GRANT'S

INTEREST RATE OBSERVER®

Vol. 32, No. 01c Two Wall Street, New York, New York 10005 • www.grantspub.com JANUARY 10, 2014

Collision course

On the authority of the retiring chairman of the Federal Reserve Board, things are looking up in America. If he's right—50-50 are fair odds—woe betide the high-flying shares of the auto-parts vendor, Dorman Products Inc. (DORM on the Nasdaq). Then, again, now that we've analyzed the situation, woe betide them anyway.

Here begins an exposition both macro and micro. You may never have heard of Dorman—the company almost seems to like it that way—and you may have no particular interest in its air-door actuators, thermostat housings, cooling-fan assemblies, Pik-a-Nut Wheel Nuts, solderless cable lugs or other car and heavy-duty vehicle parts offerings. As far as that goes, you may be averse to short selling; after 2013, even the bears are averse to short selling. Still, we commend the Dorman story to you and to every student of the Great Recession and its long-lingering aftermath. Strange occurrences abound.

Dorman had a picture-perfect slump. Americans, light in the pocket, didn't replace their cars but repaired them. New-car dealers, which sell parts in competition with Dorman, vanished by the thousands. The American light-vehicle fleet aged. A new market in professional parts installation popped up. In the four years between 2008 and 2012, Dorman registered compound annual growth in sales and earnings of 13.6% and 40.7%, respectively. Over that golden interval, Dorman's market cap leapt to $2 billion from $233.9 million. Insofar as the Street has a consensus forecast—just five analysts cover the stock—it's for more of the same.

We dispute it. One reason concerns the possible shifting of the macroeconomic scenery. Third-quarter GDP expanded at the seasonally adjusted annual rate of 4.1%. By adding an average of 189,000 payroll jobs per month between January and November, 2013 virtually matched the hiring pace of the bubble-blowing years of 2005 and 2006. According to CoreLogic, the number of upside-down homeowners fell to 6.4 million in the third quarter of 2013 from 10.6 million at year-end 2012.

One of the enumerated risk factors in the Dorman 2012 10-K report is headed, "Unfavorable Economic Conditions May Adversely Affect Our Business." We ourselves would add another warning along the following lines: "Prosperous Economic Conditions May Also Adversely Affect

Dorman Products Inc.
(in $ millions except per-share data)

	12 mos. to 9/30/2013	2012	2011	2010	2009	2008
Sales	$629.7	$570.4	$513.4	$455.7	$377.4	$342.3
Cost of goods sold	382.9	355.2	324.2	282.9	245.6	232.1
Gross profit	246.7	215.2	189.3	172.9	131.8	110.2
Operating expenses	127.4	111.0	101.6	98.0	88.1	81.8
Operating profit	119.3	104.2	87.6	74.9	43.7	28.4
Profit before taxes	119.1	104.1	87.5	74.7	43.3	27.5
Taxes	42.6	37.7	31.3	28.5	16.8	9.7
Net income	76.6	71.0	53.3	46.1	26.5	17.8
Diluted shares (mil.)	36.6	36.5	36.4	36.2	36.0	36.1
EPS	$2.09	$1.94	$1.47	$1.28	$0.74	$0.50
Cash	48.3	27.7	50.2	30.5	10.6	5.8
Debt	0.0	0.0	0.0	0.0	0.4	15.4
Net debt (cash)	(48.3)	(27.7)	(50.2)	(30.5)	(10.3)	9.6
Acct. rec.	178.7	140.2	124.3	101.9	88.2	77.1
Acct. rec. sold	226.1	180.5	137.0	77.1	55.9	55.0
Adj. accounts rev.	404.8	320.7	261.3	179.0	144.1	132.1
Inventory	149.1	145.3	115.8	120.4	89.9	93.6
Acct. pay.	49.1	42.4	31.6	34.0	16.1	21.9
Working capital	504.8	423.6	345.5	265.4	217.9	203.8
Working cap. as % of sales	80%	74%	67%	58%	58%	60%

sources: The Bloomberg, company reports

Our Business For Reasons You Probably Haven't Thought Of." Dorman thrived in macroeconomic adversity; might it therefore struggle in prosperity (or what passes for prosperity in 21st-century America)?

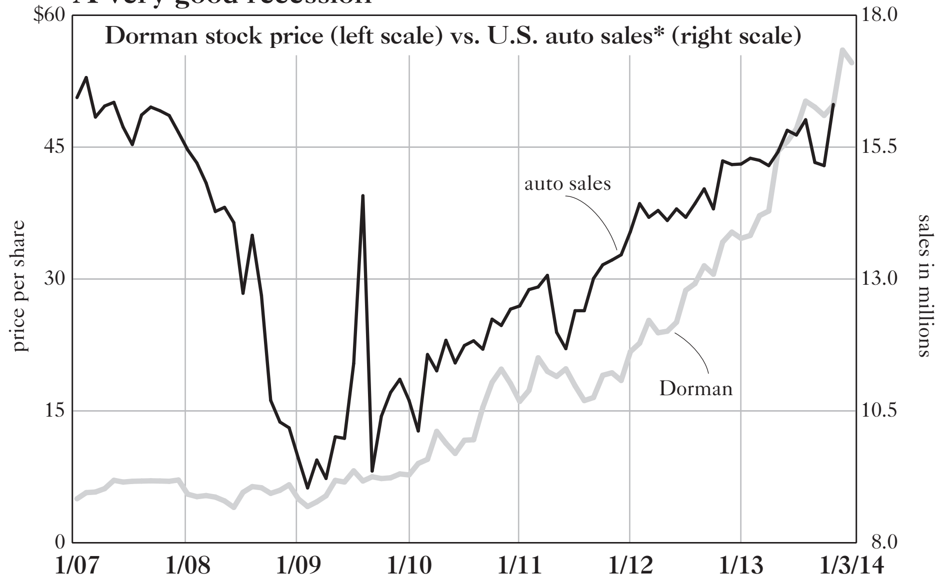
"To My Fellow Shareholders" is the salutation of the chairman's message in the 2012 Dorman annual report. It's more than a rhetorical greeting. The CEO, Steven L. Berman, and his family own 29% of the shares outstanding; Berman himself holds 13%. The letter reviews the recent years of mushroom growth, salutes the 1,321 Dorman employees ("contributors," he calls them) and recites the bedrock corporate principles of "profitable growth, risk mitigation and our culture of contribution." Turning to the future, Berman vows to continue to bring new products to market—6,700 debuted in the previous three years—and to enter "adjacent markets to supplement our automotive aftermarket growth capabilities." Medium and heavy-duty vehicle parts are among the new markets in management's sights.

"Dorman's niche is designing products for the aftermarket that were formerly only available to new-car dealers from original equipment manufacturers," colleague Evan Lorenz relates. "This is the market segment known as 'new-to-the-aftermarket.' For Dorman, it accounts for about one-fourth of unit sales and about two-thirds of dollar sales, and, so it seems, an outsize share of earnings. The company isn't one to do a lot of talking—management holds no post-earnings conference call and no one came to the phone to speak to *Grant's* when we tried to ask some questions last week."

Can the good times last? That is the overriding question. Dorman earns—or has earned—outsize margins. Over the past 12 months, the company booked a gross margin of 39.2%, compared with Standard Motor Products' 30.3%. Dorman's emphasis on new-to-the-aftermarket parts is evidently the source of the difference. How long can it go on?

In automotive terms, Dorman faces a kind of demographic winter. Thus, from 2000 through 2007, Americans bought an average of 16.8 million new cars and trucks a year. Between 2008 and 2011, they bought an average of only 12 million a year. For Dorman, the first-order effect of this collapse was hugely bullish. Not only did the repair

A very good recession



*seasonally adjusted, annualized
source: The Bloomberg

market blossom, but some 4,000 new-car dealerships went out of business. "Fewer dealers means increased sales for the independent automotive aftermarket," the 2011 Dorman annual said, "and we believe our 'Formerly Dealer Only' new product development strategy has us well positioned to take advantage of this trend."

The second-order effect of the post-recession sag in new-car sales is likely to be very different than the first. "Dorman does the heart of its business catering to vehicles just off warranty," Lorenz points out. "Dealers, using parts manufactured as original equipment, perform repairs on new cars and trucks. Dorman's specialty is vehicles aged five to 12 years. Because the post-recession drought in new-car sales started just about five years ago, there will necessarily be fewer vehicles in Dorman's preferred age group to service. IHS, which absorbed the automobile consultancy R.L. Polk & Co., predicts that the portion of the American light-vehicle fleet aged six to 11 years will shrink by 4.8% a year between 2013 and 2018. That works out to a cumulative drop of 21.9% over the next five years."

Dorman owes its fast growth and fancy valuation to the proliferation of the number of items it sells—stock-keeping units, or SKUs, as they're known in the trade. In the words of Jimmy Baker, analyst at B. Riley & Co., Los Angeles, Dorman is an "SKU proliferation story." It has grown faster than the market it serves by offering more and more parts. "Going forward," Baker notes, "it is going to have fewer and fewer opportunities to offer more parts, at least in its sweet spot." As the CEO told the shareholders, Dorman is expanding into new markets, not passively accepting the shrinkage in its customary, high-margin markets. Such a strategy, Baker observes, "introduces fairly significant execution risk. It also introduces potential margin pressure because Dorman is entering into areas where there is existing competition, whereas its bread and butter is trying to be first to market."

Dorman neither makes its own parts nor sells in its own outlets. It outsources its manufacturing to Asia (especially China) and it sells through the likes of AutoZone, Advance Auto Parts, O'Reilly Automotive and Genuine Parts Co. In the past three fiscal years, in fact, each of those four vendors accounted for more than 10% of Dorman's net sales; together, they accounted for 57% of net sales.

It happens that the four big Dorman retail clients have been shifting their attention away from the amateur handyman market toward the professional mechanic market. Dorman has been front and center with the necessary parts. "There is a different parts set that you need to carry if you are an AutoZone, for example, if you are going to sell to the professional installer vs. a do-it-yourselfer who comes in for a weekend project," Baker tells Lorenz. "There is this initial channel inventory build that takes place right now. It's clearly unsustainable growth. It is going to create very difficult comparisons going forward." Mr. Market may have only slight tolerance for disappointment in a company quoted at 25.9 times 2013 earnings and 20.6 times the 2014 estimate.

Of Dorman's four largest customers, only AutoZone is still in inventory expansion mode. Quoth the chief financial officer of O'Reilly, Thomas G. McFall, on the Oct. 24 earnings call: "We continue to project inventory per store to be flat in 2013 as we continue to identify opportunities to redeploy our existing investment into more productive inventory." A week later, McFall's counterpart at Advance Auto, Michael A. Norona, imparted a similar message: "This increase [in inventory] was higher than our expectations due to our lower-than-anticipated sales performance. We expect our inventory growth will be lower by the end of our fourth quarter."

How else might Dorman meet the kind of expectations that come with the territory of a premium equity valuation? Not through a burst of final demand. In the fiscal year ended in August, same-store sales at AutoZone, for instance, were flat. Nor through an accession of cost-saving efficiency in production. Chinese contract manufacturers are facing both a higher renminbi-dollar exchange rate (up by 2.9% in 2013) and higher wage costs (Chinese wages rose by an average 10.7% in 2013, according to Bank of America). Thus, for Dorman, sales growth doesn't necessarily translate into margin improvement. The third quarter provides a case in point: though sales showed a sequential rise of 9.7%, gross margin declined to 39.2% from 39.7%.

"There are other signs of strain," Lorenz points out. "Bulging accounts receivable is one. They registered 27% year-over-year growth in the third quarter to $179 million, nearly double the 13.8% year-over-year growth in sales. In the third quarter, it took Dorman an average of 104 days after the completion of a sale to collect its revenue; that compares to 90 days— 'days sales outstanding' is the term—in the third quarter of 2012. The DSO data would have looked worse if Dorman had not had recourse to factor financing. Adding back factored receivables, credit extended by Dorman to its customers grew by 32% year-over-year in the third quarter of 2013; DSOs were 235 days vs. 196 days in the third quarter of 2012. Dorman is in a curious financial position. Though the company has no long-term debt, its reliance on factoring to fund its working capital means that a rise in interest rates would hurt it, not help it."

No mystery as to why Dorman is in the E-Z payment business, observes analyst Baker: AutoZone, O'Reilly and the rest increasingly hold the competitive cards. They could, if they chose, outsource their own Chinese-made parts. "If you think about why the AutoZones of the world haven't already disintermediated Dorman," says Baker, "well, they are getting into new categories," i.e., into the professional mechanic product niche. "Dorman is effectively financing the guinea-pig process. They are selling them this incremental inventory; Dorman takes all the working-capital risk. They run the slowest inventory turns in the industry. It is an incredibly working-capital-intensive model they have there."

And it's likely to become even more capital intensive. The big retailers are doing their all to shift the cost of financing back to Dorman. If a supplier isn't financing 100% of a retailer's parts inventory, that retailer probably feels ill-used. AutoZone, which has contrived to have its vendors finance more than 100% of its inventory—115.6% is its ratio of accounts payable to inventory—is evidently the title holder in this burden-shifting competition. Advance Auto, with an AP-to-inventory ratio of just 83.5%, says it's striving to reach the 100% mark. Genuine Parts, with an AP-to-inventory ratio a little lower than Advance's, is similarly pushing in the direction of 100%. The better it is for the retailers, naturally, the less advantageous it is for the suppliers.

As for Dorman's senior management, actions speak louder than words. As a group, they are regular and heavy sellers of their own stock. Wise fellows, we say.

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