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Q1 2023 Right Tail Capital Investor Letter

Do you know how sausage is made? Do you *want* to know how sausage is made?

Several ingredients come together – usually pork shoulder, fat, salt and other seasonings. The resulting product tastes better than and adds value to the individual parts. Each part is important though insufficient on its own. Fat back plus salt anyone? Right Tail's research process similarly combines many ingredients. A mix of qualitative and quantitative analysis produces something special from lots of reading, calls, thinking and spreading numbers. In this letter, I will share how the sausage is made at Right Tail by describing my research on an industry I've been studying for potential investment…car dealerships.

What do you think of the car buying process? How does it make you feel? What thought comes to mind when you hear the term used car salesman?

Before studying car dealerships, my thoughts on the businesses were somewhat negatively biased. I have tried to buy quality cars at reasonable prices, and admit I do not know much about cars. Therefore, I've grown to like the no-haggle pricing model popularized by CarMax. It may not result in the cheapest car but offers significant peace of mind at a fair price. The times I visited traditional car dealerships, I felt pushed, hurried and at a severe information disadvantage.

The original research premise fit right into Right Tail's wheelhouse: a set of good businesses trading at attractive long-term valuations. Valuations look inexpensive at mid to high single digit multiples of earnings. Historically, these businesses have traded at 10-15x P/E multiples despite having more leverage and holding more inventory than they do today. In some ways, the historical multiples feel appropriate given their delicate relationships with manufacturers and cyclicality; on the other hand, these businesses have produced solid mid-teens returns with attractive reinvestment opportunities suggesting they are better than average companies. Adding another wrinkle to the puzzle, these businesses have over-earned the last few years due to Covid (car shortages, consumers flush with cash, etc.).

As I began the work, the compelling return potential warranted additional research. Lithia Motors (LAD), for example, has laid out a 2025 earnings per share target of $55-60. If the company reaches $55 in earnings and trades at a 12x P/E, we'd have a stock price of $660 – this would be a triple from today's prices and produce a ~45% IRR over 3 years. The businesses are also producing lots of cash currently (LAD has earned ~$40 per share the last few years) creating additional capital allocation optionality.

Then I further dove in to better understand the companies. I've read several filings and transcripts, talked to industry participants, and had discussions with a handful of the publicly-traded companies. Additionally, I have drawn from previous work on businesses that focus on used cars, auto parts retailing, salvage, and collision repair. This library of prior research continues to accumulate and will continue to lead to better business understanding and investment opportunities over time.

Several positives have surfaced. I've developed a better understanding for why the publicly traded dealerships have been good investments over time. For example, Asbury Automotive Group (ABG) and Lithia Motors (LAD) are up nearly 20x in the last 20 years. As Warren Buffett describes, the businesses require little capital.[1] He says, "You have no receivables to speak of. You floor plan your inventory. You can lease your real estate…so you can have very little capital actually invested in the business…you can work on fairly narrow margins and still earn a high return on capital." Not surprisingly, Berkshire Hathaway bought one of the largest privately owned dealerships in 2015. The industry has consolidated as total dealerships have shrunk from ~30K to ~17K. It seems reasonable to me that the larger, better run organizations have an opportunity to continue to take share.

A car dealership's profit stream also resembles sausage making with several components combining to support a better finished product. Gross profits from selling new and used cars are usually 25-35% of the total company mix. Higher margin items like parts and service and finance and insurance make up the remainder. The largest chunk, parts and services, tends to be the least cyclical and franchise dealerships seem well-positioned to grow this business in the years to come. Similar to sausage becoming a value-added product from several ingredients, these individual revenue streams combine to add value to the overall car dealership while providing several services that consumers want.

These businesses can be cyclical and the great financial crisis was particularly bad. Many of the companies saw revenues peak around 2005 and not surpass the previous peak until 2012. Revenues declined ~30% with profitability declining 40%+ and the stocks really suffered going down 70%+. While that was a severe recession and the industry is more consolidated, it's worth recognizing the potential cyclicality.

I continue to wrestle with a few meaningful, long-term questions.

How will the business model evolve over the next 10 years? State franchise laws have protected dealerships from manufacturers selling directly. This regulatory barrier to entry strikes me as a mixed bag. On the one hand, these barriers have historically protected dealerships. I prefer businesses that create win-win relationships with their key constituents as detailed in Right Tail's prior discussion of plumbing and HVAC distributor Ferguson[2]. Historically this has been partially true for the dealerships – manufacturers have periodically required dealers to hold too much inventory. Some dealers have irritated the manufacturers by choosing to sell cars above MSRP (manufacturer's suggested retail price) during the last few years. I question whether the manufacturers can learn to sell directly, service the cars and get the buyers whatever warranty protection and financing they desire. Tesla has circumvented some of the state franchise laws, while Ford is offering more of a direct buying experience for its electric vehicles while using the dealerships as agents. Even if dealership economics change, the dealerships may still earn strong returns on capital.

[1] https://www.youtube.com/watch?v=bqyRX6AGXGg
[2] https://www.righttailcapital.com/_files/ugd/9593df_644b23df34ea4112a3c03e69256f93ca.pdf

I expect the larger dealerships to gain market share in the coming years especially if they collaborate with their manufacturing partners. Manufacturers want dealerships to continue investing in electric vehicle infrastructure and repair capabilities. Bigger, better-capitalized dealerships are more likely to make those investments. This should allow them to further concentrate the industry (today, each of the public companies have <10% market share). The need to invest more for the future may be one reason why more private dealerships have decided to sell the last several years. However, manufacturers can limit dealer market share of particular brands to not lose too much power in the relationship. Perhaps all sides can benefit by compromising on some of these factors.

I am also intrigued by the possibility that car dealerships are becoming better businesses. Covid forced the companies to become more adept selling online, which should come with a lower cost structure for the dealerships. Some have embraced no-haggle pricing, a better car buying experience for many consumers. The jury is still out as to whether finance and insurance sales will change in a more digital environment though some evidence suggests that consumers still want the products. They may be able to research and buy what they want without feeling the pressure of an in-person sale. Additionally, dealerships have gotten more creative sourcing cars instead of relying on trade-ins.

Today, Right Tail does not own any dealerships among its limited roster of investments. The sausage is in the test kitchen, but the recipe is still being optimized. I take investing your wealth seriously and only want to invest when I feel it's one of my best 10-12 ideas. The longer term questions around the business model are my primary concerns. This research is beneficial and will stay in the Right Tail library. In fact, the majority of Right Tail's current investments were not made immediately following the initial work. Rather, Right Tail invested later either due to uncovering additional insights about the businesses or a more attractive price. This research also informs other investments, some of which are in the broader automotive ecosystem. If you know of anyone in the industry who would be interested in discussing car dealerships, please reach out.

Thank you for your partnership and continued interest in Right Tail. Your long-term mindset is one of our greatest advantages.

Best wishes for continued happiness and success,

Jeremy Kokemor
Right Tail Capital

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