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Car dealerships in the EU:

Which is the most appealing for PE investment?

Executive summary

The reasoning to analyze this type of dataset came from the interest in current events in the car price market all over the world. It started as an interest to see how much the car dealership companies were affected by price fluctuations and volatility in supply that the car market has experienced over the last 3 years. Afterward, it became interesting to dig deeper to analyze who has been the best-performing country in the last 5 years and which country and specifically which company would possibly be the best company for Private Equity (PE) investment.

In recent years, there has been a big increase in car prices, due to the short supply of semiconductors, they are an essential part of a car nowadays therefore cars can't be produced without them. It seems like car companies are starting to struggle to meet the demand thereby creating a big time of uncertainty in the market. But how has this affected car dealerships? Are they still a good investment strategy in developing EU countries?

This report analyses a potential business scenario, where a Private Equity firm wants to invest in a car dealership company in a developing part of Europe. This research focuses to analyze the best firms to invest in based on data available from the platform "ORBIS" (2022).

The analysis concludes that the Baltics are the best place currently for new investments in the car dealership business. When looked deeper, Latvia seems to be a really risky investment place with high uncertainty, while Estonia and Lithuania are looking much better. After that, by looking at return on assets measurements for big firms it became clear that Lithuania is the best place to search for a firm to invest in. After further analysis of the firms, the company with the best return on assets ratio that didn't have a big market share showed to be UAB Moller Auto. After some small assumptions, it was concluded that the potential value of the deal to invest in this company could be 13 million EUR minus the expansion and investment costs the PE firm would occur.

Project background

Car dealership company sample was taken by collecting 2021-2017 data about firms that:

- Are an active company currently
- Have complete EBIT, Turnover, net income, and employee amount data for the last 5 years
- Companies that are stated to have primary NACE code connected to the retail distribution of automotive transport.
- Companies that are registered in: Austria, France, Germany, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia, Ukraine, Finland, Norway, and Sweden.
- Companies, whose average yearly turnover was over 100'000 EUR.

Together, information about 4434 companies was collected, with the amount for each respective country can be seen in the dashboard.

To understand this report, there is a need to understand in a nutshell how PE company does business. In our project case, the report is presented to a PE company, that acquires already existing companies that they see potential in. In an average timeframe of 5 years, the company is transformed to be more efficient (improving operations) and grab a bigger market share. The latter is usually done with help of huge amounts of capital PE firms have. After companies' valuation is increased, the PE firm sells the company and keeps the profits it has gained from the difference between the selling price and acquisition price.

Analysis

Industry

Firstly, the companies are grouped into 4 groups:

1. Nordics – Norway, Sweden, and Finland
2. Baltics – Estonia, Latvia, and Lithuania
3. Developing region – Ukraine, Romania, Poland, Hungary, Croatia, Slovenia, and Slovakia
4. Developed countries – Czech Republic, France, Germany, and Austria

Observing the results, the output can be best observed from this chart:

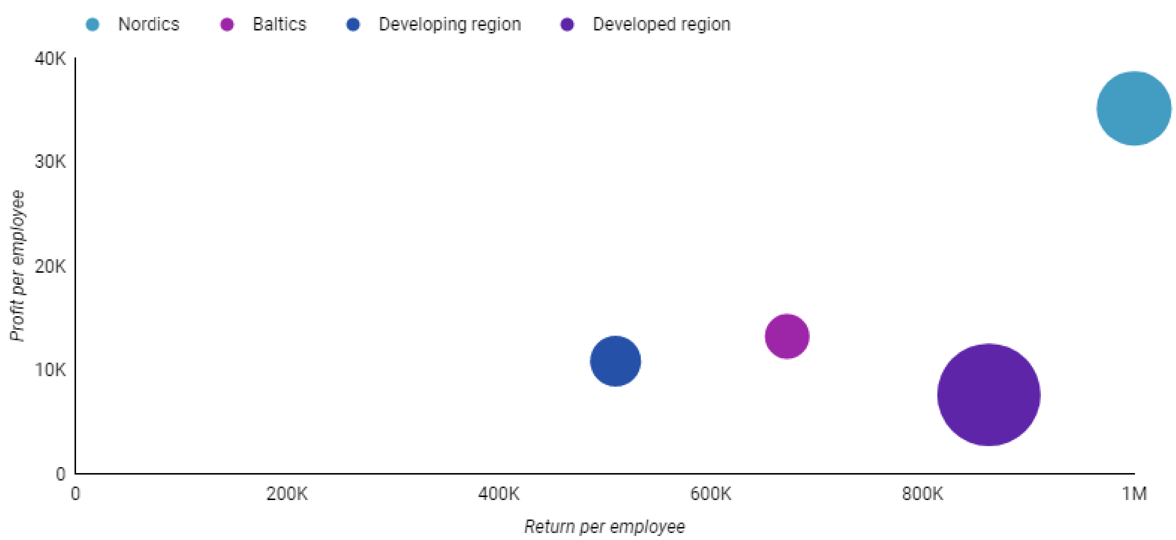

Image 1. Return VS Profit average for EU regions. (Bubble size – average turnover)

Looking at the graph clearly shows the picture that on average, firms from developed regions and Nordics have a clear lead in revenue over the Baltics and developing regions. But most interestingly, there is one more connection that seems even more crucial. The relationship that can be observed from Revenue VS Profit per employee. It can be observed that Nordic companies on average are far superior to the rest of the EU region in operational efficiency because their profit per revenue gained is much larger than any other region. This is where potential value is observed for a PE company – if a company could come into the region and increase companies efficiency and profitability, the company's valuation would be increased. Image 1 creates an impression that investment in developed regions would make the most sense, because of the high upside potential, but most car producers are from developed regions in the EU, therefore there are more direct factory dealerships. This would mean that potentially dealerships are not as interested in profits, since that is only a subsidy of a bigger car producer.

This is why going into a developed market could be considered to be too risky since a normal dealership can't compete with direct manufacturers' dealerships.

Additionally, there is no point in going into the Nordic market, because the efficiency is already reached, and PE company would have close to no changes it could potentially do to increase companies value.

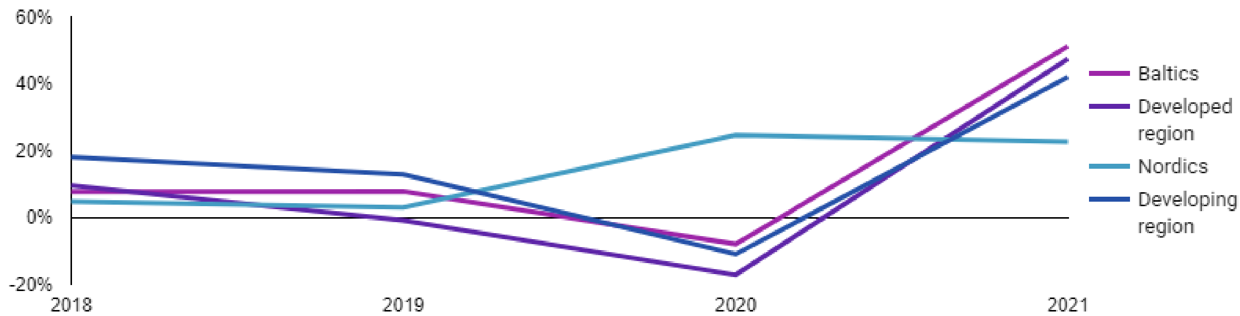

Image 2. Median yearly EBIT (Earnings before interest and tax) growth for each region.

Additionally, observing data in Image 2, an image can be seen that indicates, while developing countries experienced higher growth before the COVID-19 pandemic, after 2020, trends have shifted, and EBIT growth is actually more prominent in the Baltics sector.

Furthermore, it can be observed that in 2020 EBIT decrease from the pandemic was the softest in the Baltics, if we don't consider Nordic countries in the comparison.

Since developing countries seem to be more unpredictable, worse performing, and revenue per employee slower, it can be concluded that the Baltic region is the best region PE firm should focus on.

Countries

Private equity companies on average can change 2 major things: funding for the company and changing the company structure to make the business more profitable with the experience and expertise PE funds operate with.

To see if capital actually has any effect in our observed countries, OLS regression was created (Appendix 1) where the effect of capital on turnover was observed by looking at total assets' relationship with turnover. The results presented a big positive effect in increasing total assets, therefore the first metric that needs observing on the country scale is the return per asset efficiency. The better the efficiency, the better the country can allocate its assets.

The second metric that the analysis focuses on is the return per employee, which indicates the revenue per employee the company is getting.

While this metric is also very important, it shouldn't have the most say in a decision, because return per employee is also an operation that can be optimized, while return per assets could be influenced by the tax structure of the company, or just an overall potential return on capital, for example, rent could be cheaper in Lithuania then Estonia, therefore return on assets are better in that region and can't be changed as easily and should be looked as the main variable.

Before taking a look at previously mentioned metrics, it is important to look at financial data divided by the population of the country. Fully they can be looked at in the dashboard at the bottom of the second page. All of these measure outputs indicate, that when any metric is divided by Capita, Latvia is seriously falling back behind Lithuania and Estonia. This result is partly influenced by Latvia having worse purchasing power than the rest of the Baltic countries (Image 3), which is 5 thousand EUR lower than the rest of the Baltic countries. (Eurostat, 2022) Despite that, the measures presented seem to be much lower than this gap only would suggest, meaning that in Latvia the profits are more distributed among more firms leading to more competition.

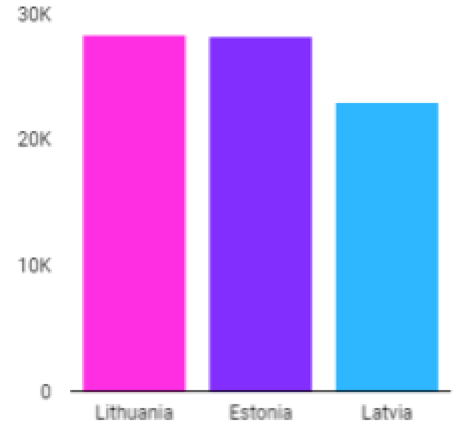

Image 3. Purchasing power of Baltic countries.

Latvia definitely proposes a big opportunity for a company to become a market leader and a big potential upside if the lack of performance could be increased. At the same time, it introduces a high risk to PE company of Latvian citizens not being able to meet the market expectations. Therefore, if the PE firm is really risk tolerant, Latvia should be examined further, but in this case, the author considers Latvia to be a too risky investment, therefore the focus should be only on Estonia and Lithuania.

Looking at the rest of the data, the conclusion of the best country seems to be contradicting. Lithuania is better in return per assets part, but Estonia is better in revenue and profit pre-employee metrics. While it is already mentioned that return on assets is the most important value for company analysis both countries will be observed.

Firms

To deep dive into firm analysis and understand the best firm to invest in, multiple points were considered, but the majority focus was put on return vs profit per employee relationship as well as performance measures with the main focus being on return on assets.

Only the top 5 turnover-making firms in each country were compared for observation, because:

- There are bigger firms usually have the most reliable data available
- Performance ratios can be very good, but actual business sales are almost non-existing, therefore Top 5 was calculated from a 5-year average: output shows already established firms that have maintained a normal cash flow throughout all 5 years.
- Already well-established relationship with a supplier.
- PE companies usually look at companies that have a good business, they are not interested in small businesses and startups.

Afterward, the firms were evaluated as not having too big of a market share, because if the firm is already a market leader, it has lower market value increase potential.

After comparing the country's top 5 performances, a clear winner emerges.

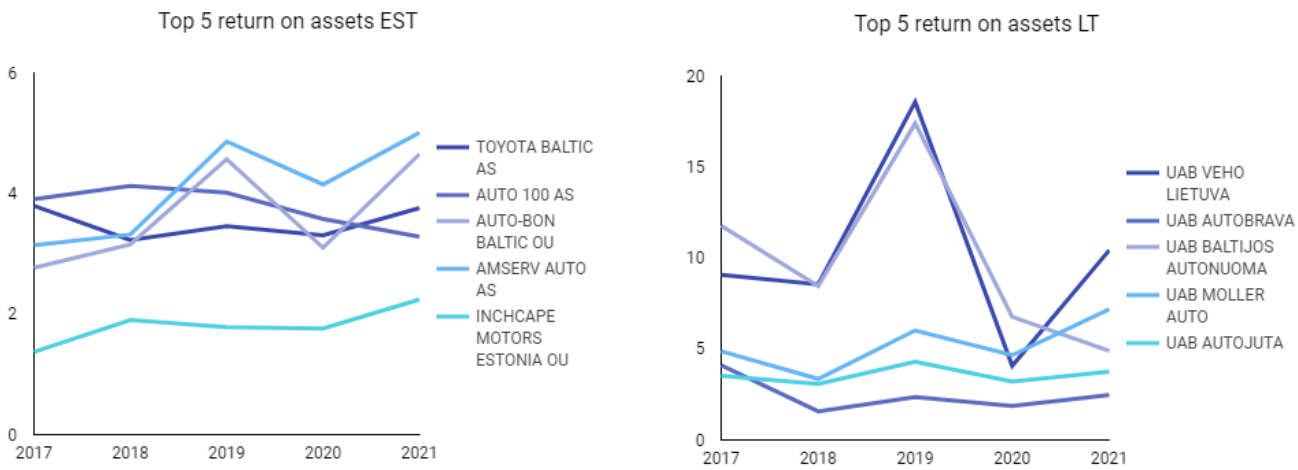

Image 4. Return on assets comparison between Estonia and Lithuania

When comparing the return on assets measured in Lithuania and Estonia for the top 5 companies (Image 4), it becomes much clearer that Lithuanian companies are a much better place for PE company to invest in, since in Lithuania top firms are much more efficient with its capital usage efficiency. Therefore, the best firm for investment will be searched in Lithuania.

Already by observing Lithuanian companies in image 4, it can be observed that UAB AUTOBRAVA is a clear leader in capital allocation. Unfortunately, the firm already is a market leader in Lithuania, with almost a 20% share of the market in Lithuania.

Next comes UAB Baltijos Autonoma, which has a huge margin, but again fails at a point where it already owns 13% of the Lithuanian car dealership market share.

Third on the list is the firm: **UAB Moller Auto**. Return on assets is higher than any form in Estonia, and the firm has only a 5% market share. Looking at the return vs profit graph, both profit and return per employee values seem to be low, but turnover seems to be at the same level as other firms that were mentioned before meaning that with more efficient operations, possible restructuring and expanding with capital and operations this firm could easily increase its valuation.

As a last check, the actual products of companies were observed. AUTOBRAVA which is the best performer all around is selling Mercedes cars, while Moller auto sells Volkswagen and Audi brands. While Mercedes can obviously have a bigger profit margin, Audi and Volkswagen are still very respectable brands meaning that Moller auto can easily reach the turnover and profit levels of AUTOBRAVA.

If the company reaches AUTOBRAVA levels, turnover would be almost doubled. Meaning potential turnover increase by 70 million, while enterprise valuation would increase by 13 million. This enterprise valuation minus the investment costs would be the profit the PE firm could have.

Conclusion

From the above-mentioned analysis, it can be concluded that Lithuania has the best-performing firms for capital-rich PE firm to acquire. More specifically – UAB Moller Auto is the one that stands out as the best option, based on the best performance of return on assets measure, as well as the company not being a market leader already. All this points to huge potential growth in the future. With a simple calculation done in the analysis part, it can be assumed that if the PE firm would be able to increase the business to the same level as UAB Autobrava, this deal could be worth about 13 million Euro, minus the investment that would be put into the firm.

Estonia was a close second but in comparison with Lithuania lacks efficiency in its asset allocation. At the same time, their average return per employee is bigger than Lithuania, therefore if a firm is more interested in employee performance from the get-go, then this country is a good option as well.

In the last place, there is Latvia, which didn't stand out in any performance metric, as well as achieved significantly lower levels on company financial data, when those data were divided by population numbers. Therefore, Latvia can be looked at as a gamble. The country could have big upside potential if one firm could achieve a big market share and incredibly boost a company's efficiency. On the other hand, the poor average performance could be an indicator of harsher market conditions, where it is harder to get extra demand. Therefore, PE company is risk averse, then also Latvia could be a good option and further investigation would be necessary.

Recommendations

For PE firms, the conclusion for the best company could differ, based on the company's experience, risk tolerance, and preferred analysis measures. To recommend some concrete strategy would be relatively hard because the analysis is only done from yearly data. If a PE would trust the report and decides to invest, it would need to approach a potential client (In this case: UAB Moller Auto), ask it to sign an NDA, and later dig into the company's financials at an even deeper level. The recommendation would be for PE managers to observe the created dashboard and after reading this paper, understand if their assumptions align with what Is written here. If the assumptions are similar: UAB Moller Auto is the best company with the best future potential.

Appendix

Appendix 1, Regression for effects on turnover

	Dependent variable:
	log(Turnover)
employees	0.001***
	(0.0001)
log(population)	0.014**
	(0.007)
log(purchasing_power)	0.614***
	(0.037)
log(Working_capital)	0.167***
	(0.008)
log(Total_assets)	0.872***
	(0.011)
log(Long_term_debt)	-0.057***
	(0.006)
Constant	-5.400***
	(0.370)
Observations	5,474
R^2	0.888
Adjusted R^2	0.888
Residual Std. Error	0.586 (df = 5467)
F Statistic	7,232.523*** (df = 6; 5467)

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