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Aristocrat of the junkyard

To the rampaging Mr. Market, John Hughes's stock was just another ticker. The panicked old gentleman seemed not to care about the sturdy business behind the cascading share price. From the pre-virus high in February to the March low, the quoted equity value of Copart, Inc. (CPRT on the Nasdaq), "one of the greatest capital-compounding machines in the history of modern capitalism," as Hughes recently put it, fell by 43.8%, a third more than the S&P 500's drop.

We write to refresh the Copart story and, through that narrative, to describe the thought processes by which Hughes buys small- and medium-cap equities for his institutional and high-net-worth clients. The reader of this essay will learn that Hughes is one smart cookie (Ben Graham said exactly that of himself) and that Copart has been, and may continue to be, a superior investment.

Before the bug barged in, Hughes, founder of Quantum Capital Management, and his staff, including second-in-command, Giridhar ("Giri") Reddy, were managing $592 million; by last week, that AUM had dipped to $524 million. The firm-wide portfolio comprises 18 positions, of which the 10 largest account for 69%.

Copart, the top auction broker of banged-up vehicles, vies with home-builder NVR, Inc. and aerospace-manufacturer Heico Corp. (respectively, NVR and HEI, each on the New York Stock Exchange) as the biggest holding. From its 2000 founding to date, the small- and mid-cap Quantum portfolio has generated average net annual returns of 10.67%, compared with 6.28%, dividends included, for the S&P 500, with contributions throughout the portfolio (no single superstock was responsible). Even so, the comparison understates the relative superiority of the Quantum record, since Hughes has averaged a 20% cash position whereas the S&P is forever fully invested.

When he talks about his favorite investments, Hughes reveals a depth of knowledge essential to any who would choose to run a concentrated portfolio. In fact, the former CPA can project a degree of conviction for which the word "bullish" does not quite measure up. In a talk at the Spring 2019 *Grant's* Conference, for example, Hughes paced the stage at the Plaza Hotel singing the praises of NVR and Heico. In reference to the latter's chairman, Larry Mendelson, he used these words: "This capital-compounder. This wonderful man."

Capital compounding takes center stage at Quantum, for which approach Hughes is quick to credit his business-school mentor, Bruce Greenwald, academic director of the Heilbrunn Center for Graham & Dodd Investing at Columbia University.

"One of the more serendipitous events in my life," Hughes advises *Grant's* by email (he's a friend and longtime paid-up subscriber, let the record show), "was my decision, in my early 40s, to become an investor at the same time Greenwald was heading the value-investing program at Columbia and, more importantly, leading the intellectual discourse on the direction in which value investing was evolving—from mean-reverting asset value to growing franchise value."

"Incumbent competitive advantage" is the phrase that describes one of Greenwald's principal messages and one of Hughes's basic stock-selection criteria. "Franchise" is another integral concept. A franchise company is armored against competition by dint of its business dominance—for example, in Copart's case, by the 10,000 acres of land that that company has painstakingly accumulated worldwide for use in parking its unsightly inventory.

Hughes, plagued like so many other professional investors to designate a "style" box, calls his M.O. "concentrated and sustained capital compounding." That means owning shares of entrenched businesses that can profitably and dependably redeploy their earnings.

A tenet of the original Graham and Dodd approach was that the future is unforeseeable. Whether tomorrow brings peace and prosperity or wars and pandemics is not ours to know. Acknowledging that ignorance, the prudent investor will demand a margin of safety. As future growth is uncertain, he or she must never pay in the expectation of securing it. Book value per share, in contrast, is here and now—you can see it on the balance sheet. It's a good thing, value doctrine has it, to buy at a discount to book.

Hughes, though he lays no claim to unusual prescience, does take a view of the future. Observing what a high-earning, deeply moated business has done in the past, he's prepared to anticipate more of the same in the future—cash flows deployed at historical volumes and at customary rates of return. Capitalize those cash flows at a reasonable multiple 10 years out, and you have the data with which to forecast an annualized return, or what Hughes calls a "total return yield."

"To our way of thinking," he says, "this approach is value investing in its purest form. The margin of safety is the quality of the enterprise. We define quality as 1) capital efficiency, 2) competitive advantage, 3) ability to grow profitably and 4) management by excellent capital allocators and operators."

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Copart, the leader in a two-company oligopoly devoted to monetizing the value of wrecked cars and trucks (IAA, Inc. is the runner-up), ticks every one of Hughes's quality boxes. More than 3 million damaged vehicles changed hands in fiscal 2019 on Copart's virtual and physical auction networks. Connecting buyers and sellers over a proprietary internet auction platform, it's no ordinary broker but a rare and protected one.

Bringing the buy side and the sell side together is no easy feat, and not just anybody can secure a foothold in the business. Copart transports, processes and conditions automotive wrecks. It continues to accumulate the not-so-readily available lots (it owns 233 of them), on which to park the hulks pending sale. Without those appropriately zoned yards, Copart would likely be known less as a great growth stock than as the No. 1 patron of the global tow-truck industry.

Till about the end of February, the Copart growth story seemed unassailable. The world's drivers would log more miles. Their vehicles would become richer in technology. There would be more crashes. And because of the difficulty of repairing today's technology-enhanced vehicles, an ever-rising share of such wrecks would be consigned to the category of "total loss"—for Copart, the most lucrative category.

Writing to his investors in late January, Hughes reflected on Quantum's first purchase of Copart 15 years ago. Over that span of time, CPRT's sales compounded at an annual rate of 11.4%, its earnings at 16.8%. Copart generated $3.48 billion in free cash flow from operations and deployed $4 billion in capital expansion, acquisitions and share repurchases. At the end of fiscal 2005, the balance sheet showed $253 million in cash. And from that year till the end of fiscal 2019, net debt showed an uptick of only $375 million.

Over the decade and a half, Hughes went on, Copart's fully diluted share count dipped to 238 million from 372 million, per annum revenue jumped to $2.04 billion from $528.6 million and annual free cash flow leapt to $601 million from $113.5 million.

The virus rewrote the narrative. Commerce stopped, cars remained in their garages and prospective accident rates crashed. The Copart share price—though the market expression of a highly profitable and lightly leveraged business—suffered the kind of Covid-19-related drawdown to which companies with preexisting financial conditions fell victim.

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Quantum's small- and mid-cap portfolio decreased by 22% in 2008 and rose by 52% in 2009, an exemplary performance that comes with the caveat that the assets under management in 2008 summed to the grand total of $10.7 million. Anyway, Hughes relates, Reddy and he determined that they would deal with the coronavirus panic as they had the Lehman crash. They would deploy cash in three tranches, or waves, buying the stocks that shone brightest in terms of forecast 10-year total return yield.

Hughes says that Quantum probably did more trading in March than in any month since the inception of the firm. It weeded weaker names, added to better ones and initiated new positions that Mr. Market had suddenly rendered affordable (and, in so doing, completed phases one and two of the three-tranche cash-deployment plan). It conducted stress tests on every portfolio company by posing the question: What percentage decline in revenue would force a reduction in expenses and/or the drawdown of the first dollar from a credit revolver?

"Excuse me, is this seat taken?"

"On a weighted average basis," Hughes relates, "we saw that the portfolio could suffer a 46% decline in revenues. Some companies (e.g., Copart) were more resistant to a deep revenue decline than others. We estimated that Copart could suffer a 55% to 60% decline in revenues at breakeven cash flow from operations." (Copart did draw down a revolver in April, in the sum of $850 million, though it was not on account of worries over solvency; there was $1 billion in cash on the balance sheet on March 19, according to an 8-K filing).

Hughes's enthusiasm is contagious, all right, but the JPMorgan equity research department is proving resistant to it. On April 23, the Morgan analysts upgraded Copart, but only to "neutral" from "underweight." At 28.7 times the estimate, the shares are simply too rich, the analysts judged.

We ourselves, with more than a few drops of pre-evolved value blood in our veins, have sympathy with the critique (the shares have rebounded sharply from the lows). Who knows what the future holds? An unanticipated breakthrough in anti-crash technology? The early arrival of a crowd-pleasing form of vehicular autonomy?

We asked our friend if, for whatever reason, he has had Copart sticker shock.

"Yes," Hughes replied, "we have sold shares based on valuation. And then repurchased shares, more than once, at higher prices. An obvious error in retrospect. A company like Copart—and most growing companies, for that matter—suffers inefficiencies as they grow. This tends to suppress their actual earning power. When Copart acquires another storage yard at a cap rate of 4%, by the time they build, fit out and staff the facility, before they process one vehicle, the incremental return on invested capital will be something less than 4%. But a yard is yet another node in the network. The network reinforces both the liquidity of its global auctions and its attractiveness to insurers to enter into national contracts. The acquired yard captures all future value creation ascribed to it and prevents landlords from confiscating that future value creation through rent increases.

"Another value-investing mentor," Hughes went on, "Tom Tryforos, once told me, 'Smart people, over time, tend to surprise you to the upside.'"

Granted, certainly, though events can surprise you to the downside.

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