Europe's auto dealerships: change is coming Agency sales model, online sales and electrification pose credit challenges

Disruption of Europe's car-dealership business will increase rapidly in the coming years amid changes in the automotive industry. The sector needs to address three main challenges: the shift to the agency sales model, the growing proportion of cars sold on online, and vehicle electrification. More intense competition, lower pricing power, upward pressure on capital expenditure -- given the need for investment in digitalisation, electric-vehicle (EV) equipment and knowhow – will squeeze profit margins and likely constrain future cashflow.

The transformation of the automotive industry is urging the car dealerships[1] to adapt

The electrification revolution is transforming original equipment manufacturers (OEMs) amid a broader shift to digitalisation and changing consumer habits related to the rapid growth of e-commerce, accelerated by the experience of pandemic-related lockdowns.

Among the OEMs, economies of scale are as important as ever, hence the recent mergers and acquisitions that led to the creation of Stellantis NV, as the industry looks for new ways to increase margins and retain customers[2]. OEM's are acting more and more like retailers and/or consumer-services companies, visible in the increase of recurring revenues[3].

The ultimate impact on the leading car retailers in Europe – such as Bilia AB, Emil Frey SA, Inchcape PLC, Lookers PLC, Pendragon PLC and Vertu Motors PLC – is far from clear. We see a deteriorating credit outlook in at least the short and medium term, not least considering the headwinds of rising interest rates, high inflation and the threat of recession.

Figure 1: Main credit impact

Agency model		Online Sales		Electrification	
Credit impact		Credit impact		Credit impact	
+	-	+	-	+	-
Decrease in operational expenditure	Decrease in pricing power	Improved diversification (sales channels)	Decrease in pricing power	Improved diversification (e.g., new services)	Decrease in revenue from aftersales (repair and maintenance)
Reduced financing needs (inventory)	Weaker profitability	Reduced staff costs (better informed customers)	Weaker profitability	-//-	Higher CAPEX
-//-	Weaker customer retention	-//-	Higher CAPEX	-//-	**Weaker cash generation**
-//-	**Weaker cash generation**	-//-	**Weaker cash generation**	-//-	-//-

[1] Dealerships usually sell new and used vehicles to end customers based on a franchise agreement with the manufacturer. In addition, they normally provide repair and maintenance service and as well as parts and accessories.
[2] For rating information on the OEMs in Scope coverage (BMW, Volkswagen and Daimler) please see our subscription platform ScopeOne https://app.scope-one.com/page-one/.
[3] An example is BMW now selling subscriptions for heated seats in several countries. A monthly subscription to heat BMW's front seats costs roughly USD 18, with options to subscribe for a year (USD 180), three years (USD 300), or pay for "unlimited" access for USD 415.

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Shift to agency model represents hug challenge

European car retailers need to adapt to survive after many years in which the traditional business model of distributing vehicles through local dealerships appeared to be consolidated and was working well.

The shift to the agency model, the growth of online sales and the transition to electrification will lead to changes in retailers' profitability, working capital and capex needs driven by reducing pricing power and leading to increased substitution risk due to the dealership being replaced by manufacturers themselves. The business risk profile of retailers will deteriorate.

Dealerships' credit profiles will likely weaken, depending on their size, market power and geographical reach as well as the ability to adapt their business model. The largest dealerships with easy access to capital might have relatively few problems in transforming their business. Smaller and traditional dealerships face more significant challenges, with even their survival in doubt.

The transition to the agency model threatens dominance of dealerships

Main impact on retailers:

- Lower revenues (credit-neutral)
- Lower pricing power, decreased margin on new car sales (credit-negative)
- Lower debt and interest fees, less risk (credit-positive)

The agency model involves the manufacturer becoming the retailer, while the dealership remains the physical point of contact with the customer. The dealership receives a commission on the sales but holds almost no stock and has no power to adjust the price. The model could be considered as a reverse franchise, where the fees are received by the agency (the franchisee) rather than the automotive company (franchisor)[4].

More price control from OEMs puts margins at risk

The new business model, allows the dealer to eliminate or reduce stock and the need to finance it, shifting the financial risk to the manufacturer, at the cost of slimmer profit margins.

Many European dealerships are not in favour of the agency model, fearing the competition and establishing of fixed prices[5].

For largest dealerships, with multiple locations and reliant mostly on sales of new vehicles, the risk is that the commissions – expected to be lower than the traditional margins on dealership sales since the agent does not take the financial risk – will not generate sufficient cash flow, compromising debt repayment.

We expect a shift towards the agency model driven by the car dealerships' country of operation. We have defined the "country retail strength"[6] (see Appendix) ranking countries in terms of strength and resilience of their retailing markets.

Countries with lower scores will not see a change to the agency model in the medium term as OEM's to have limited penetration in these markets and customers prefer having a strong relationship with their dealerships. On the other hand, countries classified as

[4] Largest European car makers Mercedes Benz, Volkswagen and Stellantis have already partially implemented or plan to implement the model from 2023. The decision aim at a higher control on prices, no more decided by the dealership, and increase margin by reduce distribution costs, as well as bust the online sale model. Amid the pandemic and the current macro-economic environment, which slow down unit sales over the past two years, manufactures were still able to make profit thanks to better pricing mix and continue to look at other-than volume-based way to increase margins.

[5] With the dealership model, the manufacturer provides a reference price (manufacturer suggested retail price, MSRP), but the dealer is free to sell the car for more or less than the MSRP based on the franchise law.

[6] For our definition of country retail strength and countries' assessment please refer to Scope retail methodology (https://www.scopegroup.com/ScopeGroupApi/api/methodology?id=ab003ea3-ce6f-4c10-9869-7f0858eae451)

high or high medium are likely to see an increasing share of the dealerships operating under the agency model in the coming years.

Shift to agency model to vary country to country

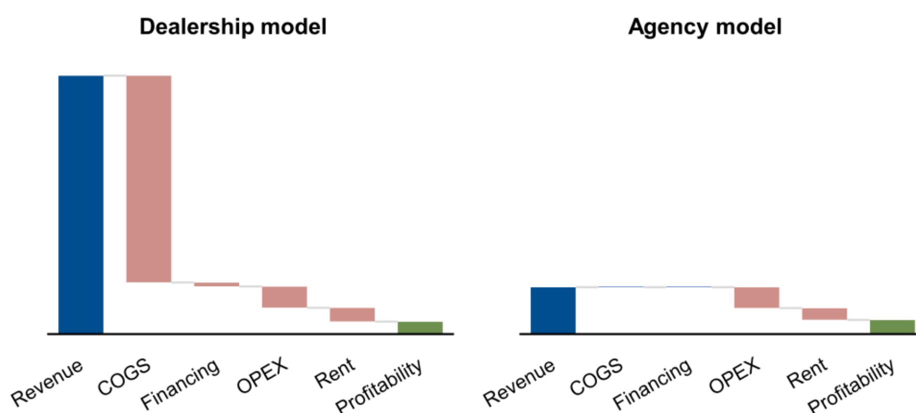
Retailers in our coverage – including Tegeta Motors (BB-/Stable) and Autowallis (B+/Stable), two of the leading companies in new car sales in Georgia and Hungary respectively – will be under less pressure to adopt the new business model, with no imminent pressure in the Georgian market though a slightly higher risk in the Hungarian market in the mid-to-long term.

Decreasing revenues are a concern for multi-brand dealerships as many OEMs have announced reductions in dealership networks in the shift to the agency model in tandem with a growing focus on online sales, leading to the cancellation of franchise agreements.

New model implies low funding, rental costs

The agency model does bring some benefits for dealerships. Some costs and working capital requirements will fall as there will be less inventory to finance and insure, implying lower borrowing needs and less financial risk. In the past, largest dealerships have faced significant inventory risk especially when OEMs push vehicles into the dealerships to reach month-end targets. Other cost savings might include rent, marketing and staff as the OEMs take over auto retailing.

Figure 2: Scope expectation (illustration) of the main differences between agency model and dealership model[7]



Source: Scope

Customer loyalty continues to benefit from local relationship

Still, there is additional risk related to the adaptability and willingness of dealerships and the customers to embrace the new model.

The agency model could make more difficult to build customer loyalty, as the power of offers and discounts shifts from the dealer to the OEMs, with whom the customer does not have face-to-face contact.

In many European countries, and especially outside cities, the customer's relationship with the dealer is more central to buying a car. Many customers make their decision based on discounts from the local seller.

[7] Assuming a business model based on new car sales only, with the agency model we expect the profitability to reduce based on reduced revenues only partially compensated by reduced opex.

Direct online sales might threaten the dealerships margins either or not in conjunction with the Agency model

Main impact on retailers:

- Possible risk of losing customers (credit-negative)
- Lower pricing power, decreased margins (credit-negative)
- Increase in capex for digitalization (credit-negative)
- Decrease in cashflow (credit-negative)
- Increase in diversification (credit-positive)
- Reduced staff costs as customers better informed (credit positive)

Online sales offer risks and benefits

Until recently selling cars online car sales was a zero-revenue business, but pandemic restrictions on opening of non-essential stores encouraged people search for and increasingly buy cars on the internet.

Dealerships have had to up their own digital game to boost sales. More transparent price comparison is one further risk to margins as dealerships lose pricing power though building strong online channels might offset the squeeze on profit margins by improving product diversification and the expansion of the customer base.

As customers shift to online pre-selection and purchases, IT development becomes crucial for dealerships' competitiveness. If dealerships do not diversify their sales channel to remain competitive, the risk is not only a decline in margins from reduced pricing power, but also a decrease in sales which compresses cash generation and liquidity.

That said, investments in IT and online channels could reduce onsite costs, particularly rents and staff.

For now, commission-free direct sales via the manufacturers' websites remain limited, as in most European countries people continue to visit showrooms and test a vehicle before purchasing it.

Online sales model gains traction… slowly

However, in the long term, direct online sales are expected to increase as customer experience improves threatening the traditional brick and mortar offer. The model is already popular in the used-vehicle market. See Carvana in US and Autohero and Cazoo in Europe.

OEMS are heading this way too. Most important EV manufactures like Tesla Inc. and Volvo Car AB unit Polestar are selling already directly to customers through company owned stores. Volvo itself and Volkswagen AG have said upcoming models will be sold exclusively online. Even if the retailers are not excluded from the sales process by the manufacturers, we see the looming risk of reduced revenues if direct sales prove to be successful or OEMs simply shift more sales to online channel channels from dealerships. especially in the used market.

The current market share of used-vehicle dealers that only sell online is below 1%, though representing a high potential for growth. According to Statista, the online sales of used car went up to 4.2% in 2020 from 2.2% in 2017 and anticipated to reach around 10% in 2025. Tegeta Motors, for example, aims to increase sales to 10% from 3% in the coming years. The current online offer relates only to parts and accessories but is due to include cars through online shops for Toyota, Mazda and Volvo brands.

As pricing power becomes strained, retailers that have pioneered an omnichannel approach look best positioned.

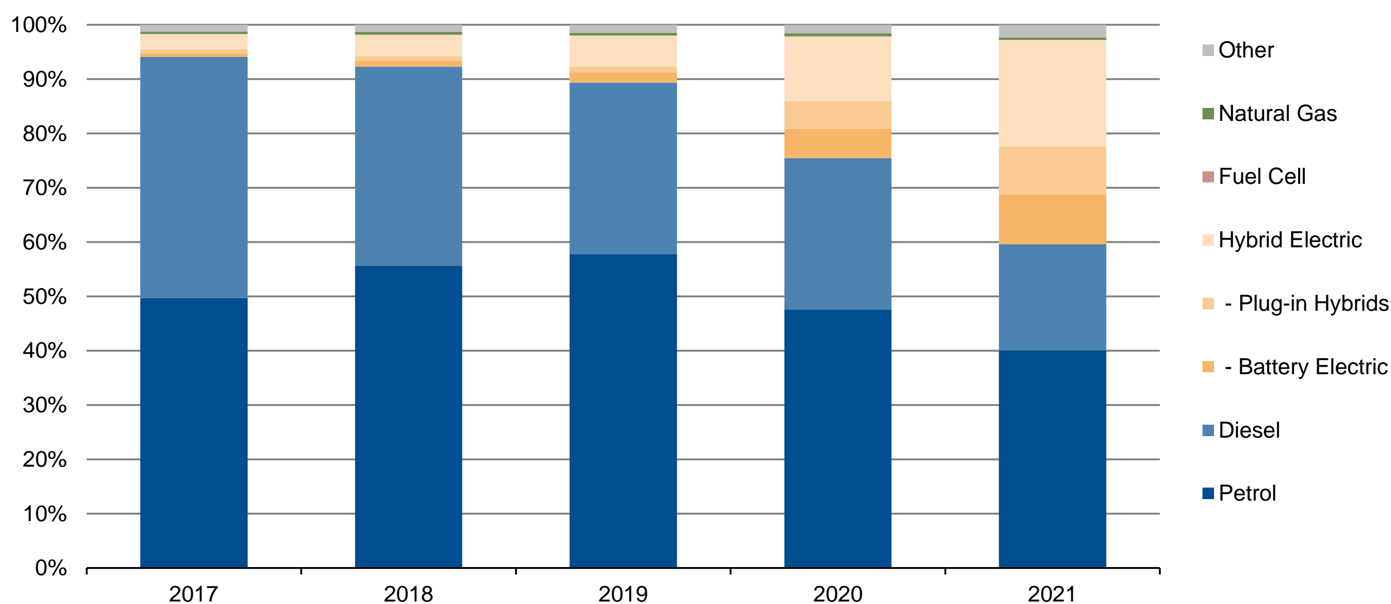
Progress towards electrification is slower for dealership than for OEMs; additional investments are needed

Main impact on retailers:

- Decrease in revenues from aftersales (credit-negative)
- Increase in capex to invest in EV infrastructure and know-how (credit-negative)
- Offer of new ancillary services to increase revenues and support cash flow (credit-positive)

The Asia-pacific region remains the leading market today for EVs but sales are progressing fast in Europe under the impetus of tougher environmental regulations. The European Parliament voted in June 2022 an effective EU ban on sales of petrol and diesel cars by 2035. More and more customers are looking for zero-emission transport, possibly influence by the rising in prices at the pump related to Russia's war in Ukraine which has pushed up oil prices. OEMs have heavily invested in technologies to produce fully electric vehicles. Figure 3 shows how EV sales accelerated over the last five years.

Figure 3: New Car Registrations by Fuel Type in Europe



Sources: ACEA, Scope

Dealerships need to innovate to maintain profit margins

Most dealerships seem to be less prepared than manufactures for the electrification shift, with little new infrastructure in place.

Margins on new cars sales are in general expected to decrease as the manufacturers plan to have more price control on EVs by having an extensive online offer.

In addition, dealerships' reliance on strong aftersales services will have to change, given the mechanical simplicity and greater software sophistication of EVs compared with internal-combustion engine (ICE) vehicles will lead to less demand for engine-related spare parts and repairs. It is also still early to assess how profitable the EV used car business will be: for now, they depreciate faster than traditional vehicles, thus reducing margins for second-hard car dealerships and increasing the cost of funding.

Margins will come further under pressure as EV prices and battery costs decline.

A shift to services might be one area where dealerships find their niche, as brokers to finance and insure cars. EVs are typically more expensive for, so the demand for these services could increase.

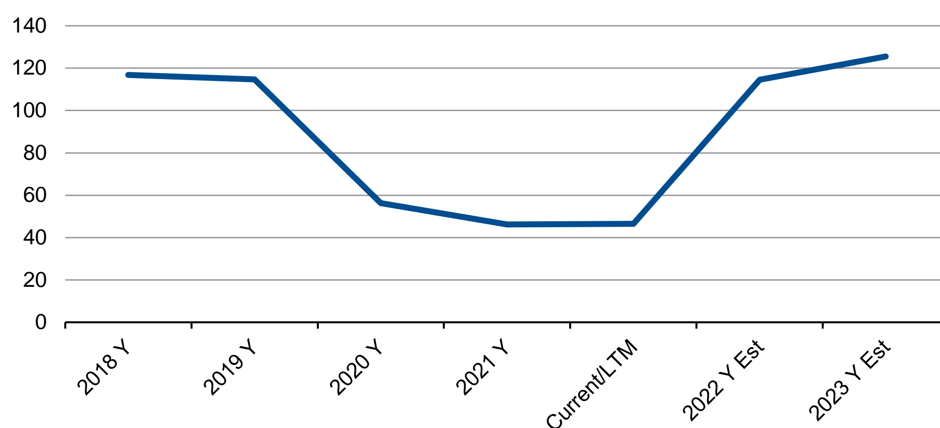
Capex increase is expected in the short term

Such a shift would mirror moves by other discretionary retailers, which started cut back on their point in time sales to implement new services (examples: repair: FNAC Darty (BBB/Stable), Ceconomy (BBB-/Stable). We expect car dealerships to focus more on ancillary services, which eventually cannot be offered by the OEMs, which will involve extra investment and cost.

Benefits of more services-based model may emerge longer term

In the short term, we expect an increase in capex (see **Figure 4**) and a decrease in FOCF with a negative impact on the business risk profile of retailers, whereas in the long term the effective implementation of services, digitalisation and the increase of ancillary services will have positive impact on the EBIDTA margin.

Figure 4: Average capex for five largest European dealerships (EUR m)



Sources: Bloomberg, Scope

Conclusion

In the overall scenario of changes, smaller dealerships might be in need to invest in modern technologies, increase capex and train the sale staff as to prepare the EV infrastructure and improve the online offer. Largest dealerships are at risk to dismiss previously made investments and expansion projects as well as sell assets to obtain additional liquidity. Dealerships will have to focus on increase diversification, offer new services as well as increase retail financing an insurance penetration and improve customer loyalty, to boost their profits.

Appendix: Overview of our rated entities based on last monitoring

	Abroncs Kereskedőház Korlátolt Felelősségű Társaság	Tegeta Motors LLC	Marso Kft	Unix Auto Kft	AutoWallis Nyrt.
Home market	Hungary	Georgia	Georgia	Hungary	Hungary
Status	Public	Public	Public	Public	Public
Business risk profile	**B+**	**BB-**	**B+**	**BB**	**B+**
Country retail strength	High-medium	Low	High-medium	High-medium	High-medium
Market position	n/a	Strong	n/a	Strong	Medium
Revenue size (in EUR bn)	0.1	0.2	0.1	0.3	0.5
Consumer good category	Discretionary	Discretionary	Discretionary	Discretionary	Discretionary
Online diversification**	Low	SCD	Low	SCD	SCD
Geographical exposure	Immediate neighbours	Immediate neighbours	Immediate neighbours	Immediate neighbours	Immediate neighbours
Product diversification	1 cyclical	1 cyclical	1 cyclical	1 cyclical	1 cyclical
Profitability assessment value	B+	BB	BB+	BB-	B+
Profitability assessment	Weak	Moderate	Moderate	Moderate	Weak
Financial risk profile ***	**BBB-**	**BB**	**BB+**	**BB-**	**B+**
SaD/Scope-adjusted EBITDA	1.2x	3.6x	2.6x	2.7x	6.0x
FFO/SaD	96%	21%	38%	32%	15%
EBITDA interest expense	7.2x	3.6x	13.5x	9.9x	9.5x
FOCF/SaD	73%	-4%	-15%	0%	203%
Liquidity	>2	inadequate	Adequate	Adequate	Adequate
Stand-alone rating	**BB**	**BB-**	**BB-**	**BB-**	**B+**
Outlook	**Stable**	**Stable**	**Stable**	**Stable**	**Stable**

* Available on ScopeOne

** 'SCD' stands for 'Single channel distributor'

*** (average Y-1; Y; Y+1)

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