COMMERCIAL VEHICLE BUSINESS IN SOUTH AFRICA: SYNERGIES AND RISKS FOR THE ITALIAN CARS GROUP

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“It seems to be a law of nature, inflexible and inexorable, that those who will not risk cannot win”.

John Paul Jones

“Risks come from not knowing what you’re doing”.

Warren Buffett
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To my Mom…my route, my best friend and the only woman of my life.
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Abstract

Some professionals say that assessing risks typically involves more art than science. Nowadays, given the fast evolving environment in which we live, understanding the opportunities and the risks related to a business activity are crucial elements for success. Especially when dealing with particularly volatile and fast growing markets or countries, quantitative risk analyses have to be combined with alternative approaches highlighting the qualitative aspects of the business risks. On-field researches are the crucial element for in-depth examinations.

During my summer internship at IVECO Italian Commercial Truck Service Center Ltd, I have been able to analyze and understand the key drivers and risks affecting the South African market, with particular attention to the commercial vehicle business. The owner of the dealer, an Italian entrepreneur called Luigi D’Ovidio, also managed to integrate the supply chain forward by initiating other complementary activities. Today, all of them go under the name of Italian Cars Group.

The stimulating work and experience made me take the decision to analyze how Italian Cars Group is generating value, whether or not it is able to exploit the synergies and if it is getting an appropriate and additional return given the risks affecting the South African market and the commercial vehicle business.

Key words: South Africa, Italy, entrepreneurship, synergies, risk, growth, commercial vehicles.
Introduction

The aim of this thesis is to demonstrate whether or not Italian Cars Group is providing an excess return with respect to the market comparable companies and if this excess return outweighs the excess risks that the company is facing given its location.

Chapter 1 gives us an overview and understanding of the African market with particular attention to South Africa and Johannesburg. Consumer spending as well as key risks have been analyzed, providing a deep overview and forecasts regarding the South African economy.

Chapter 2 analyzes the company. A deep analysis of the commercial vehicle business has been provided, with an overview of key drivers and risks. The company has been analyzed as well. These two chapters are crucial since they provide the information that justify data and numbers provided in the third chapter.

Chapter 3 compares the company returns with the ones of comparable companies. The internal rate of return for Italian Cars Group has been estimated and compared with the one provided by the market.
Chapter 1 - South African economy: a detailed macro- and micro-economic analysis

1.1 Opportunities and consumer spending in Africa

After almost half a century from independence, many economies in Africa are showing an increasing dynamism. A relevant data is highlighting this: annual economic growth across the continent has averaged 4.5% since 2000. Also, a forecast made by Oxford Economics suggests that the Gross Domestic Product (GDP) is going to outstrip that of any other region in the world between now and 2030.

There are four inter-related factors that led to this incredible success and that are going to guarantee the continent’s continued growth. First of all, all major armed conflicts have halved from the 1990’s level. This promoted a higher government stability and a stronger institutional infrastructure\(^1\). Secondly, we individuate the crucial role of commodities export. In particular, Oil and gas make up the single biggest category of exports from the continent. Not only has the commodity boom vastly improved the value of pre-existing African commodity exports, it has also triggered greater exploration and extraction, further boosting Africa’s terms of trade with the rest of the world. As a result, between 2000 and 2011 Sub-Saharan Africa’s annual exports quadrupled to reach $419bn, with natural resources contributing over three quarters of that growth. Furthermore, investments have played a key role in the last 15 years. Two key trend have been responsible for the growth contribution. Clearly, the extraction business took the highest share of foreign direct investments (FDI) and also the finance offer that was coming mainly from China\(^2\). Last but not least, we have the key role played by consumers. African consumer spending growth has averaged 3% per year since 2000, with growth as high as 10% in economies like Angola.

If the whole continent will be able to take care of the infrastructure and governance challenges, then the growth will continue to rise at the actual rates or even faster. At

\(^1\) Especially the rule of law. Also, accompanying reforms made it possible to control inflation rate level.

\(^2\) It has been estimated that China has financed projects for $100bn.
the moment, due to the expansion of the economy, Africa is urbanizing at a faster rate than any other continent and its major cities accounts for $700bn of the total GDP, meaning 36% of the country’s total output. By 2030, forecasts shows that the GDP of these cities will reach $1.7bn. Clearly the top cities also represent a large and growing consumer market with an average growth of disposable income of 5.6% per year and with a spending power that will rise from $420bn to $1trn in 2030, making Africa the world’s largest mass consumer market. Some major changes in the the distribution of economic output and consumer power have also been observed, making a switch from the cities of Northern Africa and South Africa towards areas of Sub-Saharan Africa. For instance, Lagos will double its population reaching the record of biggest city in the country and Dar Es Salaam in Tanzania and Luanda in Angola will grow so rapidly that they will reach economic giants like Cape Town, Cairo and Johannesburg by 2030.

### 1.1.1 Major cities

As anticipated in the previous chapter, changes in both the distribution of the economic output and consumer power have been extremely relevant for the growth of the whole continent. Figure 1.1 shows the 96 largest cities in terms of population in 2030 and the change with respect to 2012.

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3 Monetary values are expressed according to the 2012 rand/dollar exchange rate.

4 Source: Oxford Economics.
The larger the size of the circle the bigger is the city. The color instead depicts the change in terms of total population. The picture shows that 51 out of the 96 cities analyzed will see their population grow by at least 50% over the next years. As we can see, most of the fastest-growing cities are located in the east and west, much more than the northern and southern ones. The relevant aspect that we can understand from this analysis is that Africa’s cities are its economic powerhouse.
Figure 1.2 shows how big the cities will be in terms of GDP and how much changes there will be with respect to 2012.

Again, the size indicates the total GDP while the color represents the percentage change. In this case we can see that Cairo and Johannesburg will be the biggest in terms of GDP due to the fact that those two cities are embedded within more developed and diversified economies than the other peers. Despite the previous consideration, the astonishing growth of some other cities’ GDP will surely allow them to arrive at the

5 Source: Oxford Economics.
same level in a few other years.

Clearly, the population and economic growth of these cities translated in the growth in their consuming power. Figure 1.3\(^6\) compares the total consumer spending levels for 2012 and for the period 2012-2030. Cairo and Johannesburg will face an increase of 100% in their consumer spending while for cities like Huambo (Angola) and Abuja (Nigeria) the increase will be of approximately 300-500%.

The expansion of the consumer class in these cities signals opportunities for businesses of different kind. The key point is that the nature of these opportunities really varies from city to city because the difference in growth and also because tastes diverge a lot depending on the area.

\[\text{Figure 1.3}\]

African urban consumer spending

\(^6\) Source: Oxford Economics.
1.1.2 Customer diversity

By 2030 a new consumer class will have emerged, wielding total spending power that will top $1 trillion, from just $420 billion today. In places such as Lagos and Johannesburg, the expansion of consumer power will put them on a par with emerging market cities across the world.

It is extremely important to explore the evolution of the consumer demand in some major cities of the country because that is a crucial factor in order to build a business strategy that is able to serve it. In fact, the opportunities that one could find in each city will largely depend on the kinds of consumers rather than just the city’s aggregate spending power. The challenge is how to define the heterogeneous African consumer market since, as showed by figure 1.1 and 1.2, some cities have low per capita spending power but still growing fast in population terms while for some others exactly the opposite apply. We can individuate 4 types of consumer cities, as showed below.

1) **Volume Opportunity** cities: rapidly growing population will create a class of rapidly growing emerging consumer that are going to spend their money primarily on low cost items and essentials.

2) **Expanding Mid-Market** cities: both rapid population growth and high levels of consumer spending are going to let population spend their money on non-essential items such as hotels, restaurants and recreation.

3) **Mature Mid-Market** cities: high levels of per capita consumer spending that will make expenses on hotels, restaurant and recreation triple by 2030.

4) **Stable Essentials** cities: limited opportunities, with slow population growth and low levels of spending power per head.

Generally, across all of Africa’s cities, the fastest growing categories of consumer spending will be recreational and cultural expenditure (291%), restaurants and hotels (237%), and communications goods and services (231%). However, by far the biggest consumer categories will remain food ($120bn), and housing-related spending,
including utilities ($150bn)\(^7\). Figure 1.4\(^8\) plots consumer spending per capita in 2030 against the total population growth in the period 2012-2030 and helps us to distinguish in which category are located the 96 cities analyzed.

![Figure 1.4](image.png)

**Figure 1.4**

Africa’s consumer cities segmentation

The assumption is that cities with spending power per head above $5,000 in 2030 are considered *mid-market cities*. Also, cities above 60% level of growth are considered as the *expanding* or *volume* cities\(^9\). The majority of the cities fall into the Volume

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7 Percentages based on Oxford Economics forecast and intended by 2030.
8 Source: Oxford Economics.
9 60% is the average growth rate for Africa’s cities. This does not mean that cities below that level are not going to grow at high rates. With the purpose of isolating the best performing ones, the level of 60% has been chosen.
Opportunity and Mature Mid-Market categories, which are also the ones who reflect the major consumer opportunity in Africa.

As anticipated before, it is essential to see how the consumption basket of the typical African citizen will change over the next years. Figure 1.5\textsuperscript{10} can help us since it shows how the aggregate spending changed in absolute terms across the top African cities from now on. Leaving aside for now housing and food expenses, the relevant data for the purpose of this work is that expenses on transportation services and vehicle purchases is going to face an increase of 162\% (approximately 9\%\textsuperscript{11} per annum).

Figure 1.5
Consumer spending absolute change

\textsuperscript{10} Source: Oxford Economics. Specifically, the figure is based on consuming forecasts made by Oxford Economics.

\textsuperscript{11} 162/18 where the denominator is simply the number of years going from 2012 to 2030.
1.1.3 Industrial structure

Before analyzing deeply the South African economy, it is important to give a brief idea of the industrial structure and how it is going to impact the employment. The development of city population and the output growth are driven mainly by the manufacturing sector, which is able to absorb labor coming from the rural hinterland. The more cities develop and grow, the more land prices increase. This behavior pushes the manufacturing sector out of the city while replacing it gradually with sophisticated services such as retail, and financial and business services. In this context, public services typically increase both quantitatively, due to and in increase of tax revenues, and qualitatively, via a high health and education spending. However, this is not the only path observable. In resource-based economies, commodity extraction remains the main driver of the growth but much of the wealth is produced outside the urban area and consumed within them. This is a consequence of the so called “Dutch Disease”\(^{12}\) and the result can be that cities’ industrial structure will be based in non-tradable sectors such as consumer services and construction. Non-tradable sector growth is problematic because it limits the local supply capacity and makes prices (and so costs) rise to an uncompetitive level.

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\(^{12}\) It is a phenomenon in which currency appreciates due to increase in the export of burgeoning resources, by also making nascent export industries uncompetitive.
1.2 South African economy: risks and opportunities

South Africa is a middle-income country, but the majority of the population is still facing a high level of poverty due to a significant degree of income inequality. The population is now at 54.7\textsuperscript{13} million, with adult literacy is at 89% and life expectancy at birth is 59.6 years\textsuperscript{14}. The best performing economic sectors are mining\textsuperscript{15}, chemicals\textsuperscript{16}, car production, metalworking and machinery, textiles, iron and steel, fertilizer and foodstuffs. The economic activities are mainly concentrated in Gauteng province, which produces 1/3 of GDP, and Western Cape, which produces around 15% of GDP.

As far as industrial relations and the labour market are concerned, South Africans are free to participate and join in independent trade unions even if during the last years, due to difficult economic circumstances, strength and participation in unions decreased a lot. Nevertheless, this does not block unions from taking action to protest against job losses and to ask for higher wages and better working conditions. Also, unions are demanding that a share of the gains coming from South Africa’s economic expansion has to be given to the union members. The government is also trying to get the labour market more flexible. Regulations started to be implemented when it was discovered that companies, in order to escape labour regulation, health and safety issues and wage regulations, were relying more on the use of casual workers rather than hiring some of them.

It's important to be aware of business etiquette in South Africa since the culture on the workplace is really different from the European countries. First of all, South Africans are very friendly people and they really like to express affection openly with gestures such as, for instance, a shake of the hand. However, they are really reluctant to deal with foreigners\textsuperscript{17} and, more in general, with people they haven’t met before. Given this, it is extremely important to either obtain an introduction from a mutual contact or to draw the person’s attention to some South African business references in order to begin a business relationship. The attitude toward work is really different

\textsuperscript{13} Double the size with respect to 1970s.
\textsuperscript{14} Down from 62.0 years in 1990 due to the impact of HIV/AIDS.
\textsuperscript{15} South Africa is the world’s largest producer of gold, platinum and chromium.
\textsuperscript{16} It is the largest manufacturing sector accounting for approximately 5.0% of GDP.
\textsuperscript{17} In business.
depending on which kind of sector we are analyzing. In general, office hours are similar to those in Western countries and most South African do not work on weekends with exception of people in banking and government offices. The difference is also that the environment is much more slow and relaxed, which is affecting the productivity on work. There is a general indifference toward working, in some workplaces more than others, and even at Italian Cars Group this situation is perceptible. Some workers, especially black workers, are really slow at doing their mansions and a lot of them is absent from work for unmotivated reasons. The managers have to keep their eyes constantly pointed at them otherwise they are going to relax and take a lot of time to conclude their job. In some firms, it is also common that workers steal not only money but also products and then try to resell them on the street. These things happen not only in the SME, but also in bigger enterprises, highlighting the fact that the attitude toward work is not high. Further considerations regarding the labour market would be analyzed further since this is one of the major risks that affect profitability of companies in South Africa and so it needs to be deeply explained.

**Fiscal policy** in SA has the main objective to find the proper balance between supporting output and sustain government’s budget finances. The policy is focusing on providing social services for the poor, increasing capital spending on economic infrastructure and providing tax incentives for investment. The fiscal framework, in addition to the monetary regime and the exchange rate regime, are jointly contributing to create extremely good conditions for the one who wish to export from South Africa. The South African Reserve Bank\(^\text{18}\) is independent, although its actions are influenced by the finance minister. Monetary policy is based on inflation-targeting system, which means that the aim is to maintain the inflation objective in the range of 3.0-6.0%. The currency is the rand, which is free floating and exposed to very high volatility depending on investor sentiment, interest rate differentials between South Africa, and developed economies and changes in commodity prices.

**Exports** are clearly extremely influenced by the previous premises. Precious stones and metals are the largest category in the export profile, followed by mineral product and base meals. Gold is the most exported metal even if its share tend to vary

\(^{18}\) South African’s central bank.
depending on some external factors such as a weaker US dollar\textsuperscript{19}. Other important categories are vehicles, and machinery and electrical equipment. The euro zone used to be the leading destination for export, but things changed a bit over the last years because of the change in EU citizen’s tastes. Moreover, trade with countries like China and US is increasing. Exports will optimistically see an increase in the following years for many reasons. First and most importantly, \textit{the rand is an extremely weak currency}, which means that a foreign investor could benefit from having an extremely high purchasing power when entering the market. Secondly, prices for most of the goods are much lower\textsuperscript{20} with respect to the other countries. Additionally, some fiscal advantages were set to stimulate export activities that could potentially increase profits. First of all, when creating an export company in South Africa the Government is going to give you great monetary incentives and also, for every order executed, is going to instantly give you back the VAT\textsuperscript{21} (14\%). When doing such an activity you also need to have another company in the host country. Such a structure is particularly convenient because in this case the following system applies. The host company is getting payments in the host country so it potentially has to apply the tax rate on the revenues it generates minus the costs (which in the case of such an activity are really low). In order to benefit from South African fiscal regime\textsuperscript{22}, the company based in South Africa can now send an invoice to the host country company because the latter is basically acting in behalf of the first one\textsuperscript{23}. By doing so, costs for the host country company increase, meaning that the higher tax rate is applied on a really small amount of money, and most of the profit is taxed in South Africa (which has lower taxes). Furthermore, when considering such a structure and the extremely high volatility of the rand, one could also speculate on the exchange rate by bringing the money back in South Africa when the exchange rate is very high. All the previous factors, in addition to low prices, are setting very good environment for investors which want to enter in

\textsuperscript{19} During these periods where uncertainty is high, in fact, the price of gold tend to increase as foreign investors see it as a safe heaven.

\textsuperscript{20} Compared with products of the same quality in other countries.

\textsuperscript{21} Value-added tax.

\textsuperscript{22} Which is still more convenient with respect to the majority of EU countries and also others.

\textsuperscript{23} Since there is no precise way to evaluate which is the value of doing such an activity, for most of the people is convenient to pump the final amount so that they can have an even higher benefit.
such an activity. This suggests, again, that export activities are going to increase in the following years.

1.2.1 Country insight and outlook

The very first relevant data to check before focusing the attention on South African’s outlook headlines is that the near-term outlook varies significantly from country to country. Figure 1.6
d shows the outlook for South Africa, Brazil, Ghana, Nigeria and Tanzania. We can immediately see that the trend is deteriorating, especially for Ghana and Brazil.

![Figure 1.6](source)

Outlook for key regional countries

Generally, regional growth continues to decelerate because of the slowing demand from emerging markets and the prospect of an extended period of lower commodities prices (both oil and non-oil). This lack in the support of commodity prices will also widen fiscal deficits in addition with lowering public sector spending on necessary categories like infrastructure and healthcare. The final consideration on this regional insight is that the latest period of sub-par growth could be stopped with a comprehensive policy response which could accelerate it over the medium term.

Let’s now look at the country insight headlines. We can individuate four main areas of interest: credit, supply, market and political environments. Each of them has some

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24 Source: Haver analytics/Dun and Bradstreet.
critical issues to be solved, i.e. some risks have to be taken into account, and some opportunities.

The credit environment outlook seems to be stable over the next five years or so. Economic conditions and growth remained stable in the last few months, due to many factors just as the weakness of the currency and electricity shortage, and so was the rand. This stability allowed to moderate the inflation but not enough to lower interest rates and boost the growth. Growth in credit extended to the private sector remains below target, with credit extension to households lagging behind corporates by a significant margin. These conditions all together will leave the rand weak and the economy vulnerable to volatile portfolio investment flows in the near term. Also, domestic banks will face difficulties in increasing the profitability because of the slow growth. Despite these conditions, companies should expect sufficient access to forex markets in the next months but at the same time they should consider to hedge against increased capital market volatility and the potential for rand depreciation. This last observation will be discussed further in this work because it is one of the major issues regarding IVECO and its dealerships in South Africa.

As far as the supply environment outlook is concerned, let’s say first that South Africa’s infrastructure has improved greatly in the past decade so we can expect further substantial investments in the transport and power sectors. Recent electricity shortages have contributed to the decline in industrial production and also highlighted the energy infrastructure problem. The lack in industrial production will make industrial disputes be a feature of business environment especially because of the trade union movement and partially because of the lack of labour market reforms. Companies should keep updated with their own security procedures and safety of staff and also upgrade plans for steadier power suppliers. Overall, supply environment will be also stable in the next years.

Market environment outlook will be stable too. South Africa continues to attract FDI capital inflows but there is a risk of a reversal because of the uncertainty of the political situation. The weak rand and firming global growth will help sustain export revenues while slow domestic growth will complement the weak rand in keeping import growth contained. South Africa’s budget should be carefully managed in order to maintain the growth stable and to ensure long-run sustainability of government finances and public
debt. One of the possible next moves of the government could be to higher electricity taxes in order to fund national development plans. In general, banking, telecoms, tourism and mining present the most attractive investment opportunities also because they could offer a route into the rest of Africa. We should also expect some tariff barriers to be raised on industries such as automobiles and textiles although the risk is low. Overall, we can expect a growth in the domestic consumer market to pick up in the medium term as confirmed also by Figure 1.7\(^\text{25}\), which gives us projections of nominal GDP and GDP per capita until 2020.

![Nominal GDP and GDP per capita](image)

**Figure 1.7**
Nominal GDP and GDP per capita

**Political environment outlook** has been a very central topic during the last months. In this short paragraph there will be reported some general information regarding the situation before August’s election and clarifications will be provided further in this work. Political risk seemed to be low after the historical and ruling political party called ANC (African National Congress) was re-elected in 2014 for the fifth consecutive term. Risk seemed to diminish even more after Jacob Zuma, actual South African President, replaced Finance Minister Nhlanhla Nene and re-appointed his predecessor Pravin Gordhan. Actually, Zuma demonstrated several times his inability of governing the country and, in particular during the last year, he lost many consents among the whole country (especially cities where the white population is

\(^{25}\text{Source: Haver analytics/Dun and Bradstreet.}\)
preeminent"). This is clearly the evidence that political environment is far from being considered stable and without uncertainty. For now, it is important to highlight that policy development and legislations in terms of land reform and distribution, \textit{labour regulation} and environmental taxes could impact business operations and costs. This should be taken in account by firms since it is going to have a great impact on major businesses of the country also indirectly by, for instance, increase the volatility of the exchange rates.

\textbf{1.2.2 Case study: Johannesburg}

Johannesburg is the most populous city in South Africa with almost eight million people and is projected to grow by 16\% by 2030. It is the provincial capital of Gauteng, which is the wealthiest province in South Africa. Defined as “Africa’s world class city”, Johannesburg is also a consumer powerhouse with total consumer expenditure projected to top $138bn by 2030 compared with the approximately $65bn in 2012. The city has faced numerous difficulties since the end of apartheid in 1994, given the aftermath of the large-scale racial segregation, and reached high rates of poverty and unemployment – partly the result of labour market rigidities - and the social problems that accompany them. Nevertheless, economic growth in the city has improved since the mid-1990s, a reflection of the whole country’s improved economic performance and the lifting of international trade sanctions. Poverty is geographically concentrated within the city and the infrastructure in these poorer areas is weak. Unemployment in the city stood at almost one-in-four of the labour force in 2012. Johannesburg’s council has prioritized its sustainable reform and as a result large amounts of capital have been injected into improving the city’s infrastructure in the last ten years. Given the huge difference in citizens’ wealth, it also retains the characteristics of a very unequal city: shanty towns and poor levels of education contrast with skyscrapers and prestigious universities.

The ANC is considered the “Black Party”, meaning the political side who is doing black community’s interests, and some people also theorize that Zuma’s political philosophy includes some motives of revenge among the white community because of what happened during the apartheid (as demonstrated by some political moves that will be discussed further).
Given the analysis in paragraph 1.1.2, we can see that Johannesburg could be classified as mature mid-market city. Again, such cities are characterized by affluent populations that are comparatively stable in size. Consumers in these cities will continue to see strong average spending growth. Although the rates of growth will be less impressive than in some other cities (they start from a relatively high base), inhabitants of these cities will see the biggest increases in spending power in absolute terms. With Johannesburg residents seeing a per capita consumer spending increase in the order of $6,000 by 2030, growing affluence – rather than growing population - is the driver of commercial opportunity in such cities. As already anticipated, consumers in these cities begin to have substantial amounts of money to spend on non-essential items and so their consumption basket is also evolving. Figure 1.8\textsuperscript{27} confirms previous analysis and shows that Johannesburg’s consumption will remain basically the same in 2030 compared with 2012.

\textbf{Figure 1.8}

\textit{Stability in Johannesburg consumption}

There’s only few aspects to be highlighted. First of all, the decline in the share of food consumption in Johannesburg is not going to be as large as in other poorer African cities since people will substitute for higher quality and branded food products as they

\textsuperscript{27} Source: Haver analytics/Dun and Bradstreet.
become richer. In fact, luxury items of recreation, restaurant and hotel spending will triple in absolute terms reaching almost the 8% of aggregate expenditure in the city by 2030. Then again, even if consumption will be pretty much stable, the aggregate expenditure is going to have a huge increase passing from $68.5bn to the level of $138bn, 100% per cent increase in the whole period and 5.6% per annum. Lastly, also transportation and communications expenditure will remain stable over time.
1.3 Key risk factors analysis: outlooks and potential

The following paragraphs show in detail which are the key elements that influence the risks and the opportunities involved when doing business in South Africa. The categories are:

1) Short-term economic outlook
2) Market potential
3) Money market/exchange rate risk
4) Transfer risk
5) Business regulatory environment
6) Business continuity
7) Political risk
8) Expropriation / nationalization risk

All of them will be analyzed mainly in the short-medium term since 5 years is the horizon relevant for this work. Further, only three of them are going to be considered when assessing risk (which are key for Italian Cars Group’s business and activity).

1.3.1 Short-term economic outlook

South African economy will continue to slow in 2016; in terms of real GDP this means that a growth of 0,6% will be achieved, less than a half with respect of the 1,3% level achieved in 2015. A weak currency, deficits in fiscal and current accounts, slowdowns in emerging markets led by China and other structural bottlenecks are going to impact the growth, forcing it to its lowest levels since the previous recession ended. Figure 1.9\(^{28}\) shows the growth for real GDP and inflation until 2020.

\(^{28}\) Source: Haver analytics/Dun and Bradstreet.
In 2017 growth will accelerate slightly to 1.3% and at the same levels until 2019, years in which it will be recorded a small decrease. Focusing on 2016, recently ratings’ agency S&P held South Africa’s sovereign credit rating unchanged, ending weeks of speculation about downgrade in view of the economy’s severe outlook. A rating downgrade would have pushed South Africa into “junk” status and so the cost of borrowing in international capital markets for the government would have been costlier. Clearly, by avoiding the downgrade, the government will be able to implement the planned structural reforms that are targeted at improving South Africa’s public finances and helping improve investor confidence. Nevertheless, S&P kept South Africa’s outlook negative and a rating downgrade could happen as early as the end of the year if the government fails to show significant progress on these targets. A team sent by the International Monetary Fund (also known as the Fund) recently published a research containing a brief evaluation of the economy. While it was expressing positivity about the government and the South African Reserve Bank (SARB), it also highlighted the need for continued progress in implementing and continuing structural reforms, especially in the electricity sector. The Fund report also expressed doubts that the government will be able to meet the ambitious targets set in 2016 Budget since the low growth environment will make it increasingly more difficult to achieve them without subtracting support for the economy.

In conclusion, over the following five years, growth in wages will still support some household spending but will have a negative impact on business costs and consumer
price inflation. The upside risk to inflation and funding constraints will limit loosening of economic policy. Also, the public expenditure plans reinforce government commitment to infrastructure investment and weak rand will restrict imports into South Africa and raise payment difficulties for some importers.

1.3.2 Market potential

South Africa has the potential for a large increase in middle-class consumer households. The black majority is increasingly starting to demand for goods and services across a wide range of sectors. The country also has a various export base, which plays a key role in supplying the demand of various markets, and vast mineral reserves. Moreover, urbanization is boosting market potential but presents policy challenges, especially in regard of unemployment, income inequalities and poor municipal service delivery.

South Africa’s 2016 budget, as anticipated before, was generally business friendly and kept corporate tax and VAT rates unchanged. The recent electricity shortage has exposed the infrastructure deficit. To tackle this, the Budget allocates energy investment of ZAR70bn this year and an additional ZAR180bn over the net three years for the construction of new power-plants. Transport and logistics infrastructure also accounts for ZAR292bn in outlays over the next three years. Last but not least, black economic empowerment\(^29\) initiatives will continue to impose restrictions and costs directly on local firms and indirectly on foreign firms. This last two considerations are relevant for this work and will be explained further.

1.3.3 Money market/exchange rate risk

Given that South Africa operates within a flexible exchange rate regime, the value of the rand is determined by the market forces of supply and demand like any other commodity. The demand for a currency relative to the supply will determine its value

\(^{29}\) "Black Economic Empowerment” (BEE) is a racially selective program launched by the South African Government to redress the inequalities of Apartheid by giving certain previously disadvantaged groups”.
in relation to another currency. Theoretically, the demand for a floating currency - and hence its value - changes continually based on a multitude of factors. In the case of the rand, its current weakness can be attributed to a myriad of structural problems facing the local economy. The main determinants include the demand for a country’s goods and services (which is closely linked to the growth and national income of its main trading partners) and the domestic interest rate (if it is high it is likely to attract foreign capital, causing the exchange rate to strengthen).

But also additional factors serve to drive the currency down. These include the current account deficit. The current account deficit gets bigger when a country spends more on foreign trade than it is earning and has to borrow capital from foreign sources to make up the difference. This implies that a country requires more foreign currency than it is getting through sales of exports, and it supplies more of its own currency than foreigners demand for its products. This excess demand for foreign currency leads to depreciation in the value of a currency. Near-term FX risks are elevated due to South Africa’s large deficits in current account and budget. South Africa’s current account deficit widened from 4.6% in Q4 2015 to 5.0% in Q1 2016. Also, thanks to the weakness in the rand, exports outpaced imports and the trade deficit narrowed in Q1 but the overall current account deficit widened as the shortfall on the services, income and current transfer account increased. These deficits make South Africa vulnerable to the reversals in capital inflow that are expected as the US Federal Reserve continues its policy of interest rate normalization. The South African rand has been one of the worst-affected emerging markets currencies and further depreciation is expected.

It is interesting to visually analyze the volatility of the rand. Figures 1.10, 1.11 and 1.12\(^{30}\) shows the daily changes in EUR/ZAR rate over an horizon of respectively 5 years, 1 year and 6 months.

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\(^{30}\) Source: Bloomberg.
From the first graph we can easily see how the weakness of the rand increased during the last years. We can analyze also a very interesting thing: starting from 2015 the rand started to become more and more volatile. The reason has to be searched in China’s turmoil. South Africa’s currency lost 26% of its value in the six months after June
2015, date in which China started to face the “crisis”. This was when the Bank of China surprised markets by devaluing the yuan by 2% and changing the way it traded its currency. The aim was to weaken the yuan to boost its export competitiveness. This, coupled with slower economic growth, has aggravated the situation for South Africa as well as other African countries that rely on oil and mineral exports to China. The rand is expected to remain under pressure with many analysts predicting that it will fall further in 2016. But the rand is substantially weaker than it might have been. The sudden reshuffling of the finance ministry was seen as weakening one of the country’s key macroeconomic institutions and continues to undermine market confidence. This is a confirmation that also political stability is one of the main factors that influence exchange rates. The second and third graph shows us respectively how distance there can be between high and low peaks in one year and how much volatile the rand is on a daily basis.

Additionally, weak growth has led to currency weakness, which in turn has been the primary driver of high inflation. The weak rand has failed to provide the much-needed boost in exports, particularly manufacturing, which is usually associated with depreciation in domestic currency. South Africa’s lagging labour productivity and the scarcity of skilled workers are among factors that have contributed to declines in manufacturing in recent quarters, and rapid improvements are unlikely in the near term.

Despite fluctuations in global financial markets and the weakness of the rand, South Africa continues to have adequate levels of FX reserves. Data from the SARB show that gross gold and other foreign reserves increased from USD45.8bn at the end of December 2015 to USD46.8bn at the end of March 2016 as the gold component was revalued on account of the higher gold price. The country’s gross reserves increased further to USD47.0bn at the end of April 2016. A worsening of the global economic situation poses a threat to export earnings and the capacity to cover imports through FX reserves. Crucial portfolio investments are notoriously volatile and could undermine the rand and FX reserves in 2016.

Foreign investors should analyze the sentiment of the home country with respect to

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31 The volatility makes the South African rand one of the most traded currencies in the world.
32 International reserves before accounting for reserve related liabilities.
South Africa and consider the idea to hedge the exchange rate risk.

### 1.3.4 Transfer risk

Transfer risk remains stable in South Africa. The country has an adequate level of FX reserves and respects the obligations of Article VIII, sections 2, 3 and 4 of the IMF’s Articles of Agreement, which suggests no exchange controls operate on the current account. Regulation and supervision in the banking sector are strong and banks have developed credit risk management systems. Local banks should have little difficulty in complying with Basel III capital requirements, which will be progressively introduced in 2013-22, but liquidity targets will be harder to meet. Overall, South Africa will face a high economic and financial integration with the global economy and expect to have further steps towards capital liberalization and convertibility risk. Given South Africa’s vulnerability to external shocks, new capital controls are unlikely but cannot be fully ruled out should external conditions deteriorate. In the end, companies should expect to have sufficient access to FX in 2016 and the domestic banking system will remain well capitalized and continue to support selected projects.

### 1.3.5 Business regulatory environment

South Africa’s business environment is in good shape, especially if compared to other African countries. Plans about infrastructure investments in transport and power will improve the business environment in the near term and beyond. Relevant is also the willingness of banks to extend credit as economic environment improves and NPLs become less of an issue. The World Bank’s Worldwide Governance Indicators rates South Africa in the third highest quartile of countries surveyed, and much higher than the sub-Saharan Africa average. The World Economic Forum's 2015-16 Global Competitiveness Report ranks South Africa 49 out of 140 countries (from 56 out of 144 in 2014-15). The country is held back by aspects of infrastructure (particularly power), general health, education and training of the workforce, labour market efficiency and crime. A big deal is corruption, which is considered to be a problem in South Africa, adding to the cost of doing business in the country. Official corruption,
particularly in the Department of Home Affairs and the police force, is a concern. Transparency International’s Corruption Perceptions Index ranks South Africa 67 out of 175 countries, slightly better than 72 out of 177 countries in 2012. Corruption is among a list of structural constraints (others include skills shortages, high unemployment and crime) that act as a drag on economic growth. Overall, labour policy will become more interventionist under the pressure of the Congress of South African Trade Unions to preserve jobs, wages and benefits. Investments in transport and electricity networks will continue and improve business performance, but power tariffs will rise sharply, and also customer protection laws will rise and add costs to business.

1.3.6 Business continuity

South Africa is not exposed to natural disasters. The country’s natural disaster risk is low compared with other countries on the African continent. Estimated annual economic losses from natural disasters have been less than 0.25% of GDP in the past decade. The transport infrastructure is relatively well developed by regional standards but can be poor in some areas. Electricity supply is tight in South Africa, with reserve margins very low and blackouts can occur. Regarding logistics and infrastructure, South Africa ranks among the world’s top countries as measured by the World Bank’s Logistics Performance Index, coming 34 out of 160 countries. Business continuity can only be threatened by the ongoing electricity shortage. Eskom has been forced to shut down several units for the lack of maintenance, unstable power grid and inadequate generation in recent months. This has resulted in frequent power-cuts affecting both businesses and households, and is weighing down already weak growth prospects. The power crisis has intensified in 2015 and mismanagement at Eskom has emerged as a major impediment to a solution. Also, last year Eskom had accepted in parliament that it cannot guarantee electricity supply security for at least another five years, until construction is completed on its two new coal-fired power stations at Medupi and Kusile, which will add nearly 10,000MW to the power grid. In the meantime, however,

33 Eskom is the state-owned power utility.
power-cuts are expected to continue and are part of the bigger downside risk of an ageing and deficient infrastructure. South Africa’s failure to generate adequate electricity, persistent power-cuts and the load-shedding that has plagued the country since the beginning of the year is affecting businesses, production, and even consumers. To conclude, firms should really consider the hypothesis of relying on renewable and more green energies in order to face the electricity shortage issue.

1.3.7 Political risk

The risk of political instability increased especially during the last years. South Africa is not engaged in armed conflict with any of the nearby nations and has no active secessionist movements. There are few major security risks in the country, with the exception of crime. High rates of crime (particularly serious and violent crime) against businesses and individuals are a cause for concern and something the government is attempting to address. But the risk of civil disorder remains generally high. In fact, South Africa suffers from high unemployment, income inequality, slow land reform and poor service delivery at the municipal level. These issues can spark civil protests which can turn violent. Trade union-driven industrial tensions (including strikes and demonstrations) are frequent impediments, particularly in the mining and transport sectors. In addition to the direct output loss, persistent labour troubles reduce South Africa’s attraction as a business and investment destination and extensive structural reforms are needed to address issues in the rigid labour market. Labour market volatility is likely to remain an issue in the near term, undermining productivity and business costs.

1.3.8 Expropriation / nationalization risk

South Africa has actively pursued a privatization policy and is very open to FDI. Future privatization opportunities are likely to be limited by nationalist sentiment and the strength of the political left. However, the risk of expropriation or nationalization is fairly low in most sectors, but highest as far as land ownership is concerned. Land reform and redistribution will be subject to new legislation that could include a bar on
foreign ownership of agricultural land and the setting of maximum size limits for farms. Farms in excess of the limit could be compelled to downsize or face expropriation (with compensation); the legal basis for expropriation is being drafted in separate legislation. The risk of nationalization in the mining sector has diminished, but greater controls may be imposed through the amendments to the Mineral and Petroleum Resources Development Act of 2002.

The analysis in this chapter is key in order to understand which were the drivers of Italian Cars Group profitability and how the latter is going to modify in the following years (especially in the near term). Some relevant aspects exposed until now are going to be considered and assessed further in this work.
Chapter 2 – Italian Cars Group: company presentation and analysis

2.1 History

It would not have sense talking about Italian Cars Group without spending some words on the sole owner and actual Managing Director: Luigi D’Ovidio. He was born in Trivento, a small village in Molise (Italy), on January 1940 and immigrated to South Africa when he was 15-16 years old. Once there, he immediately applied his skills and abilities to found the empire which he proudly owns today.

Some years later, when he turned 22, he was appointed Chief Mechanic for Ernest Pieterse, former Formula One racing driver from South Africa. Luigi then boosted his career with Pieter De Klerk, a great engineer and mechanic who then became his mentor, on the Kyalami circuit with the Alfa Special. This car’s chassis was entirely designed and built by him and Pat Phillip and maintained constant grid position alongside John Surtees and Lorenzo Bandini. Luigi then supported a number of local racing drivers including Gary Formato, Steven Watson, Wayne Taylor (South African Champion in Formula Atlantic and World Champion in Sports Cars) and Stephen Simpson (Formula Renault driver for Durango Racing).

After many years in the world of racing cars, in 1968 Luigi became an Alfa-Romeo and Lamborghini agent and established the Italian Cars Tune-Up Centre in Johannesburg. This was the start of Luigi’s business empire. Luigi worked shoulder to shoulder with Pieter De Klerk and Ken Howes, another great engineer who went on to be top engineer for Hendrick Racing on the Nascar Circuit in America. During this period, Luigi also worked with Hilton Cowie in England with Fred Goddard’s F3000 team.

In 1970, Luigi founded Italian Panelbeaters in Denver, 434 Main Reef Road, where it still flourishes today. This was the start of Italian Cars Group. Thanks to his knowledge and experience, and also because of his networks in the business world, Luigi managed to expand his business until he decided to initiate the first IVECO Dealership in South Africa, which he named “IVECO Italian Commercial”. It is located near Italian Panelbeaters, in 437 Main Reef Road, and is now the flagship enterprise of Luigi’s
commercial empire.

To sum up, the company’s activities are many. In figure 2.1 we can see IVECO Italian Commercial’s headquarters.

![IVECO Italian Commercial Headquarters](image)

**Figure 2.1**
IVECO Italian Commercial Headquarters

Here we can find the IVECO dealership, the workshop for maintenance services, the parts’ shop and the offices. Right in front of it we can find another building in which we can find Trivento (the truck rental company), another workshop (which in this case provides services only to Trivento’s customers and for private cars’ owners) and two warehouses for bigger parts and trucks.
Figure 2.2\textsuperscript{34} shows a satellite image of the area in which the company is located. In blue we can find the Iveco Italian commercial buildings, in red we can find Italian Panelbeaters buildings while in yellow we can find the warehouses. This also gives us an idea of how big the company is, which is key in regard of the estimation of its value since all these buildings are owned by the company.

\textbf{Figure 2.2}
Italian Cars Group estate

Before describing more specifically the various activities it is good to highlight one point. The company is a family business and, even if there is not a holding company and some subsidiaries, all the operations are directly managed by Luigi, his daughter Tonia and his wife Dolores, which in turn are responsible financial and administrative matter (including invoices track recording and bank account safekeeping). The key assumption of this work is that we are going to consider Italian Cars Group as a unique entity since the operations and accounts are centralized and managed as a whole.

\textsuperscript{34} Source: Google Maps.
2.1.1 IVECO Italian Commercial

The dealership with IVECO accounts for the major part of the revenues of the company. It has been established 24 years ago and for all these years it played a key role in the success and promotion of the IVECO brand in South Africa. This is confirmed by the fact that it is the oldest existing IVECO dealership in South Africa. IVECO is one of the best manufacturer in the world and also an Italian flagship. It has recently been acquired by CNH, which is part of the FIAT Industrial group. It provides many kind of commercial vehicles to the South African dealer but we can limit the range to four main categories: Daily vans and Eurocargo, Stralis and Trakker trucks. These products are extremely different between them but have one, very important characteristic in common: quality.

Daily is the smallest kind of van that the company sells. They account for the biggest part of the revenues. Eurocargo and Trakker are two medium-size kind of trucks but very different from each other. The former is for the on-road travels while the latter is for the off-road ones. The Trakker is not sold as much as the Eurocargo. Depending on the customer’s preferences Daily, Eurocargo and Trakker can be modified and adapted by intervening on wheels, roofs, chassis, fenders, traction and trailer. The daily is the main choice for small companies operating in various businesses such as transportation or construction. In addition to the Eurocargo line, it is a first choice for the public sector agencies and municipal service contractors because of their adaptability to a wide range of jobs.

**Customization** is core in this business, since a bad combination of parts could make the truck useless and exposed to serious damages. Many different companies request quotes to Italian Commercial and their needs are completely different. For instance, let’s suppose that a company works in transportation. They provide services in Johannesburg’s area but sometimes it may happen that they move further. Also, 90% of the road is straight while the remaining 10% is an off-road route. First of all, in this case the proper product is the Eurocargo. Nevertheless, it could not be given stock to the customer since he/she would be facing a problem while covering the off-road path.

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35 IVECO also has other lines of products such as Bus, Defence Vehicles, Astra and Magirus. There’s not a big market for these kind of vehicles in South Africa so they are going to be ignored.
In this case it would be better to request to IVECO a truck with a higher fender and a different chassis, in addition to wheels adaptable to many grounds. Also, since it may happen to undertake few days travel, it may be responsible to take a long, high roof in order for the driver to sleep into the truck instead of a hotel (and so facing lower costs).

The Stralis is only for on-road travels and not intended for the off-road. All the characteristics may be adapted depending on the travel’s length that the company is going to undertake. The company is working extremely well with this product thanks to its quality and its lower price with respect to the competitors. Further details are going to be explained further in the chapter.

Overall, we can rank the products in a decreasing order as follows: Daily, Stralis, Eurocargo and Trakker.

It is important to understand how the selling process works. Figure 2.3 helps us to understand the process.

Figure 2.3
Sale process

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36 A longer and higher roof allows for the inclusion of a bed and also make it more comfortable for the driver.

37 From the best to the worst in terms of sales.
The dealer is nothing more than an intermediary between IVECO and the customers. It is defined as “a business that sells new or used cars/trucks at the retail level, based on a dealership contract with an automaker or its sales subsidiary”38. The first step is clearly to find the clients and the company has various methods. The first and most used is acquiring clients by its huge networks in various business and government. The second method is to directly call the potential clients after some market researches. Last but not least, since this reveals the true value of the company, existing clients bring new clients. Once the client is satisfied with his truck, he/she pays the selling price to IVECO (passage number 1) and gets the truck from the dealer (passage number 2). IVECO then pays the fee to the dealer (passage number 3). The fee and the selling price clearly varies depending on the situation. In fact, IVECO provides a document to the dealer which contains the suggested retail price and the standard dealer billing computed by considering the commercial discount39. Considerations on how the selling price varies will be done in paragraph 2.2.2 because it is key in regard of the profitability of the company.

38 This is Wikipedia’s definition
39 The commercial discount varies depending on the truck. It is usually 10% on Daily vans, 10-15% on the remaining on the Eurocargo, and 20% on both Trakker and Stralis.
2.1.2 Trivento

Trivento is the part of the company that provides rental truck services to the public and also to the existing clients who need to hire a truck while their vehicle is in for some major maintenance or repairs. The vehicles are all in perfect conditions and they also provide a 24/7 assistance on the trucks in addition to a driver if needed. This is ranked as the second part of the company in terms of contribution to revenues. The float is composed by approximately 100 trucks divided as follows: 10 Daily vans, 45 Trakker and 45 Eurocargo.

The strategy that the company uses to rent these trucks is the following. First of all, they prefer to work mainly with medium-long term\textsuperscript{40} contracts. In particular, the company constantly tries to rent from 60\% to 75\% of the whole float with these contracts. The 25-15\% is rent day to day and the remaining 15-10\% is held inside of the company and used for its daily activities and as substitute vehicles for existing clients. This strategy has a precise purpose and it will be discussed in paragraph 2.2.2 as well.

2.1.3 Parts

As already discussed before, inside the IVECO Italian Commercial’s building, the company also has an area in which it supplies parts to the clients and to the workshops. The team is able to supply customers with a full range of IVECO parts as well as other makes or brands, due to the fact that they also repair cars in one of the workshops, such as Lamborghini\textsuperscript{41}, Maserati\textsuperscript{42}, Ferrari and Alfa Romeo. Further considerations about the profitability of this area will be done in paragraph 2.2.2. Just one note before going ahead. After the merger with CNH, the company registered a slow decrease of parts’ sales and the reason, after a careful analysis, has to be searched in the customers’

\textsuperscript{40} By medium-long term we intend 1-2 years.
\textsuperscript{41} Mainly Espada, Mura and Jacuna models.
\textsuperscript{42} Mainly Cyalami and Ghibli models.
perception of the new brand\textsuperscript{43}.

2.1.4 Panel shop and maintenance services

As we previously said when discussing Figure 2.2, the company has two different workshops: one is based right beside the IVECO Italian Commercial’s offices (workshop n°1) while the other one is part of Italian Panelbeaters’s estate (workshop n°2).

In workshop n°1 many different kind of activities are done. The first one, which takes the major part of the work, is the fixing up of the ambulances, Eskom\textsuperscript{44} vans and also some police vehicles. The company, in fact, has very big contracts with the government and with big corporations and these are the ones which provide the biggest part of the work. Other than this, the company also provides maintenance services to clients who bought trucks from IVECO Italian Commercial and to other smaller corporation and enterprises, especially the ones in the low-distance/low-volume transportation business. As a consequence, the workshop is flood everyday by Daily vans converted in ambulances, mini-buses and others. It is also common to see bigger trucks such as Eurocargos but in a much lower amount relatively to the smaller vans. Workshop n°2 is intended only for the Trivento’s business and for cars fixing but it is not uncommon to see mechanics working at something that is coming from workshop n°1\textsuperscript{45}. In these place, a huge number of activities is carried on but the most frequent are: Trivento’s trucks are rent to customers, and cars and vans of various brands are fixed up.

At the end of the day, both workshops are used as a storage place for the new trucks and vans exposed outside and Trivento’s trucks\textsuperscript{46}.

\textsuperscript{43} Parts report the CNH logo rather than the IVECO logo. People got used to IVECO brand, since it was guarantee of quality, and perceived this change as a change in quality too. Things should get better in the short term.

\textsuperscript{44} Eskom is the state-owned power utility.

\textsuperscript{45} It may happen that in Workshop n°1 there is no space for the trucks or too much work to do.

\textsuperscript{46} In fact, the two warehouses highlighted in yellow in Figure 2.4 are not enough and more space is needed for the storage of both new and used trucks.
2.2 Commercial vehicles business in South Africa

In the near future, there are two worldwide markets for trucks. The first one is Europe, North America, Japan and industrialized East Asian nations. It is characterized by a high level of environmental regulation and sophisticated demand for technological improvements and other features. However, this is slow-growth market. The faster growth will be observable in the BRIC countries, Asia, Africa and Latin America. Since they are less interested in technological features, Chinese and Indians truck makers are producing the sorts of vehicles that succeed in there markets\textsuperscript{47}: their products seem to be well suited to the imperfect infrastructure of emerging markets. Ideally, global truck makers should keep in mind some facts. First of all, they should avoid India and China as markets, since there is overcapacity. Secondly, they should be able to innovate their products and expand their presence in countries in which they already operate. Last but not least, they should start to produce low-budget trucks; this would create a shift in operating models (i.e. increasing costs) but for those that can make the transition, an enormous global opportunity is available.

2.2.1 Market analysis

The market in South Africa, and in particular Johannesburg’s area, is quite huge. Total new units sold every year are approximately 5000-6000, expected to increase by 5-10\% by 2020.

A number of key players dominate the market other than IVECO, which opened a branch in Johannesburg and accounts for approximately 25-30\% of the new trucks sold every year. We can find Mercedes, Volvo, Scania, Isuzu e Nissan. Currently, IVECO is positioned well in the market since it offers the same quality of other competitors like Mercedes but at lower prices. The only problem is that the price is still a little bit higher with respect to the Chinese competitors so it still faces problems to increase the market share.

The market share is not so high for IVECO because of a number of key elements.

\textsuperscript{47} They produce lower quality trucks and they succeed because people are really price oriented.
The management until a few years ago have not been able to succeed in managing the operations, creating value for the company and increasing the brand’s name. Starting from 2013-2014, a radical change in the structure of the company allowed to reduce the high debts that they had but still some other errors have been made. They moved in another building that not only is positioned in a really unfavorable area but is also organized really bad. In fact, they only have offices and a warehouse for parts. Let’s say that, for instance, a client should substitute a light bulb. He/she should undertake one trip to buy it from the IVECO and then undertake another trip to assemble it in another workshop. The result of this structure is one: higher costs for the clients. The ideal structure would have been having the offices, the parts’ warehouse and the workshop all in one area so that, when a client is in need, he/she can be able to buy a new truck, buy some parts and receive maintenance services in one time and by undertaking one trip. Marketing have also been shabby with respect to the other competitors making the situation difficult for Italian Cars Group, which always made profits from this activity despite of IVECO’s errors. To conclude, thanks also to the help of the various dealers, the market share for IVECO should slowly increase during the next years but, again, the management should really reconsider the whole company’s structure.

It is really important to understand who are the potential customers and what are their needs. The slowing down of the economy had a big impact on their preferences and more specifically they are going more price oriented, switching to less expensive (i.e. lower quality) products. Not a very good news for IVECO which produces some of the best quality products that one could find in this market. As far as Italian Cars Group is concerned, a partition is made among the clients. In particular, ICG focuses its attention only on small and medium clients, i.e. clients that buys at max 25-30 trucks because bigger clients tend to purchase trucks directly from IVECO in order to have a bigger contractual power. By looking at what are the best selling products we can also understand two market’s need. For the Italian Cars Group, the daily line is the best

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48 Considerations regarding the importance of the area will be made in the next paragraph.

49 More time, more fuel, more services.

50 For clients who buy bigger stocks, the company also get 1 or 2 trucks more to make sure that the client instantly gets a ready-to-go truck if one from the stock gets broken.
selling one; it has the same quality of Mercedes’ comparable line and it is customizable according to the client’s needs. Eurocargo is the second one; it is also customizable but, in terms of sales, it is going to be more steady. The third product is the Stralis, which sales are exponentially increasing because it provides the highest quality/price ratio with respect to the rest of the market. The last one is clearly the Trakker, which is the line that has the smaller market. What we can understand is that there is a very small need for completely off-road trucks and that clients really want the chance to customize the final product.

Let’s take now a deeper look at how the company is making profits and what are the major risks affecting the market.

### 2.2.2 Company profitability: key strengths and weaknesses

First and foremost, the **fundamental key strength** of Italian Cars Group is the *quality of the products and services it provides*. Luigi D’Ovidio, with his experience and his natural intuition with people, has been able to put together some of the best managers and employees that could be found in the job market. This is the unavoidable value without which the company would be worth nothing. The ambience is unique and the company works as a perfect machine: everybody is in their places and perfectly know what are their mansions. This characteristic has an impact on revenues and, more in general, on the value of the company. As we previously discussed, customers’ satisfaction is key because, as a consequence, the *existing clients bring the new ones by suggesting them to go to the Italian Cars Group*. This is testified by one important fact: *in 20 and more years of activity the company had zero comebacks*. A higher number of sales and customers’ satisfaction translate into a higher value of the goodwill and so also a higher value of the company.

Secondly, the **geographic position** of the company is extremely favorable. Italian Cars Group is based in the area where all the trucks from various different companies are parked and so it is quite common for companies in that area to get maintenance services and buy parts during the day. But the key aspect is this, the company is positioned right beside the entrance/exit of the highway. In this way, all the trucks that are doing long trips always stop there for the check up. They get a lot of clients in this
way because from there you have access to both the Capetown and Durban roads.

Before seeing more in detail the process, another thing should be considered. Differently to the other IVECO dealerships in South Africa, Italian Cars Group does not have any debt and other partners. Everything, from the workshop to the offices, is property of the company so for the computation of the value also this should be taken into account. They also do not have debt with IVECO. There is no doubt that this is a good thing for the Italian Cars Group since they are the best performing dealership in the whole South Africa and having a partner or having debt would be in turn sharing the profits with somebody else and also have a shortage of liquidity. Only one thing with debt. Other dealerships have very big debt with IVECO but for them this is not a bad thing. One of the advantages of having debt is that the counterparty (in this case the IVECO) is interested in letting you work and have profits and so it may be tempted to lower the dealer billing or maybe accept a delay for the payment. This is what usually happen, however Italian Cars Group having debt would represent trouble because it may not be as much independent as it is now and the final consideration on this theme is that things work like this and there is no need to change this structure. Again, the impact on the value of the company is positive also in this case.

It is important to understand the **organization** of the company in terms of sales, services and synergies. First of all, as we already explained, the company is placed in the last part of the supply chain; it does not construct and assemble trucks or dealing with the management of IVECO, it just provides sales services and post sales services. The way it is organized make it a money machine, as we will explain now. Everything moves around the IVECO Italian Commercial, as this is the activity that accounts for the major part of the profits. IVECO provides a list for the suggested retail price and the standard dealer billing. The company doesn’t really take care of the suggested retail price, as they try to sell the products by setting some margins and try not to sell if they are under that. In particular, the margin is 30,000 rand for the Daily line, 50,000 rand for the Eurocargo, 80,000 rand for the Stralis and 100,000 rand for the Trakker. They do not really care about the upfront investment because they do not have to pay for it; it is the client that send the payment to IVECO and the dealer only gets the money in excess of the standard dealer billing. If one considers the upfront investment and

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51 Most of the trips have as a destination one of these two cities.
applies the margins for every product, the minimum acceptable return would be 7.32% while the average maximum discount to customers would be 11.31%. Here it comes the first weakness. By using such a scheme, the company is applying the same margin on products that could be different in terms of upfront investment. The model provided on the excel sheet highlights that on some trucks, they are only making 3% to 5% (sheet 3, column D). Two are the possible way to solve it. The first thing is to apply the 7.83% rate to all the standard dealer prices and it is highlighted in yellow: this makes margins higher for the Daily (which is good given the higher demand) and lower for the Trakker line (it is good because the Trakker has a very small market). The second method would be just to set a minimum required return for every category so that, if it falls down that limit, it will higher the minimum margin (this method is highlighted in blue). Overall, the company is usually making a return of more than 7.83%.

The important thing is to understand how the other parts of the company are integrated and which synergies they use. So once the truck is sold, then the company also provides for all the warranty services and parts’ supply services. The interesting thing is how the company is able to retain the clients and push them to buy again from them. First, one important thing about the trucks. Usually they become pretty useless after 650,000-700,000 kilometers have been made. After this amount of kilometers, it is better to sell the truck in parts rather than dismiss it as a whole. So what the company does is to allow buybacks: by doing so the client is able to get some value back by getting a discount on the new truck and to avoid the time expensive process of selling it in parts. Italian Cars Group then gets the trucks, repairs them and sell them as second-hand trucks. It is working at creating a place to resell them which will be ready by the end of 2016 and will increase even more the profits. Trivento also contributes greatly in terms of profit. The convenience of having such a branch in the company is clear: you are allowed to pay trucks much less with respect to competitors (since you also own the dealership) and you also provide the maintenance without paying extra money. As we already explained in paragraph 2.1.2,
the company has a precise way of managing its trucks. The strategy is very interesting. First of all, they use only trucks that can be rent even on a daily basis. In fact, it is quite easy to rent each truck everyday because a lot of companies usually don’t hire a transportation firm. It would be time wasting to rent all the float every day so they lock as much trucks as they can with medium-long term contract and then focusing the attention on renting just a small amount. Cash flows are maximized from implementing such a strategy and they are also much more steady and predictable. It is important to have parts on the place of work, so that they will be ready to be provided to the clients when there is the need.

As far as the weaknesses are concerned, they all come from external risks and so will be analyzed in the next paragraph. In conclusion, Italian Cars Group provides activities that are all complementary between them and this makes the group extremely efficient and profitable.

2.2.3 Key risks affecting the market

In the short, medium and long term the South African market, even if it is more developed with respect to other Sub-Saharan countries, is going to see a really high growth. The short-medium term will be taken into consideration from now on given the higher rate of predictability. We have already seen that the commercial vehicle business is going to be affected positively by the high growth of the whole country, however some major risks have to be taken into consideration in order to assess whether or not the profitability is justifying them. In chapter 1, some of the key major risks have been analyzed and explained. Regarding the short term outlook is important to understand that, overall, it is favorable with only some little constraints like the possible rating downgrade that could increase costs for businesses. Actually this risk is particularly high and there’s a chance of 50% to happen. It would not be a big deal since the increase in costs will be covered by an increase in the revenues due to the overall growth of the economy and an increase of the public expenditure in infrastructure. These two factors are going to offset the increase in costs. The conclusion is that this increases the risk taken by Italian Cars

55 We intend five years.
group but it may be avoided in our discussion since the profitability will be leaved unchanged.

**Business continuity** will not be a big problem too. The only concern (possible future electricity shortages) has already been taken into account by the company and in fact an independent power unit had been previously bought. This has a 15% chance of affecting the commercial vehicle business in general, but a 0% chance of affecting the Italian Cars Group profitability in further years.

**Transfer risk** and **Expropriation / Nationalization risk** can also be avoided since the first will only promote the economic and financial integration with the global economy while the latter is not going to affect the commercial vehicle business. In percentage, the chance to see the one of these two risks affecting the whole business and the company is 0%.

The first issue, and also the biggest one since it is directly affecting and increasing other risks, is the **Political risk**. Actually, this is probably the only one risk that is going to affect with a 100% chance the company profitability in the next five years. As explained in the first chapter, actual political party ANC is demonstrating inability in managing the country. The increased criticism about Zuma’s conduct is making people questioning whether the Government will fall before the general election of 2019, with more and more betting regarding the non-reelection of the ANC. Translated in other terms, **the next five years will be characterized by a really high uncertainty that is going to affect negatively the major part of the businesses, including the commercial vehicles one.** Actually, the political risk created and enhanced some other risks: it has been the spark that made the fire burn up.

The first big consequence is in regard of the **Market potential** and, in particular, as we have already said the **black economic empowerment (BEE) initiatives will continue to impose restrictions and costs directly on local firms and indirectly on foreign firms.** There’s a 100% chance that these initiatives, which include hiring a minimum number of black people in case the owner is white and providing skills development program for them, are going to affect the Italian Cars Group profitability for the next five years just like they did during the previous years. This risk alone could potentially not affect the company. It actually does because there is another risk to take in consideration and it is the **labour productivity risk.** Most of the workers, especially
the black ones, suffer of a really serious lack of education and skills\textsuperscript{56}. It has been estimated that three low skilled black workers have the same productivity of one medium skilled white worker\textsuperscript{57}. Combined together, the obligation to hire black workers and their clear lack of skills, had a severe impact on both costs and revenues: the same number of workers were generating much less revenues. In order to maintain the revenues at the same level or to make them grow, the company had to hire more workers than the number it needed with the consequence of increasing the costs, which were represented by a\textit{higher number of salaries and also monitoring cost}. Considering that the \textbf{Business Regulatory Environment} is modifying and direct interventions have been promised, and also considering that the company constantly tries to substitute the least productive workers, the chance for the labour productivity risk of affecting the business in the next five years has been estimated to be 100\%, with a possible decrease of the impact starting from late 2018. The mixed effect of the BBE initiatives and labour productivity skills already pushed costs up by 10 million rand a year since 2014. In case of more degenerative and useless political reforms, costs could increase by at least another 5-10 million a year in the worst of the cases.

There is one last risk that has to be taken into consideration: the \textbf{exchange rate risk}. As we already analyzed, its volatility is due to a combination of factors such as the China’s turmoil and the political risk. It is the reflection of the instability of the country. The exchange rate risk is having some relevant impacts on Italian Cars Group. First of all, due to the volatility of exchange rate IVECO increases trucks’ prices two or even three times a year by 3\% and parts’ prices two times a year by 3-5\%\textsuperscript{58}. This increase in prices is not going to affect the costs of the companies, since the dealership does not pay in advance for the prices of the trucks, but it is going to affect the revenues in two ways. First of all, the constant and many increases are going to make IVECO trucks too costly with respect to the Chinese competitors so the dealership could lose some potential clients. Not only this because then, in order to sell more, IVECO Italian

\textsuperscript{56}It is a clear consequence of the Apartheid.

\textsuperscript{57}These estimation comes from personal researches, after careful considerations and analysis of all the possible factors that could have led to this situation had been made. On field researches are in support of this data.

\textsuperscript{58}It is a compounded increase since, every time, the increase is applied on the previous increase. The first increase usually occurs in February/March and August for both trucks and parts while the last increase for trucks usually occurs at the end of the year.
Commercial is probably going to lower its margins and so it is going to face a decrease in revenues. This situation is actually really bad also for IVECO because there are going to be troubles in increasing, or even worse, maintaining constant the actual market share. One possible way for IVECO to eliminate this problem would be to hedge the exchange rate risk with the use of financial derivatives. By doing so, maybe they will obtain the same results in terms of profits (because they would have to face the cost of the derivatives) but they could be able to increase the market share. This costs/benefits analysis would not be done in this work. Italian Cars Group will continue to face these price increments and, as a consequence, the margins will not be as big as they should be. It has been estimated this condition is slowly lowering the margins by 9% a year on each product, i.e. 3-5 million rand a year. Political risk alone, has made costs increase by almost 13 million rand in the last two years and could potentially impact profits with an additional 10 million a year until 2020.

This chapter is relevant in order to understand how the company is making profits and also what are they key risks that it is going to face in the following years. The analysis will explain and justify the numbers that we are going to report in the following chapter.
Chapter 3 – Internal Rate of Return Analysis

3.1 Breaking down the company value and computing the IRR for Italian Cars Group

Let’s now take a look at the key voices that we need in order to compute the IRR for Italian Cars Group. The Internal Rate of Return is defined as the rate of return that will make a series of cash flows to a net present value of 0. We are going to use it in order to assess whether Italian Cars Group is actually taking an additional premium for the risk it is facing, i.e. if the company is performing better than the comparable companies operating in the commercial vehicle business. All the data regarding the company have been estimated relying on numerous documents, on field researches and management opinions.

3.1.1 The company value

It has been estimated\(^{59}\) that the value of the company is approximately 400 million rand. It is extremely high compared to its key competitors in South Africa (other IVECO dealerships included). To be precise, almost 35-40\% of this value (140-160 million rand) represents the goodwill, i.e. the ability of the company of generating value. The remaining part of the value is represented by the remaining assets. As we have seen in the previous chapter, there are some strengths that make the company stand out: *quality of the services and products, geographic position and synergies*. This value is represented mainly by these three characteristics since this is what creates additional values with respect to the other player in the market. In particular, quality\(^{60}\) generates additional value for approximately 70-80 million rand and remains the biggest intangible asset that the company owns. The geographic position also plays a very important role in generating additional value since a traffic congested area is surely a better situation for a commercial vehicles company. This is worth

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\(^{59}\) The estimation has been made after careful consideration, comprehension and review of some acquisition offers received by the company.

\(^{60}\) Especially the quality of the services.
approximately 30-40 million rand in terms of added value. Last but not least, by integrating the supply chain forward, the company is now worth 15-25 million rand more than its key competitors. The remaining part of the value is represented by other major characteristics such as not working with debt and good operations management. One important specification is that this additional value is basically generated by Luigi D’Ovidio and his management team and it is really high if compared with the one generated by the other peers.

In 2020, this value is going to be approximately 20% higher, reflecting the increased ability of the firm in making money, increased political stability and high economic growth prospect.

3.1.2 Revenues, cash flows and growth rate: the IRR for Italian Cars Group

In 2016\(^{61}\), revenues will be of approximately 80 million rand while the cash flow will be 15 million rand. The latter is going to increase by an estimated 8% over the next five years. These data are extremely positive if compared with the risks that the company is going to face. The high cash flow growth rate is justified by the fact that the increase in revenues is going to overcome the increase in costs. This is due to the numerous reasons explained in the first chapter regarding the growth that South Africa and the commercial vehicle business are going to face in the next years and also because Italian Cars Group is going to boost the quality of some divisions such as the sales team.

Provided these data, the management has estimated an Internal Rate of Return of 7.8%. Figure 3.1 shows the data reported so far.

**Italian Cars Group**

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry/Exit Value</td>
<td>(400.000.000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>480.000.000</td>
</tr>
<tr>
<td>Free Cash Flow (FCF)</td>
<td>-</td>
<td>16.200.000</td>
<td>17.496.000</td>
<td>18.895.680</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(400.000.000)</td>
<td>16.200.000</td>
<td>17.496.000</td>
<td>18.895.680</td>
<td>480.000.000</td>
</tr>
</tbody>
</table>

| IRR          | 7.8%       |

Figure 3.1

\(^{61}\) Estimated value. Analysis can be found on the excel sheet called “IRR ICG”.
“Entry/Exit value” are the amount of money that we should pay today to buy the whole company and the money we would get by selling it in 2020. As we can see, the “Entry value” in 2016 is 400,000,000 rand, which is the enterprise value of company. Cash flows are computed as proposed from the management, considering the representative 15,000,000 free cash flow in 2016 as a starting point. Obviously, in the excel sheet the cash flows for 2016 and 2020 have been included in the voice “Entry/Exit Value”.

We will now compare it with public key peers in order to derive a market IRR which is representative of the sample chosen.
3.2 Estimation of the IRR for comparable companies

The aim of this paragraph is to compute the Internal Rate of Return for comparable companies and compare them with the Italian Cars Group IRR. First of all, we need to specify how comparable companies have been chosen. It has been difficult to find some of them since our company has a very characteristic business and it is not common to find listed companies that do the same activity. So the starting point has been to find the most similar public company possible. After choosing the first comparable, which is a company called RUSH Enterprises Inc. that is based in the US, we then searched for its key peers and chose the other comparable companies from a drop-down list. The process for the computation of the IRR has been the same used with Italian Cars Group.

3.2.1 Key comparable companies description and IRR

Rush Enterprises, Inc. is a retailer of commercial vehicles and related services. The Company operates through the Truck Segment, which includes its operation of a regional network of commercial vehicle dealerships under the name Rush Truck Centers. The Company, through its Rush Truck Centers, offers services, including retail sales of new and used commercial vehicles, aftermarket parts sales, service and repair facilities, financing, leasing and rental, and insurance products. Rush Truck Centers primarily sell commercial vehicles manufactured by Peterbilt, International, Hino, Ford, Isuzu, Mitsubishi Fuso, IC Bus or Blue Bird. At its Rush Truck Centers, the Company offers third party financing to assist customers in purchasing new and used commercial vehicles. Additionally, the Company sells, as agent through its insurance agency, a line of property and casualty insurance, including collision and liability insurance on commercial vehicles, cargo insurance and credit life insurance.

In Figure 3.2 we can find the computation of the IRR for this company. All the data until 2018 have been taken by some equity research reports while data for 2019 and 2020 have been estimated by considering the historical information and also forecasts provided by the reports. Its IRR has been estimated to be 4.1%.
RUSH Enterprises Inc.

<table>
<thead>
<tr>
<th>$ million</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry/Exit Value</td>
<td>(1.501)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>1.625</td>
</tr>
<tr>
<td>Free Cash Flow (FCF)</td>
<td>-</td>
<td>28</td>
<td>41</td>
<td>60</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(1.501)</td>
<td>28</td>
<td>41</td>
<td>60</td>
<td>1.625</td>
</tr>
</tbody>
</table>

IRR 4.1%

Figure 3.2
Rush Enterprise Inc. IRR

A.P. Eagers Limited is an automotive retail company. The Company's principal activities consist of the sale of new and used motor vehicles, distribution and sale of parts, accessories and car care products, repair and servicing of vehicles, provision of extended warranties, facilitation of finance and leasing in respect of motor vehicles, and the ownership of property and investments. Its car retail segment offers new and used vehicles, maintenance and repair services, vehicle parts, vehicle protection products and other aftermarket products; truck retail segment offers new and used trucks, truck maintenance and repair services, truck parts, extended service contracts, truck protection products and other aftermarket products; Property segment acquires commercial properties for use as facility premises for its motor dealership operations, and Investment segment includes the investment in One Way Traffic Pty Ltd, Automotive Holdings Group Limited and Smartgroup Corporation Limited.

In Figure 3.3 we can find the computation of the IRR for this company. Also in this case, data until 2018 have been taken by some equity research reports while data for 2019 and 2020 have been estimated by considering the historical information and also forecasts provided by the reports. Its IRR has been estimated to be 4.8%.

A.P. Eagers Limited

<table>
<thead>
<tr>
<th>$ million</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry/Exit Value</td>
<td>(3.106)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>3.308</td>
</tr>
<tr>
<td>Free Cash Flow (FCF)</td>
<td>-</td>
<td>123</td>
<td>123</td>
<td>153</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(3.106)</td>
<td>123</td>
<td>123</td>
<td>153</td>
<td>3.308</td>
</tr>
</tbody>
</table>

IRR 4.8%

Figure 3.3
A.P. Eagers Limited IRR
Lithia Motors, Inc. is an operator of automotive franchises and a retailer of new and used vehicles and services. The Company operates in three segments: Domestic, Import and Luxury. Its Domestic segment consists of retail automotive franchises that sell new vehicles of Chrysler, General Motors and Ford. Its Import segment consists of retail automotive franchises that sell new vehicles manufactured primarily by Honda, Toyota, Subaru, Nissan and Volkswagen. Its Luxury segment consists of retail automotive franchises that sell new vehicles of BMW, Mercedes-Benz and Lexus. Its franchises in each segment sell used vehicles, parts and automotive services, and automotive finance and insurance products. Its operations involve the use, handling, storage and contracting for recycling and disposal of materials, such as motor oil and filters, transmission fluids, antifreeze, refrigerants, paints, thinners, batteries, cleaning products, lubricants, degreasing agents, tires and fuel.

In Figure 3.4 we can find the computation of the IRR for this company. All the data until 2018 have been taken by some equity research reports while data for 2019 and 2020 have been estimated by considering the historical information and also forecasts provided by the reports. Its IRR has been estimated to be 6.5%.

### Lithia Motors Inc.

<table>
<thead>
<tr>
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<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry/Exit Value</td>
<td>(4.415)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>5.024</td>
</tr>
<tr>
<td>Free Cash Flow (FCF)</td>
<td>-</td>
<td>157</td>
<td>192</td>
<td>235</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>(4.415)</td>
<td>157</td>
<td>192</td>
<td>235</td>
<td>5.024</td>
</tr>
<tr>
<td><strong>IRR</strong></td>
<td>6.5%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Figure 3.4*

Lithia Motors Inc. IRR
These were the calculation for the comparable companies. As Figure 3.5 shows, the mean IRR for companies operating in the commercial vehicle business and that, more in general, have dealerships with various brands as core business has been estimated to be 5.1%, meaning that Italian Cars Group has an IRR that is 2.7% higher.

**Market IRR**

<table>
<thead>
<tr>
<th>Company</th>
<th>IRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>RUSH Enterprises Inc.</td>
<td>4.1%</td>
</tr>
<tr>
<td>A.P. Eagers Limited</td>
<td>4.8%</td>
</tr>
<tr>
<td>Lithia Motors Inc.</td>
<td>6.5%</td>
</tr>
<tr>
<td><strong>Market IRR</strong></td>
<td><strong>5.1%</strong></td>
</tr>
</tbody>
</table>

**Figure 3.5**
Market IRR

In the next paragraph we are going to discuss what justifies this difference and try to check whether or not risks are remunerated in a proper way.
3.3 Key considerations

In the previous paragraphs, lot of information, forecasts and analysis have been provided in order to be able to understand the problem and motivate the answers. We now arrive at the ending point, that is, checking if Italian Cars Group will be remunerated properly considering the risks that it is going to face in the next five years. First of all, we need to explain one important point. While data about comparable companies have been taken by equity research reports, Thomson Reuters databases and other papers, Italian Cars Group data have been estimated by on field researches and other management indications. A sensitivity analysis has been implemented for ICG in the excel spreadsheet called “IRR ICG” in order to understand what are the drivers that could have an impact on the IRR. The “Entry Value” is pretty accurate, so there was no reason to discuss about its changes. On the other end, cash flows for the period 2016-2020 and the “Exit Value” in 2020 has to be discussed. The analysis verifies that the internal rate of return changes of a very small amount given a different growth rate of the cash flows along the period. For growth levels of 2%, 8% and 10%, the IRR are respectively of 7.5%, 7.8% and 8%. This tells us that the IRR is not so much sensitive to changes in the cash flows growth rates. On the contrary, changes in the 2020 “Exit Value” could strongly affect the internal rate of return for Italian Cars Group, highering and lowering it by very big amounts. In the worst case scenario, that is 2% cash flows growth and a 20% lower “Exit Value”, the company is going to have an IRR of only 2%. In the best case scenario instead, that is a 10% cash flows growth and 20% higher “Exit Value”, the company is going to have an IRR of 12.7%, a much higher value than the comparable companies sample. This means that the IRR is really sensitive to changes in the “Exit Value” so it should really concentrate on keeping it as higher as possible. Based on our estimates and analysis, there is a very high chance that the company will be valued at 480 million rand in 2020. Going back to our analysis, Figure 3.6 shows the results that we obtained in the previous paragraphs.

62 Their names are going to be included in the biography.
The internal rate of return for our company is going to be higher than the one estimated by the other key peers. Comparable companies are bigger, they operate in more stable markets with respect to South Africa and they are also geographically and products diversified. They do the same activities but in different markets. As a consequence, they are also accepting to have lower and more stable returns. Italian Cars Group instead is operating in a market that, even if provides additional risks (discussed in chapter 2), has extremely high growth prospects and opportunities. In this environment, ICG has been able to capture the growth opportunities and our work shows that it is going to continue to do it. Luigi D’Ovidio and his team are going to be able to capture the growth and, provided that risks will affect the company in the way we have estimated, are going to have higher returns than comparable companies and competitors in the commercial vehicle business. This situation makes it worth for the Italian Cars Group to continue to operate since it is going to have returns that fully justify the additional risks affecting the market.

According to the estimates and assumptions we made in our work.
3.4 Conclusions

Low returns of comparable companies can be explained by many factors. First of all, they are operating in more mature economies with respect to South Africa, such as the United States and Australia. Considered that these two countries have already experienced periods of high growth, as a consequence, they are providing lower and more stable returns. In addition to this, the commercial vehicle business is irremediably linked with any other sector because it provides some of the most basic products and services that almost any kind of firm needs in order to conduct the daily activities (trucks, maintenance services, etc.). Being exposed to so many businesses helps to maintain stable revenues because specific risk is minimized\(^{64}\). We can conclude that returns are consistent to the amount of risks that they are facing.

Italian Cars Group, as we highlighted in our analysis, is providing a much higher return with respect to the chosen comparable companies. The question is: is it providing the appropriate rate of return? With reasonable certainty we can conclude that the answer is yes. ICG had already been hit by the risks that we exposed in our work. There is a high chance that these risks are going to make costs increase over the next five years but, given the ability of the managing director and the high growth that South Africa is going to experience, the excess return provided by the company is going to outweigh the excess risks.

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\(^{64}\) The company is not linked to a particular business. If one sector is doing bad, maybe another one is doing good and so the exposition to risks is lowered.
Conclusion

Information given by Chapter 1 and 2 were needed in order to motivate the information provided by the management and in order to make the right assumptions regarding the Internal Rate of Return. Key comparable companies internal rate of returns are lower than the one provided by Italian Cars Group. The key point is that ICG had already been hit by the risks that we exposed in our work. There is a high chance that these risks are going to make costs increase over the next five years but, given the ability of the managing director and the high growth that South Africa is going to experience, we can conclude that, with reasonable certainty, the excess return provided by the company is going to outweigh the excess risks.
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Summary

Introduction

Some professionals say that assessing risks typically involves more art than science. Nowadays, given the fast evolving environment in which we live, understanding the opportunities and the risks related to a business activity are crucial elements for success. Especially when dealing with particularly volatile and fast growing markets or countries, quantitative risk analyses have to be combined with alternative approaches highlighting the qualitative aspects of the business risks. On-field researches are the crucial element for in-depth examinations.

During my summer internship at IVECO Italian Commercial Truck Service Center Ltd, I have been able to analyze and understand the key drivers and risks affecting the South African market, with particular attention to the commercial vehicle business. The owner of the dealer, an Italian entrepreneur called Luigi D’Ovidio, also managed to integrate the supply chain forward by initiating other complementary activities. Today, all of them go under the name of Italian Cars Group.

The stimulating work and experience made me take the decision to analyze how Italian Cars Group is generating value, whether or not it is able to exploit the synergies and if it is getting an appropriate and additional return given the risks affecting the South African market and the commercial vehicle business.

Chapter 1 gives us an overview and understanding of the African market with particular attention to South Africa and Johannesburg. Consumer spending as well as key risks have been analyzed, providing a deep overview and forecasts regarding the South African economy.

Chapter 2 analyzes the company. A deep analysis of the commercial vehicle business has been provided, with an overview of key drivers and risks. The company has been analyzed as well. These two chapters are crucial since they provide the information that justify data and numbers provided in the third chapter.

Chapter 3 compares the company returns with the ones of comparable companies. The internal rate of return for Italian Cars Group has been estimated and compared with the one provided by the market.
After almost half a century from independence, many economies in Africa are showing an increasing dynamism. A relevant data is highlighting this: annual economic growth across the continent has averaged 4.5% since 2000. Also, a forecast made by Oxford Economics suggests that the Gross Domestic Product (GDP) is going to outstrip that of any other region in the world between now and 2030. Changes in both the distribution of the economic output and consumer power have been extremely relevant for the growth of the whole continent. By 2030 a new consumer class will have emerged, yielding total spending power that will top $1 trillion, from just $420 billion today. In places such as Lagos and Johannesburg, the expansion of consumer power will put them on a par with emerging market cities across the world. The development of city population and the output growth are driven mainly by the manufacturing sector, which is able to absorb labor coming from the rural hinterland. South Africa is a middle-income country, but the majority of the population is still facing a high level of poverty due to a significant degree of income inequality. The population is now at 54.7 million, with adult literacy at 89% and life expectancy at birth is 59.6 years. The credit environment outlook seems to be stable over the next five years or so. Economic conditions and growth remained stable in the last few months, due to many factors just as the weakness of the currency and electricity shortage, and so was the rand. As far as the supply environment outlook is concerned, let’s say first that South Africa’s infrastructure has improved greatly in the past decade so we can expect further substantial investments in the transport and power sectors. Recent electricity shortages have contributed to the decline in industrial production and also highlighted the energy infrastructure problem. Market environment outlook will be stable too. South Africa continues to attract FDI capital inflows but there is a risk of a reversal because of the uncertainty of the political situation. Political environment is far from being considered stable and without uncertainty. Johannesburg is the most populous city in South Africa with almost eight million people and is projected to grow by 16% by 2030. Although the rates of growth will be less impressive than in some other cities (they start from a relatively high base), inhabitants of these cities will see the biggest increases in spending power in absolute terms. Although the rates of growth will be
less impressive than in some other cities (they start from a relatively high base), inhabitants of these cities will see the biggest increases in spending power in absolute terms. The analysis regarding risks affecting South Africa have been based on:

1) Short-term economic outlook
2) Market potential
3) Money market/exchange rate risk
4) Transfer risk
5) Business regulatory environment
6) Business continuity
7) Political risk
8) Expropriation/nazionalization risk

Chapter 2

Italian Cars Group has been found by Luigi D’Ovidio many years ago. The dealership with IVECO accounts for the major part of the revenues of the company. It has been established 24 years ago and for all these years it played a key role in the success and promotion of the IVECO brand in South Africa. This is confirmed by the fact that it is the oldest existing IVECO dealership in South Africa. Products are extremely different between them but have one, very important characteristic in common: quality.

Trivento is the part of the company that provides rental truck services to the public and also to the existing clients who need to hire a truck while their vehicle is in for some major maintenance or repairs. The company has two different workshops: one is based right beside the IVECO Italian Commercial’s offices (workshop n°1) while the other one is part of Italian Panelbeaters’s estate (workshop n°2). In the near future, there are two worldwide markets for trucks. The first one is Europe, North America, Japan and industrialized East Asian nations. The faster growth will be observable in the BRIC countries, Asia, Africa and Latin America. Since they are less interested in technological features, Chinese and Indians truck makers are producing the sorts of vehicles that succeed in there markets: their products seem to be well suited to the imperfect infrastructure of emerging markets. The market in South Africa, and in particular Johannesburg’s area, is quite huge. Total new units sold every year are
approximately 5000-6000, expected to increase by 5-10% by 2020. A number of key players dominate the market other than IVECO, which opened a branch in Johannesburg and accounts for approximately 25-30% of the new trucks sold every year. It is really important to understand who are the potential customers and what are their needs. The slowing down of the economy had a big impact on their preferences and more specifically they are going more price oriented, switching to less expensive (i.e. lower quality) products. The fundamental key strength of Italian Cars Group is the quality of the products and services it provides. Secondly, the geographic position of the company is extremely favorable. Italian Cars Group is based in the area where all the trucks from various different companies are parked and so it is quite common for companies in that area to get maintenance services and buy parts during the day. Differently to the other IVECO dealerships in South Africa, Italian Cars Group does not have any debt and other partners. The first issue, and also the biggest one since it is directly affecting and increasing other risks, is the Political risk. Actually, this is probably the only one risk that is going to affect with a 100% chance the company profitability in the next five years. The first big consequence is in regard of the Market potential and, in particular, as we have already said the black economic empowerment (BEE) initiatives will continue to impose restrictions and costs directly on local firms and indirectly on foreign firms. This risk alone could potentially not affect the company. It actually does because there is another risk to take in consideration and it is the labour productivity risk. Most of the workers, especially the black ones, suffer of a really serious lack of education and skills. The mixed effect of the BBE initiatives and labour productivity skills already pushed costs up by 10 million rand a year since 2014. In case of more degenerative and useless political reforms, costs could increase by at least another 5-10 million a year in the worst of the cases. There is one last risk that has to be taken into consideration: the exchange rate risk. The exchange rate risk is having some relevant impacts on Italian Cars Group. First of all, due to the volatility of exchange rate IVECO increases trucks’ prices two or even three times a year by 3% and parts’ prices two times a year by 3-5%. Italian Cars Group will continue to face these price increments and, as a consequence, the margins will not be as big as they should be. It has been estimated this condition is slowly lowering the margins by 9% a year on each product, i.e. 3-5 million rand a year. Political risk alone, has made costs
increase by almost 13 million rand in the last two years and could potentially impact profits with an additional 10 million a year until 2020.

**Chapter 3**

It has been estimated that the value of the company is approximately 400 million rand. It is extremely high compared to its key competitors in South Africa (other IVECO dealerships included). To be precise, almost 35-40% of this value (140-160 million rand) represents the goodwill, i.e. the ability of the company of generating value. The remaining part of the value is represented by the remaining assets. There are some strengths that make the company stand out: quality of the services and products, geographic position and synergies. This value is represented mainly by these three characteristics since this is what creates additional values with respect to the other player in the market. In particular, quality generates additional value for approximately 70-80 million rand and remains the biggest intangible asset that the company owns. The geographic position also plays a very important role in generating additional value since a traffic congested area is surely a better situation for a commercial vehicles company. This is worth approximately 30-40 million rand in terms of added value. Last but not least, by integrating the supply chain forward, the company is now worth 15-25 million rand more than its key competitors. The remaining part of the value is represented by other major characteristics such as not working with debt and good operations management. One important specification is that this additional value is basically generated by Luigi D’Ovidio and his management team and it is really high if compared with the one generated by the other peers.

In 2020, this value is going to be approximately 20% higher, reflecting the increased ability of the firm in making money, increased political stability and high economic growth prospect. In 2016, revenues will be of approximately 80 million rand while the cash flow will be 15 million rand. The latter is going to increase by an estimated 8% over the next five years. These data are extremely positive if compared with the risks that the company is going to face. The high cash flow growth rate is justified by the fact that *the increase in revenues is going to overcome the increase in costs.* This is due to the numerous reasons explained in the first chapter regarding the growth that
South Africa and the commercial vehicle business are going to face in the next years and also because Italian Cars Group is going to boost the quality of some divisions such as the sales team.

Provided these data, the management has estimated an Internal Rate of Return of 7.8%.

The following figure shows the data reported so far.

**Italian Cars Group**

<table>
<thead>
<tr>
<th>Rand</th>
<th>2016</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entry/Exit Value</td>
<td>(400.000.000)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>480.000.000</td>
</tr>
<tr>
<td>Free Cash Flow (FCF)</td>
<td>-</td>
<td>16.200.000</td>
<td>17.496.000</td>
<td>18.895.680</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>(400.000.000)</td>
<td>16.200.000</td>
<td>17.496.000</td>
<td>18.895.680</td>
<td>480.000.000</td>
</tr>
</tbody>
</table>

| IRR           | 7.8%     |

“Entry/Exit value” are the amount of money that we should pay today to buy the whole company and the money we would get by selling it in 2020. As we can see, the “Entry value” in 2016 is 400.000.000 rand, which is the enterprise value of company. Cash flows are computed as proposed from the management, considering the representative 15.000.000 free cash flow in 2016 as a starting point. Obviously, in the excel sheet the cash flows for 2016 and 2020 have been included in the voice “Entry/Exit Value”.

We will now compare it with public key peers in order to derive a market IRR which is representative of the sample chosen. We need to specify how comparable companies have been chosen. It has been difficult to find some of them since our company has a very characteristic business and it is not common to find listed companies that do the same activity. So the starting point has been to find the most similar public company possible. After choosing the first comparable, which is a company called RUSH Enterprises Inc. that is based in the US, we then searched for its key peers and chose the other comparable companies from a drop-down list. The process for the computation of the IRR has been the same used with Italian Cars Group. Rush Enterprises, Inc. is a retailer of commercial vehicles and related services. Its IRR has been estimated to be 4.1%. A.P. Eagers Limited is an automotive retail company. Its IRR has been estimated to be 4.8%. Lithia Motors, Inc. is an operator of automotive franchises and a retailer of new and used vehicles and services. Its IRR has been estimated to be 6.5%. The following figure shows the mean IRR for companies operating in the commercial vehicle business and that, more in general, have
dealerships with various brands as core business has been estimated to be 5.1%, meaning that Italian Cars Group has an IRR that is 2.7% higher.

<table>
<thead>
<tr>
<th>Company</th>
<th>IRR</th>
</tr>
</thead>
<tbody>
<tr>
<td>RUSH Enterprises Inc.</td>
<td>4.1%</td>
</tr>
<tr>
<td>A.P. Eagers Limited</td>
<td>4.8%</td>
</tr>
<tr>
<td>Lithia Motors Inc.</td>
<td>6.5%</td>
</tr>
<tr>
<td><strong>Market IRR</strong></td>
<td><strong>5.1%</strong></td>
</tr>
</tbody>
</table>

The internal rate of return for our company is going to be higher than the one estimated by the other key peers. Low returns of comparable companies can be explained by many factors. First of all, they are operating in more mature economies with respect to South Africa, such as the United States and Australia. Considered that these two countries have already experienced periods of high growth, as a consequence, they are providing lower and more stable returns. In addition to this, the commercial vehicle business is irremediably linked with any other sector because it provides some of the most basic products and services that almost any kind of firm needs in order to conduct the daily activities (trucks, maintenance services, etc.). Being exposed to so many businesses helps to maintain stable revenues because specific risk is minimized. We can conclude that returns are consistent to the amount of risks that they are facing. Italian Cars Group, as we highlighted in our analysis, is providing a much higher return with respect to the chosen comparable companies. The question is: is it providing the appropriate rate of return? With reasonable certainty we can conclude that the answer is yes. ICG had already been hit by the risks that we exposed in our work. There is a high chance that these risks are going to make costs increase over the next five years but, given the ability of the managing director and the high growth that South Africa is going to experience, the excess return provided by the company is going to outweigh the excess risks.
Conclusion

Information given by Chapter 1 and 2 were needed in order to motivate the information provided by the management and in order to make the right assumptions regarding the Internal Rate of Return. Key comparable companies internal rate of returns are lower than the one provided by Italian Cars Group. The key point is that ICG had already been hit by the risks that we exposed in our work. There is a high chance that these risks are going to make costs increase over the next five years but, given the ability of the managing director and the high growth that South Africa is going to experience, we can conclude that, with reasonable certainty, the excess return provided by the company is going to outweigh the excess risks.