Aston Martin Capital Holdings

Ticker: ASTONM

Isin	Issue Size	Rating M / S&P	Coupon	Min Piece	Maturity	Next Call	Offer	YTC	YTM
XS1533915564	£285mm	B2 / B-	5.75% s/a	£100k	Apr 2022	Apr 2019 @ 102.875	106	2.99%	4.18%
USG05891AA76	$400mn	B2 / B-	6.50% s/a	$200k	Apr 2022	Apr 2019 @ 103.250	106	4.20%	4.96%

Aston Martin ("AM") has been through its ups and downs during its long history, but it maintains a unique and distinguished brand and has worked long and hard to put itself on a solid financial and operational footing. Over the years its bonds have generally traded higher than the credit profile would suggest, thanks to affection for the brand and faith that there will always be someone around who is enamoured enough to take it over if necessary. Long-term plans have finally started to bear fruit in 2017 and the group's short- and long-term outlooks have shifted to positive.

Bonds

- Senior secured, sharing collateral with the £80mn revolving credit facility, but when it counts – on enforcement – the RCF is super senior. Being issued out of a financing entity, it's structurally subordinated.
- Collateral is captured via guarantees from group subsidiaries that represented 96% of group EBITDA, 65% of group revenue and 92% of group assets at issue. It includes first priority security over various companies' shares and the notes' proceeds loan. There is also a fixed and floating charge over material operating bank accounts, material intercompany receivables, intellectual property and shares in other guarantors and material companies.
- 40% equity clawback at 105.75% for the GBP bonds and 106.5% for the USD bonds. This is important to note given market speculation of an IPO later this year. Change of control put at 101.
- Covenants: limitation on liens require a fixed charge coverage ratio to be at least 2.0x, but regardless of that, AM has considerable latitude to borrow under the various permitted indebtedness buckets available. We estimate extra debt/liens can be taken on via various buckets up to £300mn and potentially more if income trends continue. There is also a minimum fixed charge cover ratio of 2.0x to limit restricted payments, but again, there are plenty of exceptions, and after April 2018, AM can make all sorts of payments as long as a consolidated net leverage ratio remains at 2.5x or lower.
- Cross default and acceleration clauses in place for principal amounts of £25mn or more.

Business

AM has a long history as an iconic British motoring brand, having been founded in London in 1913, and with repeated starring roles in James Bond movies over the decades. It has also seen the extreme highs and lows that many leading marques have experienced. Ultimately, the strength of the brand has translated into longevity well beyond what financial performance at various times might have otherwise determined.

AM designs, engineers and manufactures its high luxury sports cars in the UK with around1,600 employees plus over 700 contractors. Vehicle sales account for over 90% of revenue, with sales of parts (7%) and servicing of vehicles (3%) making up the rest. Geographically, the UK still represents the largest market with almost 32% of sales, followed by Europe with 24%, the Americas not far behind at 22%, China with 5% and the remainder distributed around the rest of the world. Q1 is usually a low point given the northern hemisphere winter, and twice-yearly new vehicle registration in the UK in March and September has a positive impact on resale value of vehicles registered starting on the first of those months. Middle East and USA sales are driven by model year changes. Summer vacation time is a low point in many markets, and that means a slow Q3 for the northern-hemisphere dominance of AM's sales. Cash needs are seasonally correlated, highest use is in Q1 when profitability and margins are lowest and lowest is Q4 when the most sales are concluded.

Key suppliers are Ford and Daimler. Ford supports assembly of V12 and some V8 engines from dedicated Aston Martin production facilities via an exclusive supply agreement that expires at the end of 2020, at which point it goes onto a rolling 12-month basis. Daimler provides certain entertainment and electronic systems, and certain engines (the AMG V8 for the DB11 and new Vantage models) and powertrains. AM owns or exclusively licences the engines' intellectual property rights. AM intends to maintain considerable intellectual property as it develops the first fully electric sportscar (Rapide E), with production due in 2019.

AM maintains a global network of around 160 dealer franchisees who buy the units for sale to end clients, the very few exceptions to that being highly exclusive limited-edition cash sales direct to end clients. An important part of AM's business model is using its little black book of existing and prior AM owners to showcase new model prototypes in small, private viewings. Deposits taken to reserve models, in what are sometimes single-digit production runs, provide additional capital to fund development and commence production. For the new Vantage that launched on 21st November 2017, three showcases per day over weeks in October-November had yielded reservations from 70% of attendees. AM was looking to repeat the success of the DB11, for which initial deposits fully funded the capex required to bring the model to production.

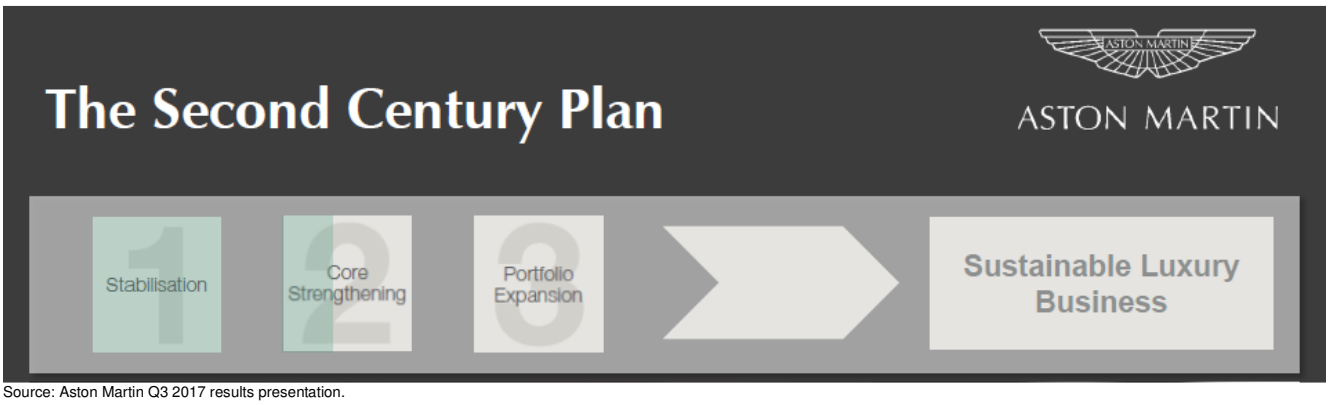
Very special, high value models with very low volumes are extremely appealing to AM fanatics and are an asset class in themselves – their resale value appreciates thanks to their exclusivity, such as the Vulcan track car (150 made). They are designed to be at least cash neutral through the life of the model, production being funded by customer deposits. The Valkyrie's 150-unit production run was four times oversubscribed. For significant new models, such as the DB11 in 2016, deposits are used more to ensure there are serious buyers in the pipeline. Deposits will be roughly 10-20% of the sticker price, often in two payments; first to reserve the car, and a second at a minimum of twelve weeks ahead of expected production completion, at which point the customer's customisation specifications are taken. As well as satisfying die-hard AM and luxury sports car fans, AM's investment in new models is now attracting new buyers to the AM brand.

Affordable lease financing for end clients has expanded for all vehicle manufacturers and AM is no different. That said, the kind of high net worth customers buying AM's cars tend to be relatively immune to downturns and have the resources to keep buying new, interesting models throughout the cycle. AM was outselling Ferrari in 2007 before the global financial crisis, but while Ferrari could maintain development capex through the great recession, AM lacked the capital and fell behind, unable to match competitors in new model releases. The capital shortfall since has since been addressed.

Long Term Strategy

Since 2007, when Ford had to restructure its large and varied operations, AM has been firmly in the high yield investment camp. At that time it was bought by a consortium fronted by well-known UK auto entrepreneur, David Richards, and majority shareholders Investment Dar and Adeem. Adeem required some restructuring of its own in 2012, and is now a shareholder with Tejara Capital via Investment Dar. Investindustrial, which had successfully transformed Ducati, came on board, bringing an extra £150mn for a 37.5% stake valued AM at £800mn. Investment Dar/Adeem/Tejara retain the remainder. Investindustrial looked like a good fit at the time, and it certainly looks that way in hindsight.

The resulting plan was to invest £500mn over five years to bring annual sales from 2,520 cars in the year to September 2012 back to pre-recession levels of around 7,000. Doing this would require significant investment in 'designing and bringing to market exceptional new models in very limited numbers, reflecting AM's ethos of exclusivity and rarity'. The shareholders were backing the move to revitalise the luxury car company. A tie-up with Mercedes-Benz AMG high performance division the following year brought Daimler into the AM sphere along with a 5% equity stake and an observer position at board meetings. Crucially, it also locked in bespoke engines, including a V8, and electrical/electronic components. Things did not go entirely smoothly, with over 1,000 vehicles recalled in China during 2014. The same year saw the CEO move to the board, Andy Palmer (Nissan) take the helm, and a new chief engineer arrive from Lotus. Fresh capital was forthcoming as the plan unrolled over time, with £200mn in preference shares.



Source: Aston Martin Q3 2017 results presentation.

The six-year Second Century Plan depicted above commenced in 2014 and is due to complete its four phases by the end of 2019, at which point AM should be broadly self-sustaining. Stabilisation completed with the bond refinance, that reduced funding costs by around a third. Core strengthening started with the new DB11 that launched in 2016 (more exclusive than the Porsche 911), the new Vantage (deliveries start in April) and the Vanquish replacement. This means the core sportscar models will have been fully replaced by the middle of 2018. With the heavy investment lifting done when developing the DB11, its proven technology, components and physical architecture could then be used when bringing the Vantage and Vanquish to market, reducing execution risk and keeping costs down.

AM is now moving into the portfolio expansion phase, creating new models to leverage both the brand and the technology already developed on other models. The resulting product strategy has three pillars: (1) sports & supercars (2) sedans, such as the four-door Rapide, and (3) SUVs. An important aspect is the intention to launch seven cars over seven years with seven-year lives to smooth development capex, averaging around £250mn p.a. through the cycle, although there will be natural peaks and troughs therein. Deposits from vehicle reservations provide most of the required capital, if not all. Contrary to mass market auto manufacturers, AM works to pull vehicle sales from demand, rather than pushing supply, thereby spreading costs further while increasing volume at better margins. As models move through their seven-year life cycle, AM is adept at limiting supply of more customised derivative models, such as convertible versions.

At this stage of the Second Century Plan, AM appears to have considerable traction as a highly exclusive, truly luxury brand in the car market. It is increasingly desirable to high net worth individuals – a strongly growing segment in the USA and Asia – and one that can usually absorb economic cycles without noticeable discomfort. UK and European sales are tracking very well. Average selling prices are up 20% to £150k in the current year and final 2017 results will see the group finish with its best annual profit in seven years.

Partnerships on luxury apartments, powerboats and submersibles, and the new sponsorship of Red Bull's F1 team have all been done very selectively and with little financial expense – the risk is reputational and therefore closely guarded. Revenue comes from licensing and royalties, with all capex investment undertaken by partners, who are very carefully vetted. AM will not be selling caps or otherwise putting their logo on every possible product; they do niche collaborations and licensing in areas that their existing clients are already very active. As long as AM sticks to its highly exclusive knitting, does not cheapen its brand, and maintains attention on its cars, it should continue to improve its bottom line.

Financials

Securing solid, long-term backers was the first good step in a long-term plan to revitalise the brand and, ultimately, its financial performance. They provided the capital to make AM truly competitive in its niche market. As the table overleaf shows, three years later AM is now demonstrating progress with a clear acceleration in performance during 2017 demonstrated by a steady improvement across revenue, profit and cash flow. It has been a long time coming, but the hard work and £1bn in capex spent since 2010 is finally starting to pay off. The £22mn profit before tax in the first nine months of 2017 is an excellent sign and the final quarter will see the normal seasonal boost from strong delivery rates as customers return from summer breaks and are available to take delivery. If AM meets its expectation for EBITDA to finish around £200mn this year, and that seems likely, leverage should drop down into the 3.5x-4.5x area from a high of 6.9x in 2016.

Management is looking to ensure long-term product development is funded from positive free cash flow, and that is very good news because in recent history it has been distinctly lacking in sufficient cash flow to cover its substantial and necessary investments. Operating cash flow has steadily improved from a paltry £21mn in 2013 to £150mn in the first nine months of 2017. There is increased probability AM will be cash flow positive after capex in 2018, and a possibility it will be also remain positive after interest, but management does not want to overpromise. Either way, there is a clear, positive trend.

Intangibles are high at £832mn, although only £242.6mn of that represents AM's brand. Goodwill is relatively small, at just £85mn. There is a bit of technology and intangibles related to its dealer network, but the largest part is deferred development costs, which totalled £347.3mn at the end of 2016. Deferred development costs include facilities, CAD and R&D with suppliers, and engineering. They arise from confirmed, feasible projects, with reductions made when models go into production and development costs can be released against their corresponding revenue. Payments to suppliers for development projects are generally staged against agreed deliverables, and that is when they shift to the income statement. In that sense, there is considerable value to the development intangible, but as usual we take the conservative approach, hence the deeply negative tangible net worth. As mentioned, leverage has been very high, but is heading in the right direction now that unit sales and EBITDA are rising.

Summary Financial Excerpts

£ millions	YE 2010	YE 2011	YE 2012	YE 2013	YE 2014	YE 2015	YE 2016	*9m Sep 2017*
Revenue	474	507	461	519	468	510	593	*567*
Cost of Goods Sold	390	334	313	352	313	345	372	*344*
Gross Profit	85	173	148	167	155	165	222	*223*
Gross Margin	17.86%	34.11%	32.12%	32.19%	33.07%	32.32%	37.33%	*39.39%*
SG&A	10.42%	30.96%	35.67%	33.37%	37.00%	43.74%	42.78%	*28.18%*
LTM EBITDA	98	71	67	73	57	75	87	*141*
Operating Profit	35	8	(9)	1	(18)	(58)	(32)	*64*
Operating Margin	7.43%	1.65%	(1.85%)	0.29%	(3.92%)	(11.42%)	(5.45%)	*11.21%*
NPBT	7	(33)	(34)	(25)	(72)	(128)	(163)	*22*
Operating Cashflow	102	72	100	21	58	75	165	*150*
Cash Interest Paid	14	18	35	32	32	32	33	*32*
Operating Cash Interest Cover (x)	7.4	4.0	2.9	0.7	1.8	2.3	5.0	*4.6*
Capex	85	66	102	103	123	161	190	*210*
Free Cash Flow	4	(12)	(37)	(114)	(97)	(118)	(58)	*(92)*
Cash & Equivalents	43	47	50	75	89	66	102	*72*
Trade Receivables	94	12	14	27	28	47	91	*92*
Inventory	68	66	73	70	98	80	117	*167*
Property Plant & Equipment	199	192	195	181	174	166	196	*226*
Intangible Assets	485	496	523	571	626	677	707	*832*
Total Assets	921	851	896	968	1,084	1,109	1,270	*1,426*
Trade Payables	64	51	47	50	61	64	93	*395*
Accruals	51	73	110	78	99	116	246	
Total Debt	304	296	336	311	432	549	701	*783*
Tangible Net Worth	(152)	(218)	(259)	(155)	(273)	(413)	(634)	*(745)*
Leverage (x)	2.7	3.5	4.3	3.2	6.0	6.5	6.9	*5.0*
Current Ratio	1.05	0.99	0.69	1.23	1.24	1.01	0.89	*0.78*
Inventory (days)	64	72.27	85.55	72.54	114.60	84.95	115.07	
Receivables (days)	73	8	11	19	22	34	56	
Payables (days)	60	55	55	52	71	67	92	

Accruals are also a notable figure, jumping from £116mn to £246mn in 2016. This figure includes deposits for vehicles on order, as well as capital accruals ahead of DB11-related tooling that flowed through to cash payments during 2017. The business has increased overall scale, and there was a particularly intense step up in activity over 2016 and 2017. With new models being designed and produced, selling at higher prices and selling more units, we see the effect quite clearly here.

Working capital reflects the investment in new models as well as general growth in the business. Suppliers have shifted out to 90-day terms, hence the bump to 92 days in 2016. Inventory has naturally increased to support the long-term strategy and reflects increased marketing inventory, as well as the combination of growing business and the seasonal peak. We will be watching to see where trade payables days and inventory days settle in coming years – ideally they will drop back a bit. Cashflow from operations has strengthened over 2015 and 2016, and covered interest payments several times over; they have room there to tighten up their working capital cycle a bit without straining cashflow.

The latest actuarial valuation of AM's defined benefit pension was in April 2014 and showed a minor surplus, but it has since deteriorated and a £70mn deficit liability has been recognised in the balance sheet. Recovery payments of around £2.8mn p.a. are being paid until March 2021 in addition to normal contributions. Improved performance could add up to £3mn more p.a. to the annual bill if targets are met. AM has held discussions with employees, unions and trustees, and will be moving to a defined contribution scheme. Payments to reduce the deficit will rise in future, but we do not expect them to be onerous.

As announced early this year, AM sold 5,117 units in 2017. It was an important milestone and underpins the positive outlook for a record result in 2017 and further improvement in 2018.

Funding

AM took advantage of money market conditions in early 2017 to refinance the bulk of its debt, leaving it with the maturity profile in the table below. What we have here is funding set up to finance the flow of work through development, production, shipping and finally to delivery to the buyer's local dealership. Development is funded from deposits, cash flow and with the RCF on hand. Inventory finance funds shipping until the cars are placed with dealers. Wholesale finance is coordinated by AM for the sale of vehicles to dealers and then the final owners pay cash or have

personal finance to complete their purchases. The group's capital structure is underpinned by the long-term bonds and preference shares

£ millions	2018	2019	2020	2021	2022	2023+	Total
Revolving Credit Facility					80		80
Senior Secured GBP 5.75%					285		285
Senior Secured USD 400mn 5.75%					290		290
Wholesale Finance Facility (off-balance sheet)	150						150
Inventory Finance	25						25
Redeemable Cumulative Preference Shares						246	246
Total	**175**	**0**	**0**	**0**	**655**	**246**	**1,076**

The **revolver** shares collateral with the senior secured notes, matures in January 2022 and is super senior. There are no covenants, but otherwise conditions are similar to the bonds.

Inventory finance includes coverage for inventory in transit domestically and from the UK to the USA and China ("on water financing"). The North American facilities total $10mn and AM can make drawings against invoices issued for cars sold. Drawings can range up to 90 days depending on the facility. AM is required to repay outstanding drawings at the end of their term. The Chinese inventory funding ranges across four facilities from local lenders and totals CNY 100mn. While AM is party to the agreements along with certain local dealerships, there is no recourse to AM. A £3mn facility finances certain inventory for the servicing business. In total AM had £7.4mn drawn under inventory finance facilities in Q3 2017 against total facilities of roughly £25mn.

Most sales from AM to dealerships are facilitated via **wholesale finance**, which is provided by Standard Chartered Bank plc. "Substantially all the risk" is transferred to Standard Chartered, and it is underpinned by credit insurance, hence the facility's off-balance sheet status. Aggregate risk for AM for the two years to August 2018 is limited to £200k, although there are additional circumstances under which AML/AMLNA may be required to repurchase a receivable (continuing default or receivable no longer enforceable, for example). Those circumstances are rare – there was one such instance back in 2009 and AM is now in a much better position to cope with such problems. The wholesale financing has been in place for 15 years and is renegotiated every 2 years. Having risen to £150mn at the last review, AM will likely seek to negotiate an increase in coming months to support anticipated growth. The cost resides with the dealerships that avail of it.

As mentioned, the **bonds** include a fixed charge cover ratio of at least 2.00x (secured) and a consolidated senior secured leverage ratio of 3.50x or lower. Those covenants do not preclude drawings on the CF or other permitted indebtedness. **Preference shares** arose from the long-term funding plan devised for the six-year Second Century Plan and drawn in two equal tranches in 2015 and 2016 as the plan progressed. The prefs carry 15% PIK interest and warrants for a pro rata allocation of P shares (non-voting ordinary shares) representing 4% of the fully diluted share capital of the company. The figure in the funding table represents principal and capitalised interest to September 2017.

Talk of an IPO valuing AM at £5bn would make a great payday for its private equity sponsors, who have supported AM through its transformation. That's a very high multiple, but even at Ferrari's current 18x multiple, or even substantially lower, there would be good scope to re-landscape the capital structure to a much more conservative profile. The flexibility that solid equity provides would serve it well, giving it room to continue crafting its models, reducing the cost of capital and thereby boosting profit margins. It would also reduce leverage, bringing it down below 2.0x assuming clearance of the preference shares, 40% clawback on the bonds and EBITDA at the expected 2017 level of £200mn. Obviously there is more upside with improving EBITDA.

View

There are two years of the Second Century Plan left to go, AM is on a reasonable footing and its new production facility in Wales will come on online next year. It is consistently producing attractive new models. It knows how to drive margins higher and leverage its powerful brand. Its shareholders have shown a lot of faith and capital commitment to AM over the past decade. Whether the market will be in the mood for an IPO when AM is ready is the question, but regardless, without any major missteps, AM should be capable of producing regular profits and covering its own development costs. That makes any sort of capital easier to come by.

Please contact the desk if you wish to discuss.

Penelope Fitzherbert

2 February 2018