GRANT'S

INTEREST RATE OBSERVER®

Vol. 40, No. 24e 233 Broadway, New York, New York 10279 • www.grantspub.com DECEMBER 23, 2022

Deal us out

Evan Lorenz writes:

"The value of a new car drops the moment you drive it off the lot." Such was the automotive gospel from Henry Ford till Covid. Thanks to the upsurge in pandemic-era used-car prices, however, the value of your new vehicle, if you could find one, appreciated on its way home from the dealership.

The auto dealers in general, and Asbury Automotive Group, Inc. (ABG on the New York Stock Exchange) in particular, are the subjects at hand—they and the microeconomics of supply chains and the distortions of inflation. Our featured companies are profitable, and their share prices are elevated. In preview, we're bearish on them.

Surprise and confusion, as much as bullishness or bearishness, are the words to describe the state of mind of the observant car dealer over the past couple of tumultuous years. For instance, despite every sign of torrid demand, sales fell by 9.4% in the first 11 months of the year. Why? There were not enough parts, notably microchips, to sustain desired automotive production rates. Unable to secure a new vehicle, thwarted customers—individuals and rental-car companies alike—bid up the prices of slightly used ones. Thus, 2021-vintage vehicles fetched an average of $48,765 at the start of 2022 against $38,585 in April 2021, according to J.D. Power data cited in *The Wall Street Journal*.

One dislocation led to another. As most auto sales involve a trade-in, the jump in used-vehicle prices boosted the consumer's spending power. The demand side of the market kicked into higher gear just as the supply side was sputtering. The result was the anomaly, on view from August 2021 through October 2022, of new vehicles selling at a premium to their manufacturer's suggested retail prices. While it's not uncommon for a hot model in any given year to trade above MSRP, this was the first time in history that the industry sold its entire stock above the sticker price.

Taking one thing and another—automakers raising prices, dealers raising them, too, and consumers splashing for fancier trim levels—the average transaction price of a new vehicle rose by 28.2% as of last month from December 2019, or to $47,681 from $37,183, according to Edmunds.com, Inc.

AutoNation, Inc., Asbury and Lithia Motors, Inc. have never had it so good. From 2019 through Sept. 30, the gross profits they earned on new vehicles leapt to an average of $5,979 from $1,812; gross profits on used vehicles rose to $2,402 from $1,689.

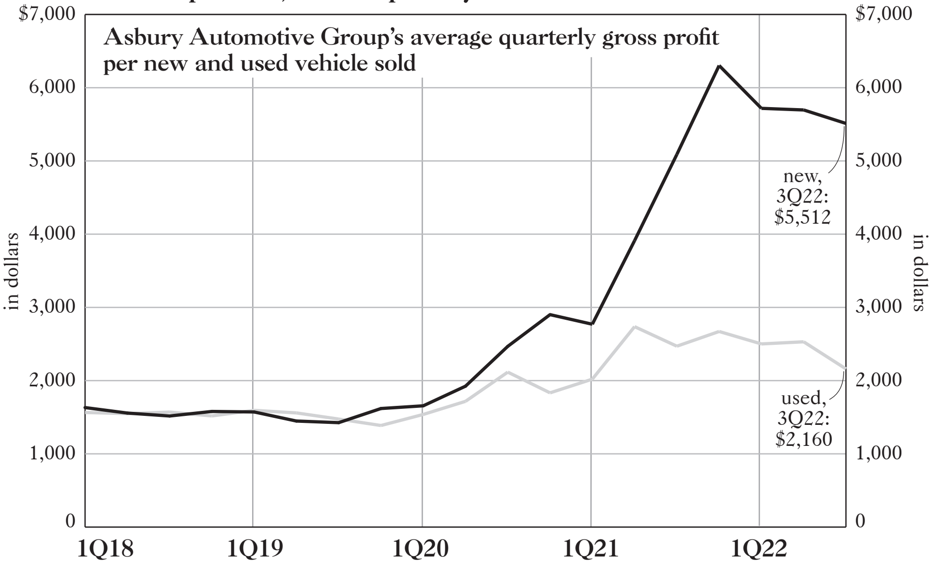
Not content just to pay higher sticker prices, consumers also demanded more add-ons: Gross profits from finance and insurance and prepaid maintenance packages increased to $2,424 from $1,681 over the same span. "I frankly don't think margins will return to pre-2020 levels because I do believe that we are going to see discipline in the inventory levels," Michael Manley, the CEO of AutoNation, told his audience on the Oct. 27 earnings call.

Lithia is on record as dissenting from

Riding high

source: The Bloomberg

Take a picture, it's temporary



source: company reports

that view, but—no doubt—earnings have leapt from pre-virus levels. Thus, from full-year 2019 through Sept. 30, AutoNation's trailing earnings per share grew by 387%, Lithia's by 286% and Asbury's by 268%. Besides, the bulls say, even if gross profits per unit did return to their pre-Covid trend, earnings would be unlikely to follow suit, inasmuch as the dealers have applied this extraordinary level of cash flow to constructive purposes.

For instance, AutoNation spent $3.9 billion buying back its own stock, thereby reducing its share count by 41%, to 52.3 million, as of Sept. 30, compared with 89.3 million at year-end 2019. It means that even if gross profits on new and used vehicles did fall, dealer earnings, at least on a per share basis, would not soon revert to their pre-Covid levels.

"If you think about the five biggest deals in the history of auto dealers, four of them have been done in the past two years," Bret Jordan, who rates ABG a hold for Jefferies Group, LLC, tells me. "Van Tuyl, the Berkshire Hathaway deal, was done seven years ago. But Group 1 acquired Prime Automotive, Asbury acquired Larry H. Miller Dealerships, Lithia acquired Suburban and Sonic acquired Rick Ford," all after 2020.

As for recession risk, a bull might retort that the feared slump is already upon us. Thus, in the five years ended 2019, new-vehicle sales averaged 17.2 million units a year. Compare and contrast the recession-like 13.8 million annual pace logged in the first 11 months of this year. Three years of automotive production problems, the argument goes, have created enough pent-up demand to sustain the dealerships through whatever foul cyclical weather today's steeply, radically inverted yield curve presages.

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Such arguments would be more persuasive if used-vehicle prices were not declining, if rental companies were not returning to the new market to replenish their fleets and if used-car dealers like our sparring partner Carvana Co. (*Grant's*, Aug. 7, 2020) were not licking the wounds they inflicted on themselves by caring more about selling online than selling for a profit.

From January to November, the Manheim Used Vehicle Value Index slumped by 15.6%. As a reminder, almost every automotive sale, whether new or used, involves a trade-in. Appreciating used-vehicle prices fatten consumer wallets as they support consumer confidence—and, of course, vice versa.

Rising interest rates and higher vehicle prices have taken their toll on affordability. According to consumer-credit reporting company Experian plc, the average monthly loan payment for new vehicles soared to $700 in the third quarter from $550 in the three months ended September 2019.

"CarDealershipGuy," the Twitter handle of the owner of three East Coast used-car lots, tells me that a customer with a "super prime" FICO score of more than 820 was recently quoted loan rates of 8%-plus from Capital One Financial Corp. and 10%-plus from Ally Financial, Inc. It didn't take long for CarDealershipGuy to place the customer with a local credit union at a rate that began with the number "five."

"What's really happening is that these lenders are tightening up because they see, No. 1, they have all of this collateral from the past two to three years that's underwater," our informant explains. "I can tell you anecdotally that we're seeing an increasing number of customers coming to us that are underwater on their vehicles. The problem with that is we can't help them."

Asbury Automotive Group at a glance
all figures in $ millions except per share data

	TTM*	2021	2020	2019	2018
revenue	$14,382.7	$9,837.7	$7,131.8	$7,210.3	$6,874.4
operating income	1,206.1	791.8	370.8	325.0	310.9
net income	784.6	532.4	254.4	184.4	168.0
diluted shares	22.3	20.1	19.3	19.3	20.3
earnings per share	35.11	26.49	13.18	9.55	8.28
cash	149.2	189.9	1.4	3.5	8.3
floor plan financing	28.2	564.5	702.2	788.0	966.1
debt	3,325.6	3,582.6	1,201.8	939.4	905.3
total assets	7,816.3	8,002.6	3,676.3	2,911.3	2,695.4

* For the 12 months ended Sept. 30, 2022.

source: company reports

Trade-in, or "residual," values were another singularity of the Covid-19 auto market. In the 2010s, according to the ALG unit of J.D. Power and Associates, they averaged 48% of the original MSRP on a three-year-old vehicle offered for trade. "We ended the fourth quarter of 2021 at 74.4%," Eric Lyman, vice president of ALG, tells me. "Our previous high was 53.5% for 2011."

Based on the current downtrend in used-car prices, Lyman sees residual values falling to 72.5% by Dec. 31 and to 55% by 2025. (While ALG does not anticipate a recession, Lyman acknowledges that a downturn would steepen the descent.) As many auto lenders use projections from ALG and peers as an input into their credit models, banks, too, are assuming that used-vehicle values will continue to shrink. Such expectations help to explain why lenders are tightening underwriting standards.

A bull may hope that automakers have learned their lesson about flooding dealer lots with inventory, but, whatever else the 21st-century auto-manufacturing industry may be, it's no production-rationing oligopoly. "You are starting to see a couple of manufacturers with incentives ticking up over the last couple of months," Charles Chesbrough, senior economist at Cox Automotive, Inc., tells me, even if—as in the case of the Ram brand of trucks—those incentives have been pared back lately.

We'll see if pricing discipline holds, as November marked the first month since July 2021 in which dealers sold vehicles below MSRP. "[T]he drop in price is concentrated across larger trucks, SUVs and luxury vehicles, whereas there is still increased demand for lower-priced mainstream vehicles," Edmunds.com reported last week. Perhaps feeling the chill winds of the business cycle, consumers are steering clear of expensive models in favor of cheaper alternatives.

Unit profits weren't the only line item in the dealers' profit-and-loss statements to inflate over the past 2¾ years. From full-year 2019 through Sept. 30, sales, general and administrative (SG&A) expenses per vehicle sold rose by 17% for AutoNation, 32% for Lithia and 39% for Asbury.

"Just as it is with retailers like Walmart and Target, the biggest portion of overhead expense/SG&A dollars is going to come from compensation and benefits," Mike Montani, who covers used-car dealers CarMax, Inc. and Carvana for Evercore ISI, tells me. "We've seen historic levels of wage inflation as well. Dealers aren't immune to it." Lithia, for one, says that two-thirds of its SG&A expenses in the third quarter were labor.

An instinctive managerial reaction might be to slash headcount (we mean, of course, after the holidays), but where would that leave the pennywise dealer if sales came roaring back from the current depressed rate?

Asbury, with its elevated SG&A costs per vehicle sold, is particularly vulnerable to a reversion to the mean. Say that gross profit per unit for new vehicles, used vehicles and finance and insurance dropped to 20% above their 2019 levels. And assume that new- and used-vehicle unit sales increased by 8% while SG&A remained flat. In other words, pencil in an 8% decline in overhead cost per unit during a recovery. This would deliver EPS of $12.19 compared to $35.11 in 12-month trailing earnings and $9.55 in 2019. If we assume that gross profits per unit revert to their 2019 levels, higher overhead expenses would push EPS below its mark of three years ago.

Asbury, the fifth-largest automotive retailer in the United States, operates 148 new-car dealerships, 7 used-car dealerships, 34 collision centers and retails 31 new-auto brands. In the 12 months ended Sept. 30, the company sold 284,629 vehicles (140,531 new and 144,098 used), generating $14.4 billion in revenue. Luxury brands (Lexus, Mercedes-Benz, BMW, etc.) produced 31% of its new-vehicle sales, imports (Toyota, Honda, Hyundai) accounted for 39% and domestic nameplates (Stellantis, Ford, GM) delivered 30%.

Asbury's balance sheet is moderately leveraged; net debt was equivalent to 1.9 times adjusted (and quite likely peak) Ebitda as of Sept. 30. On a trailing 12-month basis, operating income covered interest expense seven times. Asbury is rated Ba2/double-B-plus, near the top of speculative grade.

The stock trades at an optically cheap 4.6 times EPS; think of it as a modest multiple of super-normal earnings. In the five years before the bug bit, Asbury changed hands at an average of 11.1 times trailing earnings. As noted, if gross profits normalized to 20% above the 2019 level and vehicle sales increased by 8%, EPS could drop by 65%, to $12.19. Putting an 11.1 times multiple on that figure would value the stock at $135 versus the current share price of $158.71. The consensus acknowledges that earnings are likely to fall next year, but only by 15%, to $31.43, from an estimated $37.04 in full-year 2022.

Short interest is elevated at 8.7% of the equity float, though only one of eight analysts on the Asbury case says "sell." Over the past 12 months, insiders unloaded 29,884 shares for proceeds of $5.8 million; not one bought.

Next year could be the inverse of the 2021–22 bacchanal for dealers: a potential recession, rather than a stimmie-enhanced recovery; rising, rather than falling, interest rates; increasing, rather than flagging, new-vehicle production and (as rental companies toggle back to a better-supplied new-car market) persistently falling used-vehicle prices.

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