how much longer current conditions will continue. It appears to us as though demand will exceed supply for some time to come. Here is some data to consider.

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A: That's an excellent question! A number of leading OEMs have said they don't plan on building inventories back to the pre-pandemic levels, where some had as much as a 100-day supply of vehicles at dealers' lots or in transit. If their competitors follow suit, then the "new normal" will be a healthier environment for dealers and OEMs. Dealers will have more pricing power with consumers, so their margins and profits will be higher than before the pandemic, although lower than today. And the OEMs will need to spend less on advertising, subvention and rate incentives, and possibly factory support programs like floor plan assistance, so they should be more profitable, too. If lower inventories become the new normal, then dealership valuations will likely settle out somewhere between pre-pandemic levels and where they are today. But we've spoken to a few CEOs who believe the OEMs won't be able to help themselves and will go back to over producing, which will mean lower margins and profits for OEMs and dealers. If this happens, dealership values could fall sharply to levels above pre-pandemic valuations, but below where they are now.

Q: Are there any risks that dealers must be aware of that could impact their profitability and valuations?

A: The short-term threat we see is the possibility of a recession. Some economists predict that we're likely to have a recession in 2023, which would reduce

demand for vehicles and potentially impair the incredibly high profits on vehicles that dealers are enjoying today. As profits decline, so would valuations.

In the Q4 2021 Haig Report, we highlighted some medium to long-term threats that dealers will need to consider:

Tesla and Other New Entrants:

Tesla now has become the leading luxury brand in the U.S. and its next product launch, the Cybertruck, is aimed at the heart of the domestic brands. Other new entrants, such as Rivian Automotive and Lucid Motors, also are entering the market, as well as new brands being launched by traditional OEMs, like Polestar. These new entrants will likely experience mixed results in the marketplace, but there's a good chance that competing dealers across the country will lose customers and profits as a result. Perhaps a greater threat to dealers is that new entrants may push traditional OEMs to force the agency model on dealers (see below).

The Agency Model:

Traditional OEMs have seen that millions of customers are willing to go to a website, order a vehicle and then wait for it to be delivered. And these OEMs also see they no longer need to produce millions of vehicles for dealers' storage lots, guessing at which vehicles customers will actually want, and then heavily advertise and provide incentives in order to get customers to purchase the vehicles. Their profits per vehicle are far higher when they produce only what customers want to buy. And finally, they see that retailers are making massive profits.

This new set of facts is causing a number of OEMs to reconsider their relationships with their dealers and consumers. Ford's plan to separate into two divisions, the Model e Division that will produce only EVs and the Blue Division that will produce only internal-combustion engine (ICE) vehicles is an example of a potential Agency Model in play. Customers who want to purchase an EV will have to order from Ford's Model e website. It doesn't appear that customers will be able to purchase Model e vehicles directly from dealers. This is a profound change as the OEM will now set, instead of "suggest," retail pricing and the OEM will be the point of contact with customers. The customer can choose which dealer will deliver the vehicle, but the price will be determined by Ford, which also will decide how much to pay the retailer. The buyer will become Ford's customer, rather than the dealer's customer. This agency model, where the dealer becomes an agent and is not a retailer, is common in other areas of the world. It is our understanding that dealers in these areas make far less profit than dealers in the U.S. And Ford is not alone in its thinking. OEMs have been envious of

Tesla's stock market valuation that is partly based on this direct sales model.

Electric Vehicles:

Some dealers are concerned that EVs will require much less parts and service work than ICE vehicles, which will hurt their service departments.

Consolidation:

While still a highly fragmented industry, consolidation in auto retail accelerated in 2020 and 2021. Groups like Lithia Motors, Group 1 and Asbury Automotive Group bought dozens of stores to expand their nationwide network of dealerships, accompanied by digital retailing tools that will allow them to sell and service customers who prefer online shopping. These auto groups and other dealers are increasingly convinced that large scale will matter more in the future than it has in the past. They plan to offer consumers a larger selection of vehicles and more ways to shop than smaller dealers can offer. If successful, they will gain market share and please their OEM partners and shareholders. Their gains would come at the expense of smaller dealers that cannot match these capabilities.

Haig Partners offers potential remedies for dealers for each of these concerns. But due to space constraints, we can't explain them in detail here. However, you can read about these remedies on pages 14 and 15 in the Q4 2021 Haig Report.

These risks are real. However, dealers are highly resilient and we expect they'll find ways to mitigate these risks. We are still bullish on the franchise system.

ABOUT THE PANELIST

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Haig Partners is committed to serving clients with the highest level of integrity and professionalism. The team has unmatched auto retail experience with backgrounds in leadership and corporate development roles for AutoNation, Asbury, Bank of America's Dealer Financial Services team, and DHG's Dealership Practice. They leverage their expertise and relationships to lead a confidential and customized sale process helping dealership owners maximize the value of their life's work. The team at Haig Partners has represented 20 of the Top 150 dealership groups on the Automotive News Top 150 list, more than any other firm. They author the Haig Report, the leading industry quarterly report that tracks trends in auto retail and their impact on dealership values, and are co-author of NADA's Guide, "Buying and Selling a Dealership." For more information, visit www.haigpartners.com.



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