

**BLACK BEAR**  
VALUE PARTNERS

# AUTO DEALERS: THE BUG OR THE WINDSHIELD?

*June 2017*

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# INTRODUCTION TO BLACK BEAR VALUE PARTNERS, LP

*“An investment in knowledge pays the best interest.” – Benjamin Franklin*

## Overview

- Black Bear Value Partners is an a fundamental and value-oriented investment manager approach highlighted by certain attributes:
  - Preservation of capital
  - Understandable ideas
  - High margin of safety
  - Contrarian approach
  - Concentrated portfolio
  - Industry and asset class agnostic

## Investment Philosophy

- Significant personal investment as an LP
- Invest with a margin of safety
- Capital preservation is critical
- “Back-to-basics” - Performance driven culture with lower fees
- Longer term capital base
- Patience and disciplined capital allocation
- Aligned interests with our LPs

## Portfolio Manager

- Led by Adam Schwartz, a 14 year professional buy-side investment analyst with extensive experience across a wide range of asset classes and investment themes including equities, structured credit, corporate credit, capital structure arbitrage and real estate
- Adam was a senior member of the investment team and a Director at Fir Tree Partners, a \$13BB AUM investment manager from 2007-2015
- Partners will have a significant amount of their investable net worth invested in the Fund

## AUTO DEALERS: RAZOR/RAZOR BLADE MODEL?

- Are auto dealers:
  - Sticky cash-flow generators hidden by low-margin distribution businesses?  
OR
  - Low margin businesses that are yesterday's news?



## BRIEF INDUSTRY OVERVIEW

- New cars and light trucks in the United States are sold through franchised dealers:
  - ~90% are owned privately/10% owned by public companies
- Fragmented industry and with ongoing consolidation
- Auto dealers make money primarily 4 different ways:
  - Selling new cars (low margin & cyclical)
  - Selling used cars (low margin & less cyclical)
  - Providing parts & services (high-margin and not cyclical)
  - Finance & insurance (high-margin and somewhat cyclical)
- Why not buy auto manufacturers?
- Maybe we should avoid auto-related investments heading into a SAAR slowdown?

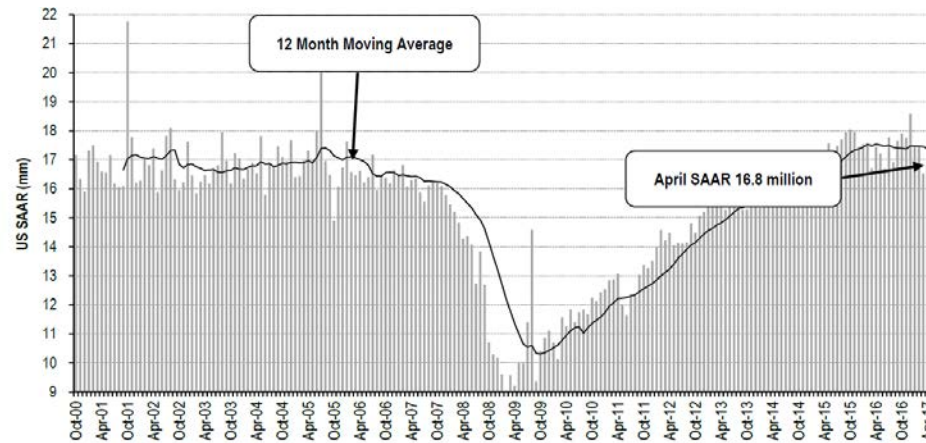
# ISSUES FACING THE AUTO INDUSTRY



"I meant, how flexible are you on price?"

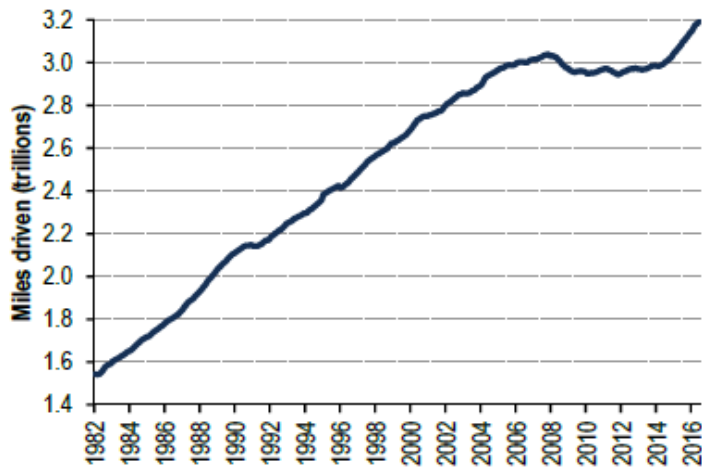
# ISSUES FACING THE AUTO INDUSTRY

- SAAR = high and hard to predict – likely declining in the near-term
- More miles are being driven and cars are older



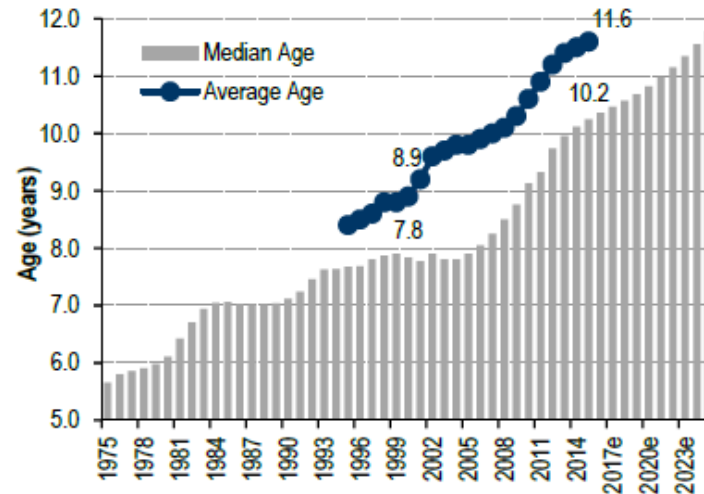
Source: Ward's AutoInfoBank, BofA Merrill Lynch Global Research

Chart 9: US miles driven – annualized rate



Source: Federal Highway Administration

Chart 10: Median and average age of vehicles in US fleet

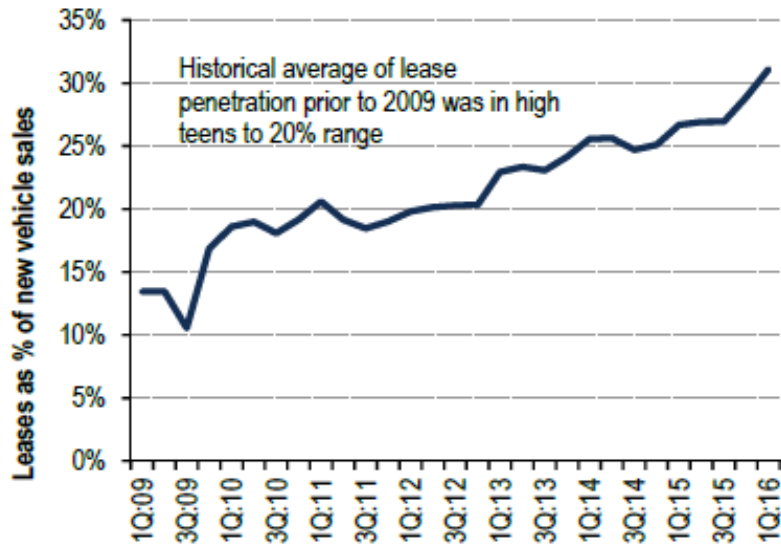


Source: R.L. Polk, BofA Merrill Lynch Global Research estimates

# ISSUES FACING THE AUTO INDUSTRY

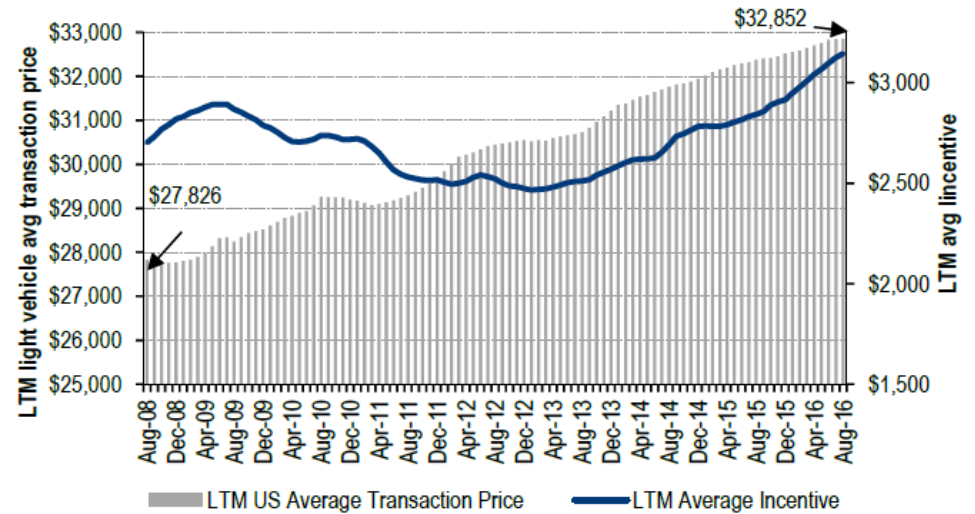
- Leases and incentives are leading to high SAAR and bringing demand forward

Chart 25: Lease penetration rate



Source: BofA Merrill Lynch Global Research, Experian

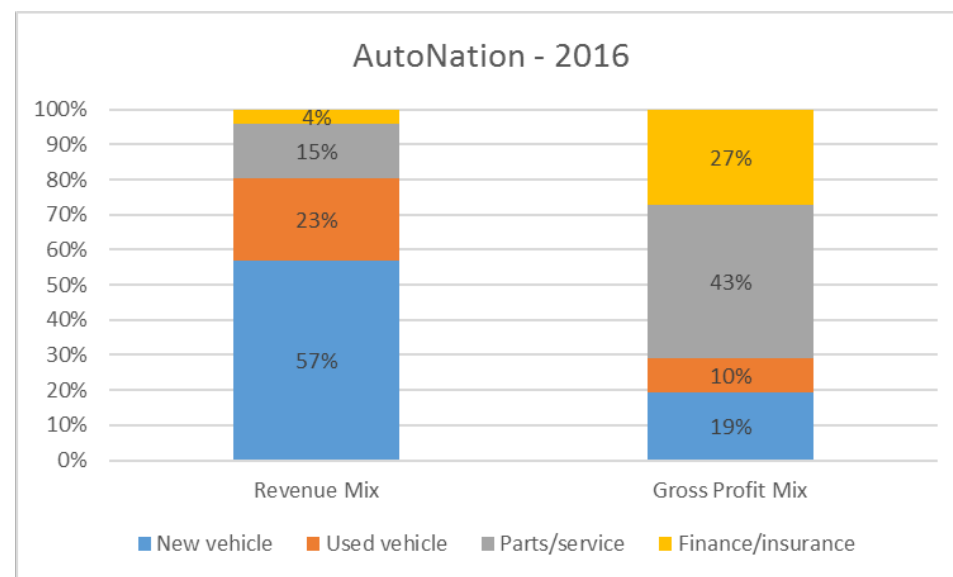
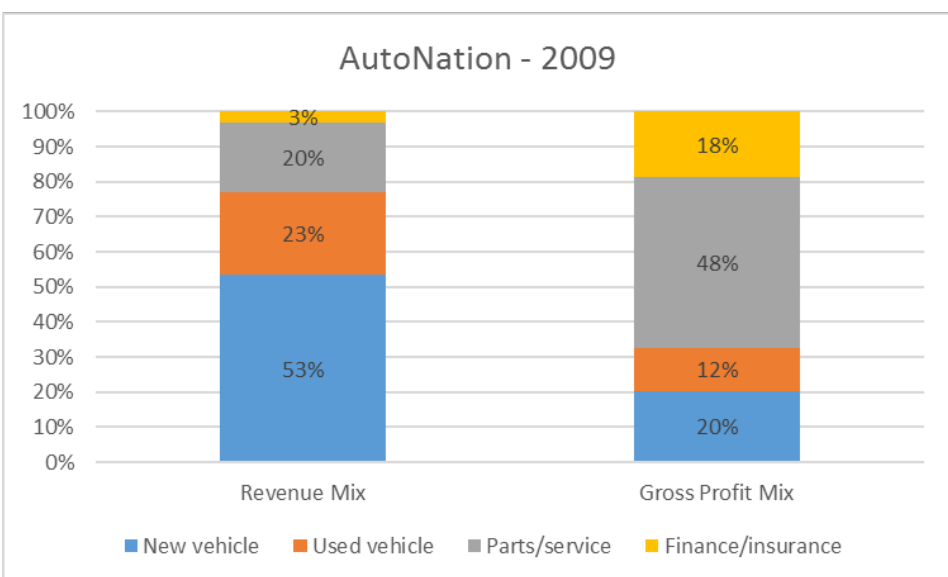
Chart 29: LTM average transaction prices and average incentives per vehicle



Source: AutoData, TrueCar



## WHAT DRIVES PROFITS AT AN AUTO DEALER?

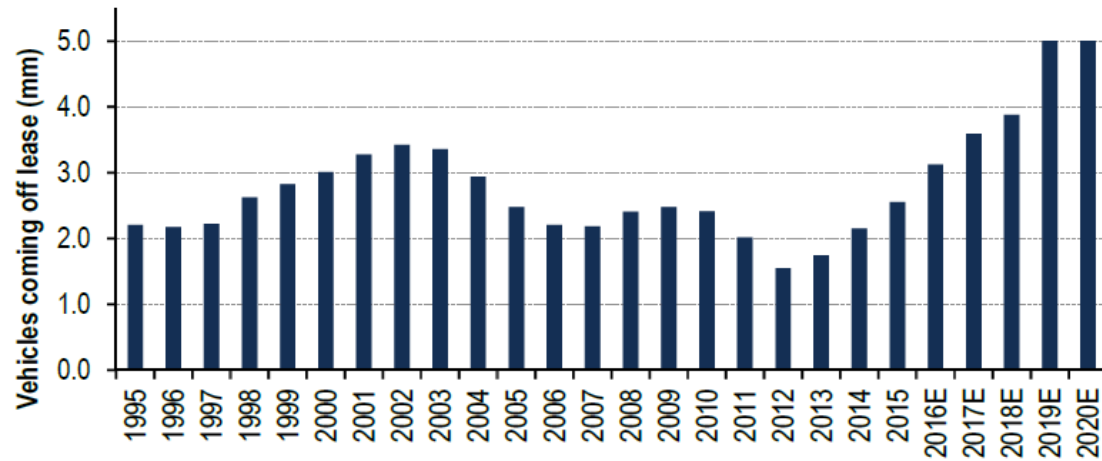


- Selling cars (both new & used) = 80% of revenues and 30% of gross profits
  - New/used: 5-7% and 6-9% gross margins respectfully
  - Low-margin “distribution business” hides higher-margin services business
- Parts & service and Finance/insurance = 19% of revenues and 70% of gross profits
  - Parts & service have historically produced 42-44% gross margins while F&I is a full 100% pass-through (commission based)

# USED CARS

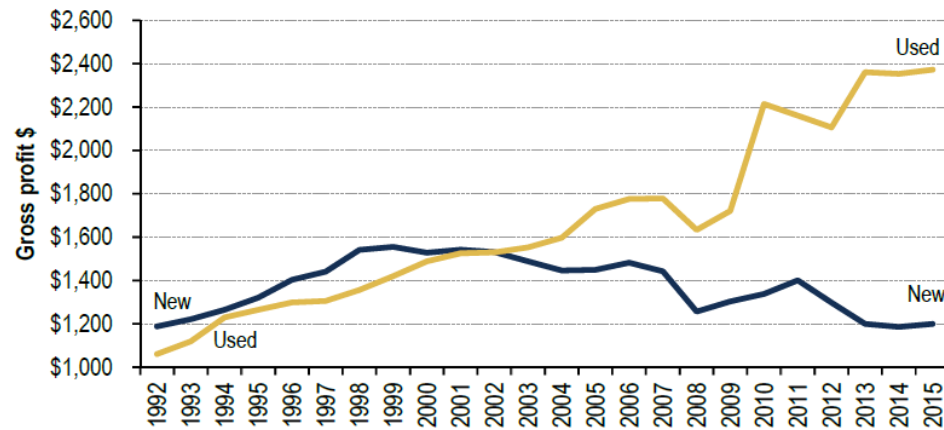
- Increased volumes may partially mitigate SAAR issues and/or
- Negative catalyst for pricing

Chart 39: Number of off-lease vehicles per year



Source: Manheim

Chart 66: Gross profit \$ per unit, new and used cars

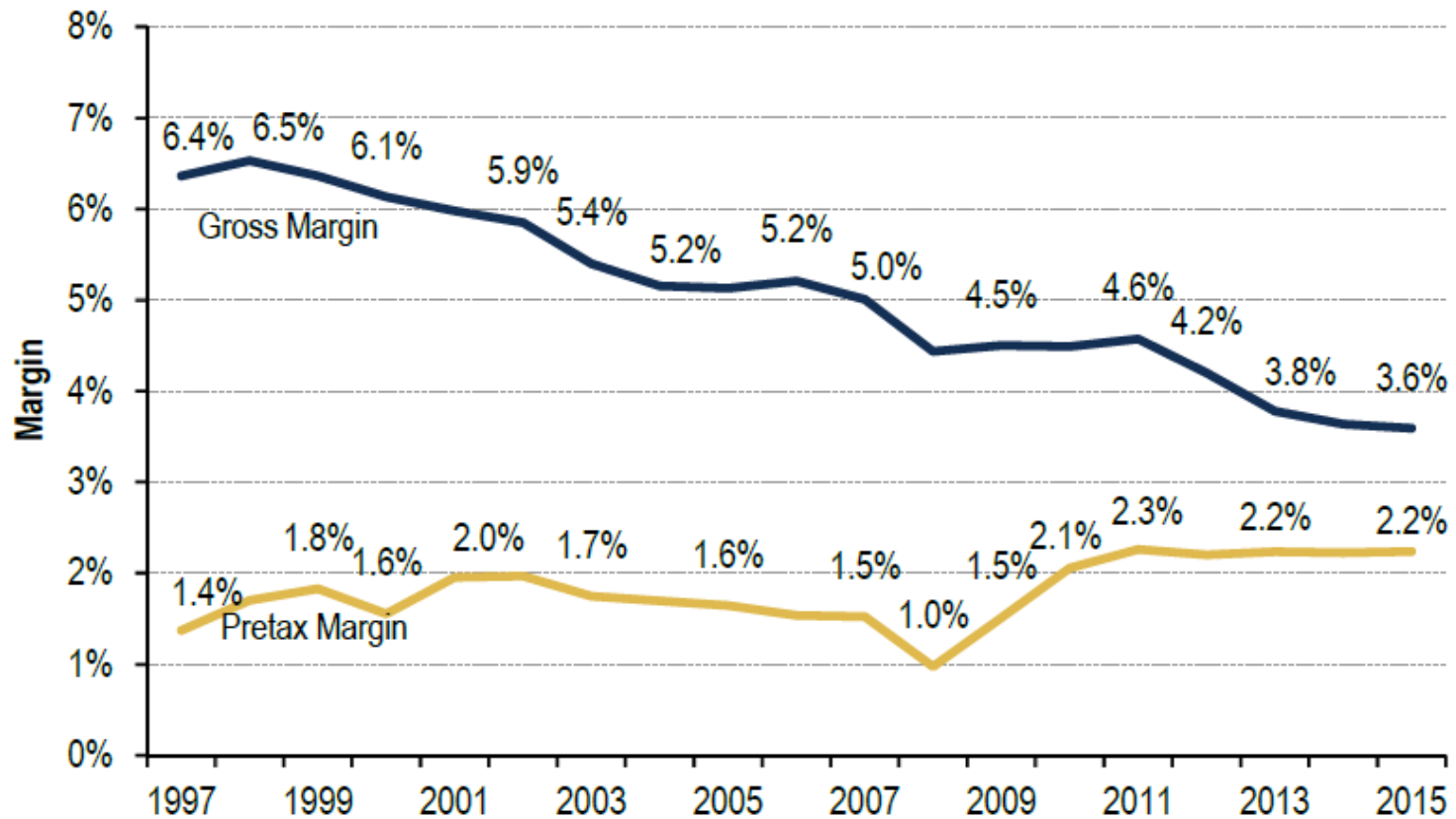


Source: NADA

## NEW CAR SALES – NOT A PROFIT CENTER

- Making low margin on new cars is not a new phenomenon

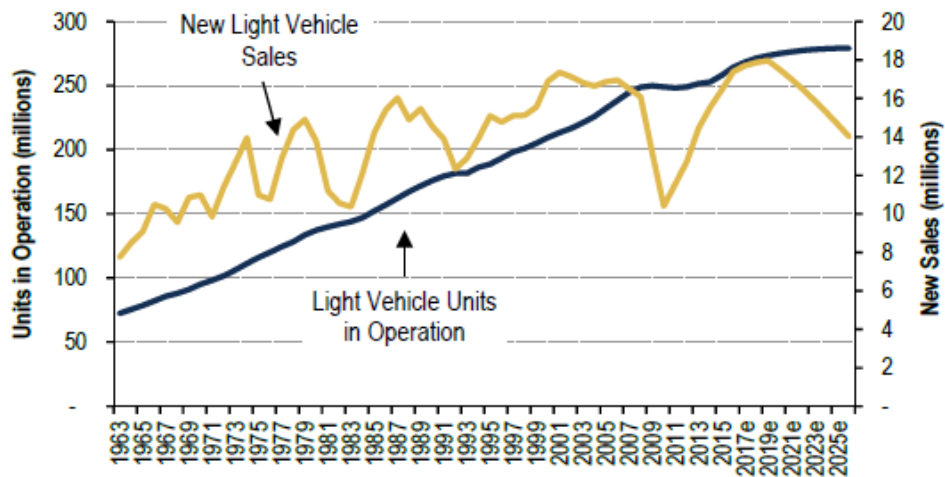
**Chart 54: Franchised dealers' new vehicle gross margin & pretax margin trends**



Source: NADA

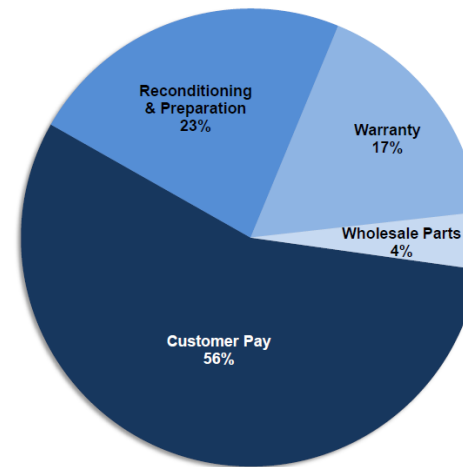
# PARTS/SERVICE

- Hard to predict # of cars sold in any given year
- Number of cars on the road + miles driven is stickier



Source: RL Polk, WardsAuto Group

**Parts & Service Gross Profit Mix (Same Store)**



Source: U.S. Federal Highway Administration fred.stlouisfed.org

myf.red/g/dpIX

## ROUGH STATS ON AUTONATION

- Cash Flow
  - Free cash flow positive through the financial crisis
  - 2016 FCF = \$4.29 per share, \$3.03 ex-WC benefit
  - Last 5Y FCF/Divided sharecount = \$3.44
  - AN has bought back ~50% of shares in last 10Y
- Returns on capital of 25+% last 5 years, 20% last 10 years including financial crisis
- Margins look very low (15% gross margin, 5% EBITDA)
  - The auto sales/distribution side hides the higher margin finance & parts/service business
  - EBITDA as % of gross profit = 30%
  - Operating Income as % of gross profit = 27%
- 2.4x levered on Ebitda – Capex
- Looking backwards it looks cheap ~9% FCF yield – are we the bug or the windshield?
  - Are we stepping in front of a moving train given the likely slowdown in SAAR?

# VALUATION

Financial Metrics						Capitalization			Returns-Steady State					
		2013	2014	2015	2016									
ROCE (E-C)		28%	27%	27%	25%	Share Price		\$41.00				Down	Base	Up
ROE (FCF)		20%	16%	11%	18%	FD Shares		101		2019 FCF per Share		\$2.86	\$4.11	\$4.93
FCF Yield		10%	8%	6%	10%	Market Capitalization		\$4,141		FCF Yield Assumption		10.0%	7.5%	7.0%
EBIT Growth		15%	11%	6%	2%	Less: Cash		\$65		Implied Share Price		28.59	54.84	70.47
Value Accretion		25%	19%	12%	12%	Plus: Debt		\$2,721		Current Stock Price		\$41.00	\$41.00	\$41.00
						Plus: Pension		\$0		Dividend		\$0.00	\$0.00	\$0.00
FCF-PS (Today's Sharecount)		\$4.03	\$3.35	\$2.46	\$4.22	Plus: Minority Interest		\$0		P/L		-\$12.41	\$13.84	\$29.47
FCF-PS Ex-WC (Today's Sharecount)		\$3.18	\$3.23	\$3.40	\$3.02	<b>Enterprise Value</b>		\$6,797		<b>P/L% - Simple</b>		<b>-30%</b>	<b>34%</b>	<b>72%</b>
EV/Operating Income		9.2x	8.3x	7.8x	7.6x					FCF Yield		10.0%	7.5%	7.0%
EBIT/EV (Earnings Yield)		10.9%	12.1%	12.8%	13.1%					EBIT Growth		-2.2%	4.0%	7.6%
EV/FCF		16.7x	20.1x	27.4x	15.9x									
Net Debt/EBIT		3.6x	3.2x	3.0x	3.0x					Implied Value Accretion		7.8%	11.5%	14.6%

<u>Rev. Per Annum</u>	<u>Down</u>	<u>Base</u>	<u>Up</u>		<u>Margins</u>	<u>Down</u>	<u>Base</u>	<u>Up</u>
New	-5%	0%	1%		New	5%	6%	6%
Used	2%	3%	4%		Used	6%	7%	7%
P&S	3%	5%	6%		P&S	42%	43%	44%
F&I	-3%	1%	3%		F&I	100%	100%	100%
Implied Total	-2%	2%	3%		SG&A (% of GP)	72%	71%	70%

## HISTORICAL CASH FLOW

		<u>2006A</u>	<u>2007A</u>	<u>2008A</u>	<u>2009A</u>	<u>2010A</u>	<u>2011A</u>	<u>2012A</u>	<u>2013A</u>	<u>2014A</u>	<u>2015A</u>	<u>2016A</u>
<b>Adjusted OCF</b>		\$400	\$420	\$661	\$240	\$364	\$416	\$456	\$568	\$548	\$496	\$671
Adjusted WC		(\$77)	\$18	\$339	(\$111)	\$20	\$18	\$10	\$86	\$12	(\$95)	\$122
<b>Capital Expenditures</b>		(\$169)	(\$157)	(\$90)	(\$75)	(\$150)	(\$149)	(\$161)	(\$161)	(\$209)	(\$248)	(\$245)
<b>Free Cash Flow</b>		\$230	\$263	\$571	\$165	\$213	\$267	\$295	\$407	\$339	\$248	\$427
<b>Free Cash Flow (Ex-WC)</b>		\$392	\$443	\$239	\$175	\$310	\$289	\$423	\$321	\$327	\$343	\$305
Shares		207	180	177	172	148	136	121	121	113	111	101
<i>Change in shares</i>			-13%	-2%	-3%	-14%	-8%	-11%	0%	-6%	-2%	-9%
<b>FCF Per Share</b>		\$1.11	\$1.46	\$3.23	\$0.96	\$1.44	\$1.97	\$2.44	\$3.37	\$2.99	\$2.24	\$4.24
<b>FCF Per Share (Ex-WC)</b>		\$1.89	\$2.46	\$1.35	\$1.02	\$2.09	\$2.13	\$3.50	\$2.66	\$2.88	\$3.10	\$3.03

## CONTACT DETAILS



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