Vertu Motors (VTU): What Are the Risks I'm Missing?

A Focused Compounding App subscriber asked this question about **Vertu Motors (VTU)**:

"Just wanted to query your thoughts on Vertu…It's the position I have the most conviction about…which I go back and forth on whether to increase.

I really find it hard to see any scenarios where it isn't worth 150-200% of what it's worth today in the medium term – say 3-5 years but perhaps more than that, I really struggle to see any scenarios where it's worth less than the c20p it's currently trading at.

Certainly the main thing holding me back from adding is the fact that it's continued to sit around the 20p mark which has me wondering whether I just 'don't know what I don't know'?

I believe I understand the bear cases, being:

– increase in automotive e-commerce retailing and the flip-side hindering VTU's predom physical dealership model.
– substantial decrease in unit sales due to 'robo-taxi's', uber and so

forth.
– reduction in servicing requirements with a move to EV's over ICE.
– depressed sales due to the current recession.
– balance sheet stress due to shut downs.
– share dilution, perhaps increasingly likely with what I assume is a target rich environment for acqs.
– the ongoing macro factors that are front and centre of the EU and Britain.

I struggle to see these risks being material in the moderate term or, with the risks I do believe may be material, I don't think they're as substantial or pressing as the current valuation suggests.

I guess my question is do you see anything that I'm glaringly missing? It seems irrational to me that it's even trading here to begin with.

I'm certainly mildly concerned about Robert issuing shares at the current price for an acq, but I'm hopeful this won't be the case and he'll use debt/cash if he does look to move on some opportunities. Aside from this, I really like Robert from what I've seen/read.

And obviously Brexit is a concern, however I just simply have no real idea how to underwrite that risk. I tend to (maybe ignorantly) believe that things will most likely get better, or remain the same, rather than worse – I think I'm purely basing that on somewhat of a mean reversion and being completely conscious of the fact that I have no real idea of trying to place a bet on something macro that I have such little insight in to."

[Ask Geoff a Question of Your Own]

I agree with the risks you laid out. Some reports I read on the auto industry in general and U.K. in particular did single out electric vehicles, online sales, and Brexit. There is also possibly – with the U.K. – concerns about regulations of their finance/additional products business. U.S. and U.K. car dealers probably make similar amounts of gross profit per car sold by selling financial products along with the car. U.S. companies often break this out. U.K. companies often don't. If you read some discussions of these stocks in the U.K., they have concern about regulation of that part of the business. It is difficult to calculate the probability, magnitude, and speed at which these risks could occur. Generally, though, if I try to plug numbers in – say a 40% chance that electric vehicles will be x% of all new cars sold by such and such a date and how much that might decrease the service/parts business compared to gasoline powered cars and so on — the numbers you get are just not very big possible hits to present value.

The things I actually hear from people most often about Vertu are simply that it has issued shares in the past at low P/B, it has underperformed (in large part because it issued those shares) compared to Cambria over time, and it has an inferior mix of brands (investors don't like Ford dealers for example as much as the high end dealers Cambria has recently added). I can't disagree with any of those points. I don't dislike Cambria as a business. And I don't especially like Vertu's mix of dealer brands better than other companies. However, to me that would be like saying you shouldn't buy a U.S. TV station owner because the affiliates are mostly ABC and NBC and CBS is doing real well now or something. I mean, my feeling on that is car brands will fluctuate in popularity and I wouldn't want to go all-in betting that one mass market brand will continually outperform another mass market brand. It's good to have a mix of major brands. And it's good to have strong relations with those brands. I didn't choose or not choose to invest in Vertu based primarily on the brands it sell. But, I did – and do – feel more certain about the combination of market position (including brands), balance sheet, management, and stock price at Vertu than at any other car dealer stocks in the U.K. or U.S.

So, management and dealer mix are actually the two complaints I hear from people about Vertu specifically. And other than the trends you mentioned – it's just risk of regulation of financial products that I've also heard. Nothing else I'm aware of to explain the stock's price.

In reality, U.K. car dealers got cheap on Brexit concerns and stayed cheap. I don't know if there is more to it than that. They completely lost popularity around the time Brexit concerns were first dominating the U.K. stock market outlook. And, historically, U.K. car dealers have often traded at a discount to U.S. car dealers. One explanation for this is capital allocation. In some cases – not all – we could assume the higher price on the equity of a U.S. car dealer group vs. a U.K. car dealer group is the way the U.S. group has historically used leverage and stock buybacks as compared to the U.K. car dealers. Also, some U.S. car dealers have greater scale. That is sort of the point of Vertu's existence. If we go back to the start of Vertu and look at the playbook for U.S. car dealers – it would've made sense back then to think that more consolidation in the U.K. market would happen (which it has) and that this would eventually result in better multiples on U.K. car dealer groups that successfully scaled up.

So, I do just want to point out that U.K. car dealer groups have usually been cheaper than U.S. dealer groups. And then U.K. car dealer stocks have all gotten cheaper – and stayed cheaper – since investors in U.K. stocks became focused on Brexit. This is especially noticeable when looking at things like the EV/EBITDA and P/B multiples of the group year-by-year. The poor stock price performance has clearly been attributable to large (and now persistent) contractions in all the relevant price metrics. Actual business performance of dealers ranged from flat to slightly worse for some of this period. But, the price multiples on the stocks pretty much all got massively worse.

They've stayed there since. Why? It could be the risks you described. It could also be lack of popularity of U.K. stocks versus U.S. stocks in some periods of recent stock run-ups in past years, concerns about Brexit keeping people away from a consumer durable business (a car is the second largest purchase for homeowning households and largest for renters – so, very economically sensitive), and finally COVID shutting these things down. So, any possible increases in the popularity of these stocks as value investors got attracted to the multiples might have been squashed at times by Brexit and COVID. That's the sentiment based explanation for the low prices. The fundamentals based explanation is exactly the risks you laid out.

[Ask Geoff a Question of Your Own]