Teneo
The Global CEO Advisory Firm

Automotive Rental

Teneo Insights
November 2021

A brief history and some context

Over the last 18 months, the automotive industry has experienced a period of enormous change, with OEMs, suppliers and dealerships each continuing to face their own unique challenges. In this article we are going to summarise some key dynamics and challenges facing the automotive rental segment.

Recent challenges faced by the automotive industry are a result of both changing customer demand and the impact of Covid-19 forcing structural changes. Changes to customer demand include an increased adoption of electric vehicles and greater appetite for both online and direct to consumer sales models. Structural changes forced by Covid-19 have resulted in the industry having to re-assess their reliance on their global supply chain partners for increasingly important components such as semi-conductors and batteries.

Supply chain issues have had a material adverse impact on vehicle production volumes globally; taking into account actual Q1 and Q2 global vehicle production numbers, IHS Markit estimates the full year light vehicle production shortfall in 2021 resulting from semiconductor shortages will be between 6.3 million to 7.1 million units (of a total 80.8 million units forecast in 2021).

While there has been an increase in challenges across the sector, more agile businesses have capitalised on market dynamics to thrive.

For example, a number of large dealership groups have benefitted from a combination of accelerated digital transformation, Original Equipment Manufacturer ("OEM") support, funder forbearance and Covid-19 government support measures as well as the unprecedented increase in wholesale used vehicle prices.

As of September 2021, the UK based Auto Trader Retail Price index reached record levels of a 21.4% year-on-year and like-for-like increase, allowing many dealerships to maintain high margins (offsetting new vehicle supply issues) and remain cash rich – however it is unclear how long this dynamic can last (as stock levels are reducing due to supply dynamics).

Overview

There has been a well publicised and material issue with the supply of new vehicles, compounded by an increase in costs. Some key factors are:

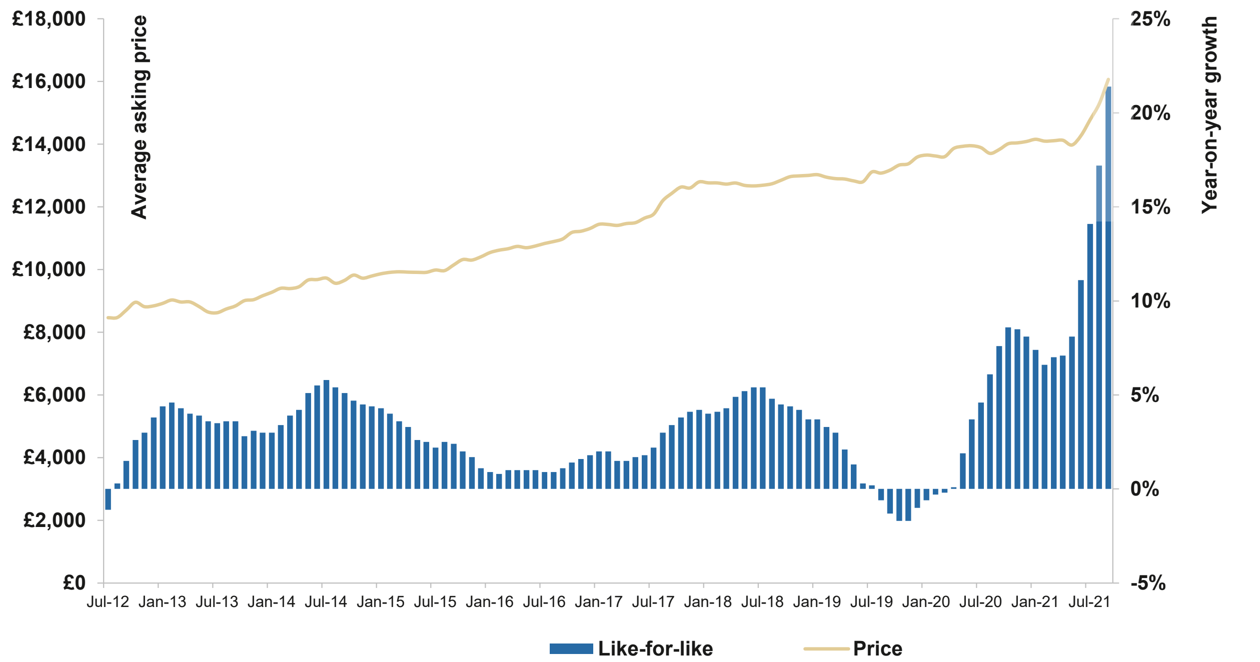
- Semiconductor, magnesium (and other key component) related new vehicle supply issues are expected to continue to materially impact supply into 2022, leading to depressed new vehicle supply (and lower new vehicle sales) and rapidly increasing used vehicle pricing; and
- Ongoing component cost increases such as hot rolled steel prices (up 215% since March 2020 (Source: MarketWatch).

The rise of Electric Vehicles (EV), battery sourcing constraints and EV infrastructure requirements (both in terms of availability of charging points available for the public and at fleet storage sites) continues to be an opportunity and a challenge for the automotive industry. From a rental perspective, there is an increasing expectation from customers that EVs will be available. However, with a limited supply, fleet mix will need to be carefully managed.

Automotive rental and leasing operators encompass a significant proportion of vehicles on the road today, with the British Vehicle Rental and Leasing Association ("BVRLA") estimating its members were responsible for 4m vehicles on UK roads in 2020 (10% of passenger cars, 17% of vans / Light Commercial Vehicles ("LCVs") and 20% Heavy Goods Vehicles ("HGVs")).

Rental operators are impacted by wider automotive trends, as well as a number of specific challenges as they seek to balance supply and demand. We highlight some of the key dynamics to be aware of in this article.

Auto trader retail price index - Fuel Market / Whole Market



Leisure and corporate travel: demand recovery timing & vehicle supply

The Leisure channel (international inbound and domestic) was materially impacted by Covid-19 at the end of Q1 2020 and has not yet recovered.

Our proprietary airline revenue forecasting methodology segments monthly revenue by geography (into EU, North America and Rest of World), and purpose (Business and Leisure) in order to apply a range of assumptions to each segment over time and to consider the impact of five suppression drivers (restrictions, government conditions e.g. PCR tests / quarantine, fear, economics as well as consumer behaviour and attitude). We forecast a recovery to 2019 revenue by November 2025.

A number of operators assumed that there would be a more substantial recovery in inbound leisure and corporate travel over summer 2021 and applied this assumption in forecasts used to support additional funding requests and facility covenant waivers / resetting during 2020.

In response to reduced travel, many operators materially reduced their fleet during 2020. Following the vaccine developments, an increase in US domestic leisure travel and general easing of global restrictions, consumer confidence has increased and generally, demand from leisure customers has improved. Many operators have faced challenges in increasing their fleet size as a result of new vehicle supply shortages.

According to data collected by Jefferies, the largest auto rental operators in the US have increased prices substantially. Daily hire rates charged by three of the largest operators in August 2021 ranged from 57% to 147% higher than median rates for the same period between 2015 and 2019 [1].

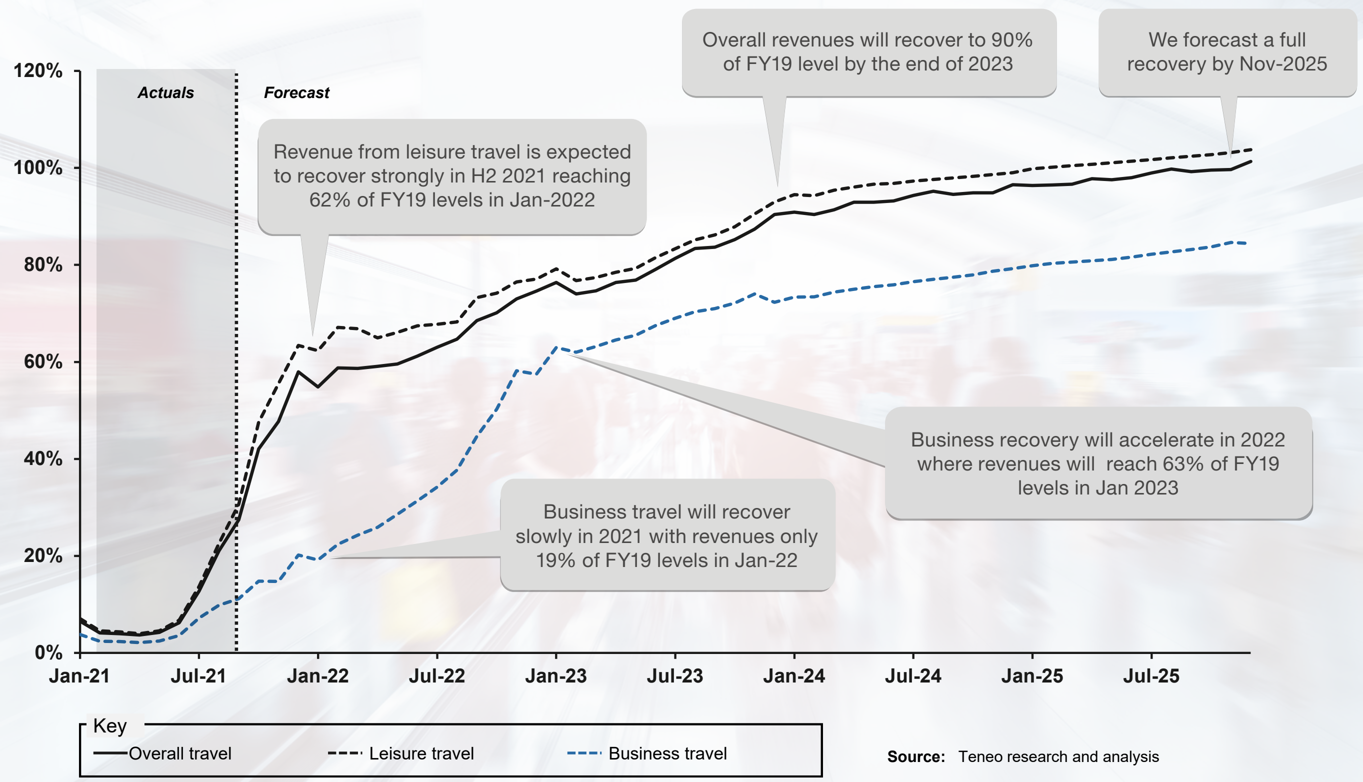
However, whilst the increase in demand during summer 2021 has led to a shortage of vehicles available for hire to customers, there is a risk that any significant and sustained recovery in leisure and corporate travel revenue may not be achieved for several years.

While the US Government indicated the full reopening of the key UK-US travel corridor is to take effect from early November 2021, exact timings remain uncertain. There is potential for long term demand suppression due to environmental focus, behavioural changes and residual reluctance to travel due to the pandemic. This leaves operators needing to adapt and delicately balance the seasonal, short term demands against the potential for a more gentle longer term recovery which may require further structural cost reductions to improve operational efficiency.

[1] *Jefferies Equity Research - Car Rental: Routine Fleet Inspection August 2021*

Teneo's Central Case suppression forecast

% 2019 revenue, 2021-2025



Source: Teneo research and analysis

Vans: Business-to-Business led demand increase & diversification to mitigate leisure decline

Van fleet numbers continue to increase to meet growing demand. In the UK, BVRLA data suggests that the overall van fleet increased by 5% in Q1 2021 relative to Q4 2020 (a 4.3% increase compared to Q1'20 - Q4'19)[2].

The demand for LCVs is driven by Business-to-Business ("B2B") contract hire (only 1% being Business-to-Consumer ("B2C") rentals), and is seen as a growth area by large international operators (previously associated with B2C passenger vehicle rental) that are seeking to further diversify and reduce reliance on leisure. This move has increased competition in the B2B market that was traditionally dominated by commercial vehicle rental and leasing specialists.

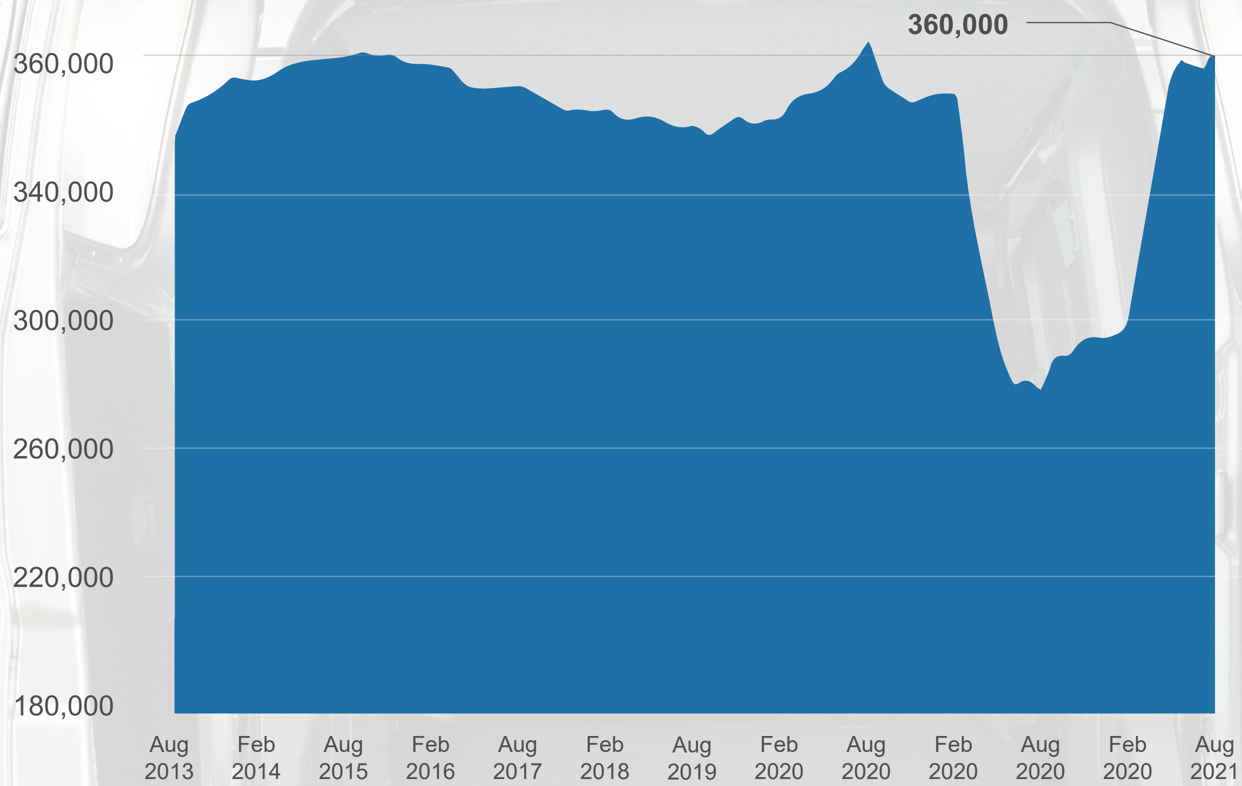
The increase in environmental legislation (including low emissions zones in key cities) may continue to drive growth as customers seek to renew less environmentally friendly older models with a new fleet.

Rental operators expect demand in the van market to remain strong, as greater flexibility (compared to traditional long-term leases or asset purchase) is attractive to fleet managers in the current climate.

The supply of new LCVs is under pressure as OEMs prioritise the supply of higher margin passenger vehicles. As such, customer expectations may have to change in respect to the age of the vehicles available to rent.

The B2B van market is becoming increasingly congested and high levels of competition may reduce operator margins over time. Successful operators will need to strike a balance between vehicle supply, age of fleet, flexibility of rental periods, short and long term rental contracts and maintaining average revenue per day on hires. Those that don't may encounter liquidity and covenant issues and require restructuring support.

LCV output - rolling year totals 2013 to 2021



Source: https://www.smmt.co.uk/vehicle-data/lcv-registrations/

The increase in environmental legislation and increasing c-suite focus on environmental, social and governance may continue to drive growth as customers seek new vehicles to reduce fleet emissions.

[2] *BVRLA Leading Outlook Report July 2021*

Fleet considerations:
fleet cycles, concentration risk and crown preference

Rental operators have faced shifts in traditional buying cycles and uncertainty over levels of peak demand due to leisure trends.

Traditionally, the BAU cycle for passenger vehicle rental operators was one of defleeting after the peak summer season and increasing the fleet in spring ahead of the leisure driven uptick in demand.

This cycle seeks to ensure target utilisation is maintained, which is commonly a key fleet covenant of a vehicle funding agreement. However, Covid-19 has materially disrupted vehicle rental operators typical operating model with a significant shift to the BAU cycle. Unseasonal defleeting was required immediately after the Covid-19 oubreak to manage reduced demand. As previously highlighted, this was compounded by issues in securing new vehicles from OEMs to increase fleet sizes.

The supply issues have caused some operators to be unable to meet demand, and material price rises for consumers as operators seek to minimise margin impact with a reduced fleet. Operators currently face multiple variables when deciding upon, and securing, new vehicles to replenish their fleet, such as having to take into account the potential cash benefit of increased used vehicle prices when disposals are eventually necessary.

BVRLA estimate that by the start of 2022, the UK leasing industry will have invested c.£5bn in EVs and Plug in Hybrid Electric Vehicles ("PHEVs"), together considered Alternatively Fuelled Vehicles ("AFVs") as operators seek to meet growing demand. Recent news of large orders of EV's by multinational rental operators suggest this investment is likely to accelerate in the short term. However, with this level of investment there is an increasing fleet concentration risk to be managed.

This is further complicated by the future residual value ("RV") risk being relatively unknown at this stage, with limited data in existence when compared to traditional Internal Combustion Engine vehicles.

In addition, technology advances may have a significant (adverse) impact on RV's as new technology and innovation continues to change over time.

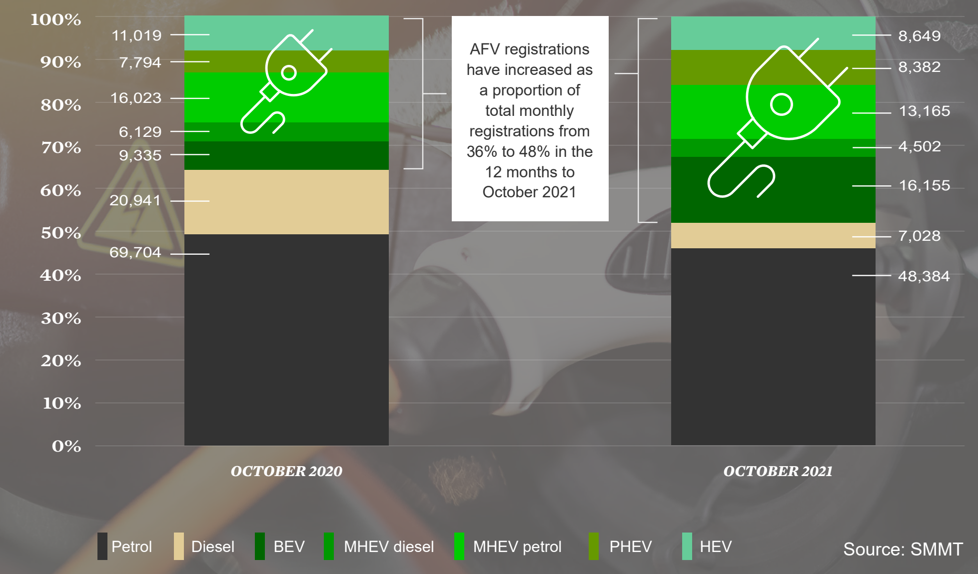
Solid state batteries have the potential to be lighter, have more energy density, offer more range, and recharge faster than traditional lithium ion batteries. Manufacturers are expected to move the technology into EVs, as highlighted by BMW and Ford investing $130m in Solid Power, a US based solid state battery start up that is reported to be planning a Q4 2021 IPO on the NASDAQ at a valuation of $1.3bn.

Volkswagen announced that it plans to switch to solid state batteries for all EVs in 2025. Realisable value is a significant factor in pricing, so operators need to balance remaining competitive on pricing with assumed future realisable value, to avoid future liquidity and funding headroom issues.

While in most restructuring situations there are a number of options available that avoid an insolvency event (with early engagement being key to maintaining a wide range of options), in an insolvency of a rental operator, stakeholders should be aware of the dynamics of HMRCs new preferred status (since 1 December 2020). In particular, in the event of a shortfall on their debt, vehicle funders may be eligible to make a Regulation 38 claim to HMRC for the VAT element of their debt, requiring them to issue a VAT credit note to the Company.

Whilst these claims improve returns to vehicle funders, they can also materially increase the operator's (preferential) VAT creditor claim, therefore reducing realisations available to both secured creditors holding a floating charge and non-preferential trade creditors.

Monthly vehicle registrations by fuel type (October 2020 vs October 2021)



Summary

Some large rental operators have capitalised on pent up travel demand during summer 2021 (particularly US domestic travel) and high average daily rental charges due to reduced new vehicle availability.

However, supply issues are forecast to continue into 2022 and as such the medium term prospects continue to be uncertain with corporate travel expected to remain subdued.

Longer term, rental businesses may target a shift to car sharing / mobility schemes, however, the success of these are contingent on vehicle availability.

There is a structural trend towards shared mobility resulting in a shift away from traditional ownership models in the automotive sector, that provides an opportunity for rental operators to capitalise on. Early take up and a willingness to embrace changes in the market can also provide opportunities for proactive operators to adapt and become businesses fit for the future of the industry.

While automotive rental operators are facing a number of challenges due to the backdrop of turbulent market conditions, we have a team of sector specialists that can help corporates, lenders and other key stakeholders navigate the volatility and deliver the best results for stakeholders.

This support can range from performance improvement, liquidity optimisation, business plan / forecast support and challenge, financial restructuring, creditor led business reviews and option identification – if you or any of your clients would like to discuss any of these issues further, please contact key members of our team.

Key contacts

Sandy Duncan
Senior Managing Director
+44 7968 903014
Sandy.Duncan@teneo.com

Rob McCrosson
Director
+44 7971 186281
Rob.Mccrosson@teneo.com

Matt Roe
Director
+44 7917 895536
Matt.Roe@teneo.com

Ian Morgan
Director
+44 7918 685748
Ian.Morgan@teneo.com

Harrison Kruger
Manager
+44 7825 676199
Harrison.Kruger@teneo.com

Teneo
The Global CEO Advisory Firm

London

5th Floor,
6 More London Place
SE1 2DA

www.teneo.com