The Colonial Motor Company Limited

CHAIRMAN'S ADDRESS TO THE 99th ANNUAL MEETING
on 3 November 2017

We have had another exceptional year. Trading profit at $22m is 14.5% up on last year. From the low point of the global financial crisis, which for us was 2010, the trading profit has risen from $6.1m to this year's $22.0m. Better still, over those seven years, in all bar one (2015) there was an improvement on the year before. Our growth has been steady and almost continuous. Steady growth is unusual in what is normally a cyclical business.

Trading profit is an accurate measure of our underlying profit. It is a measure of how well the Company has performed. It is also the primary driver of our dividends, so it is not surprising that dividends have followed the same pattern; from the low of 15 cents per share in 2010 rising to 44 cents this year - very close to a three times increase in seven years.

We emphasise trading profit and dividends. That is because this Company aims to reward its existing shareholders. There are two main methods that a company can use to provide a return to its shareholders; by paying dividends or by increasing the share price. A share price increase gets most of the attention but it remains unrealised until a shareholder sells. This Company has a very long-term shareholding with very small daily turnover. Dividends are the mechanism we use to reward long-term shareholders.

The world economy is in a low interest cycle and has been since the global financial crisis. A consequence of low interest rates is to drive up the share price of companies that pay dividends. The combined effect of an increasing dividend and lower interest rate expectations has seen our share price rise from $2.18 in 2010 to $7.50 this year (using 30 June as the date.) The shareholder return chart in our annual report shows the mix of return, dividend yield and share price movement. Today's price of over $7.60 is justified in the current economic environment but it depends on our ability to pay dividends and on the current low interest rates. This risk is reflected in the yield from the shares, a gross of 9%.

The Market

The obvious driver behind the Company's strong financial performance is the growth in the new vehicle market. Its continuous growth since the low point in 2010 is well reported. But it is the detail within the total that gives a better guide to our success.

There are ongoing major shifts in consumer preferences. Sales of the traditional sedan, hatchback and wagon, are falling while SUVs and light commercials are growing. Last year, year-to-date September, SUVs represented 37% of the market, this year, for the same nine months, it is 40%. It is a similar story for light commercials, up from 28% to 30%. Sedans and hatches have dropped from 34% to 29%. They are now the smallest segment in our market.

We are a franchisee company and, as such, we depend on the products that the car companies supply. Car brands that only supply sedans or hatches are facing a smaller market than last year. Our two main brands, Ford and Mazda, have differing strengths. Mazda has a competitive line-up of SUVs from the small CX3, through the midsize CX5 to the large CX9. Mazda's SUVs are constantly refreshed and meet the market's expectations. Ford is strong in light commercials. Ford's Ranger continues to top the sales charts as the most popular vehicle in NZ. We are very dependent on our franchisors supplying us with the right mix of product at the right price at the right time.

The media have emphasised the growth in the new vehicle industry. For the first six months of 2017 it was up 14% on the same period a year before. Since then, the pace of growth has slowed with only 2.8% growth in the September quarter. All of that growth was in rental car sales not to the public at large. Total registrations are not the full story. Cars are ordered about six months ahead and, once ordered, they will arrive and then must be sold. There is no accurate measure to separate registrations representing customer demand from registrations representing franchisor push to quit old inventory. One is profitable, the other is not.

Success comes when we balance four often opposing pillars,

1. Our franchise brands. They supply our product and our identity. They have similar but distinctly different expectations of us as franchisees.
2. Our customers. We need customers who buy from our dealerships, who willingly spend their dollars with us.
3. Our staff. People who are motivated, who care, who can work as a team.
4. Profitability. No one will support us if we are unprofitable.

Our management have to balance the demands of all four. Often the demands of one are at variance with another. A large measure of the success of this company is the quality and commitment of the management.

Heavy Trucks

Southpac Trucks is the NZ distributor for Kenworth and DAF heavy trucks. The two brands are subsidiaries of the same holding company, Paccar, but they cover different segments of the heavy truck market. Kenworth is a premium, robust, built-to-order truck while DAF is a standardised European unit.

Southpac imports and sells the trucks with a network of service franchisees. Both brands have product that is suited to New Zealand's unique road conditions with its steep hills, tight corners, and unique axle and tare weight combinations. Correctly specified product and emphasis on customer service have seen Southpac gradually grow from a small player to now be one of the largest extra heavy truck suppliers in NZ. The combined share of the extra heavy truck market for the two brands is now over 20%. This share growth has been achieved in a fluctuating total market. The heavy truck market was severely hit by the global financial crisis. Only 910 Units were registered in 2010. The market grew to 2,600 in 2014, then dropped in 2015 and again in 2016. The market is only now growing again but is not expected to exceed the 2014 peak. Southpac Trucks is a major success story and is a material part of The Colonial Motor Company.

Christchurch

The Christchurch earthquakes in 2010 and 2011 damaged the parts and showroom buildings of Team Hutchinson Ford. Access was denied for 11 weeks as the dealership was in the red zone. Then the damaged buildings were pulled down and a new exterior wall for the workshop building had to be built. Soon after, in 2012, the Christchurch rejuvenation plan was announced which identified the block around Team Hutchinson Ford as the South Frame, an area with buildings in a park like campus environment to separate the central city from the rest of Christchurch. The original announcement included a lane meandering between low density buildings in a green space. The Team Hutchinson Ford site became subject to compulsory purchase by the Crown.

However, the South Frame plan was soon contradicted by the building of a four storey office block for Environment Canterbury immediately next door to Team Hutchinson Ford (on land owned by the Christchurch City Council). Over the following years there were bursts of activity with proposals and negotiations that were never followed through or completed but slowly it was established that a straight pedestrian greenway would be put through THF's workshop building. In line with this, the compulsory purchase provision was then limited to the proposed greenway.

The Colonial Motor Company has worked in good faith now for over five years to structure the business around this greenway, which would cut the site into two halves. To that end the company obtained a resource consent from the Christchurch City Council to expand the sales and administration buildings and allow for demolition of part of the workshop for the greenway.

Effectively Team Hutchinson Ford would be cut in two with sales and service reception facing Tuam Street and service vehicles crossing the lane to the workshop.

The Christchurch City Council has signed off on this plan. Subsequently the Colonial Motor Company and Team Hutchinson Ford signed an agreement with LINZ, the Crown's land purchasing authority, to lease in perpetuity the land for the greenway, including timetables and the costs involved. This agreement was approved by the minister, Nicky Wagoner. For a short while it looked probable that Team Hutchinson Ford could finally look forward to certainty, seven years after the earthquakes. However, Otakaro, the government regeneration authority for Christchurch, has decided to not approve the plan.

It is totally frustrating. The Christchurch rebuilding process has been slow. For seven years we have been willing, able and want to rebuild our facility on a site that has been continuously owned and occupied by the company for 88 years. The workshop building, one of the few surviving buildings in the block, was purpose-built for the company in 1930.

It has been impossible to get agreement from the multiple authorities with quite different agendas. The contradictions between what one authority will insist on and another will allow is staggering. Equally staggering is the inconsistency between allowing a new building next door to access its carparks using the greenway but not allow the dealership to cross the same greenway where it cuts the current site into two. It would appear that some planners want empty land in central Christchurch not a thriving business community.

It is not all bad news. Team Hutchinson Ford is a very successful dealership despite empty land around it. Across town at Avon City Ford the new commercial workshop reception area is nearing completion and options are being reviewed to upgrade the showroom.

South Auckland

South Auckland Motors has a large territory with a rapidly expanding population and market. The region is being developed on a hub and spoke model i.e. it has a large, all-departments hub with spokes that concentrate on servicing the cars that are sold from the hub.

Buyers do not want to travel far for after-sales servicing. The emphasis is service branches. Some of the service centres do have sales functions that are managed by the centrally-based sales manager. South Auckland Motors has its central hub at Manukau with an expanding array of service locations. The first purpose-built facility was at Botany, on Harris Road, built in 2003 with 10 service bays. Next came Pukekohe which was moved from a small, old facility to its present location on Manukau Road in 2008. The airport service centre on Timberly Road was opened in 2016 with seven bays. The newest, at Takanini, is due to be opened soon, in early December, with seven bays. All of the service centres are large, with 7-10 service bays.

The next step is to expand the Pukekohe centre where the 2008 facility is rapidly reaching capacity. We are looking at potential sites in the Pukekohe, Paerata, Drury areas. The hub and spoke model optimises the service experience for the customer without excessive capital cost.

Queenstown

We are awaiting the issue of a property title which will finalise the land purchase and trigger the construction of a long-planned new Macaulay Motors sales and service centre for both Ford and Mazda. The new facility will be twice the size of the current facility.

Southpac, Te Rapa

The new workshop and parts centre at Te Rapa, Hamilton, opened in June. It is a large 8,000sq m facility with five drive-through truck bays. Most of the national network that services Southpac's Kenworth and DAF trucks are owner-operated by service franchisees to Southpac Trucks. Only Manukau, Rotorua, Christchurch (sales and parts) and now Te Rapa are managed directly by Southpac itself.

Wellington
Capital City Motors continues to lease the current Taranaki Street site on a rolling basis. Meanwhile, we have purchased a property further up Taranaki Street that will become the future city retail service outlet. We have also purchased a property near Stevens Motors in Lower Hutt.

Electric vehicles
They make wonderful stories for discussion but my emphasis is how would this Company adapt? We live in a world where there is constant change. The issue to this Company is not the technology that cars may or may not have; rather, the issue is how they will be sold. Will the franchise model that has been part of the company for over a century continue to be a successful arrangement for this company?

We continuously face this risk. The Company has had to adapt to changes initiated by the franchisors and by the market. Most franchise arrangements can be cancelled by the franchisor at relatively short notice. It is up to us to ensure that we provide more than the franchisor can provide itself. Yes, it is a risk and always has been. It is not a new risk. At present, new electric vehicles cost about twice as much as a similarly specified conventional vehicle and, for that double price, they have limitations compared to what a conventional vehicle can do. Compared to the alternatives, it just does not add up for the mass market.

The Company has to be prepared to adapt. A key policy in that respect is the financial preference to own the key operating properties. Short term, there are return-on-investment gains from leasing but, when faced with those once-a-decade major upheavals, direct ownership has allowed the Company to adapt. In the 1990s the Company had to shrink as the new vehicle market went through ten years of decline. In the 1980s most of our dealerships had to exit the tractor business. The current environment is one of growth; an environment that favours debt. However, we have continued to avoid long-term debt and have few long-term property commitments. Financially we are well placed to adapt to changes. A profitable company with few long-term liabilities is able to adapt.

The outlook
Predicting the profitability of the Company for the next month is not accurate, let alone for six months ahead. At best, we can look at trends and estimate the direction. Even that is not reliable when looking more than a few months ahead. In 2015 we had a poor first quarter and, based on that, we were cautious of the future only for the second quarter to surge ahead and then repeat for all of the second half. Last year we had a good start but stalled in the second quarter. The first quarter this year is up on last year with a strong result from heavy trucks but car profitability is down. A good start, but one quarter is not a full year. The unknown is consumer confidence.

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