AutoNation Inc. (AN.US)

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International Stock Market Weekly

Consumer Discretionary: Specialty Retail: Mid Cap Value

AutoNation Inc. (AN.US)

AutoNation is winning the vehicle sales and service race in the US. The company is already the largest automotive dealer in the country, with ~230 dealerships and more than 300 locations. The company also has four auction sites, six AutoNation USA used-vehicle stores, and 74 collision centers in 18 states. To date, the company has sold and serviced vehicles to more than 13mn customers. It has access to more than 100,000 new and used vehicles, which enables it to sell vehicles to customers based on their individual requirements. In addition, the company also provides auto financing, insurance, sells used vehicles, parts, and repair services. The company is growing on a combination of 1) extremely strong demand for new and used vehicles due to multiple factors; 2) historically low interest rates and favorable financing, and 3) the largest footprint in the fastest-growing markets in the US coupled with a comprehensive digital presence.

The pandemic has created an environment that has been difficult for automotive companies, and many have had to temporarily shutter plants in North America due to the semiconductor shortage. While this has proven a bane for automakers it is a boon for other players in the automotive industry, with those operating used car businesses doing particularly well. Indeed, the unique recipe of the global semiconductor shortage and corresponding shortage of available new vehicles, fiscal stimulus, and low rates has created a voracious appetite for automobiles, especially used ones. And one of the biggest beneficiaries of this is AutoNation, Inc. (AN). The company just posted its fifth consecutive record quarter. And while it has been on a tear in terms of performance, demand still continues to outpace supply for new vehicles, and overall demand for new and used vehicles, as well as related services, should sustain into 2022 and beyond on the back of greater demand for personal transportation combined with lower interest rates.

AutoNation is our international stock pick of the week due to a confluence of multiple positives around the company will provide the stock with considerable tailwinds for the foreseeable future. Our recommendation is based on an attractive valuation, the company's share repurchases, and the assumption that previous operational headwinds are now a thing of the past. While the stock trades at multiples above peer averages, AutoNation deserves a premium given its superior margins. Overall US vehicle sales should undergo a strong recovery in 2021, and AutoNation is positioned to continue its aggressive repurchasing of shares, which should continue to drive the share price higher.

Stock pick for the third week of August

AutoNation, Inc. (AN.US)

About AutoNation, Inc.

AutoNation, Inc. (AN) is a Ft. Lauderdale, FL US based automotive retailer. The company provides a range of automotive products and services, including new vehicles, used vehicles, parts and services, which includes automotive repair and maintenance services, as well as wholesale parts and collision businesses, and automotive finance and insurance products, including vehicle service and other protection products, as well as arranging of financing for vehicle purchases through third-party finance sources. It operates through three segments: Domestic, Import and Premium Luxury. Its Domestic segment consists of retail automotive franchises that sell new vehicles manufactured by GM (GM), Ford (F) and FCA US (FCAU) The Import segment consists of retail automotive franchises that sell new vehicles manufactured primarily by Toyota (TM), Honda (HMC) and Nissan (NSANY). The Premium Luxury segment consists of retail automotive franchises that sell new vehicles manufactured by Mercedes-Benz (DMLRY), BMW (BMWYY), Range Rover (TTM) Audi (AUDVF), and Lexus (TM).

AutoNation is America's biggest and most recognized automotive retail brand and is transforming the automotive industry. As of Jun 30, 2021, the company owned and operated over 300 locations across the US. The company has to date, sold more than 13mn vehicles, the first automotive retailer to achieve this. Its success is driven by a commitment to delivering a peerless experience via customer-focused sales and service processes. The majority of its dealerships are located in California, Florida, and Texas, where the bulk of its revenue is generated, and this means there is considerable space for expansion. AutoNation's wide dealer network, enabling it to relocate its inventory to better satisfy demand. This contributed to it inking a deal with Waymo to service its AV fleet. AutoNation invested USD50mn in Waymo in Mar 20. In addition, its digital AutoNation Express service makes shopping at AutoNation Express service more appealing than shopping at rival dealers.

Rationale

The pandemic has created an environment that has been difficult for automotive companies, and many have had to temporarily shutter plants in North America due to the semiconductor shortage. While this has proven a bane for automakers it is a boon for other players in the automotive industry, with those operating used car businesses doing particularly well. Indeed, the unique recipe of the global semiconductor shortage and corresponding shortage of available new vehicles, fiscal stimulus, and low rates has created a voracious appetite for automobiles, especially used ones. And one of the biggest beneficiaries of this is AutoNation, Inc. (AN). The company just posted its fifth consecutive record quarter. And while it has been on a tear in terms of performance, demand still continues to outpace supply for new vehicles, and overall demand for new and used vehicles should sustain into 2022 and beyond on the back of greater demand for personal transportation combined with lower interest rates.

The global chip crisis has hammered the global auto sector. Auto OEMs are unable commit to timelines for new vehicle deliveries and have starting foregoing key features from newer models to keep the assembly lines running. Supply chain disruptions from the pandemic lockdown have resulted in a shortage of both new and used vehicles, resulting massive pent-up demand. The pandemic has altered market sentiment, with consumers now preferring personal mobility over shared mobility. And record-low interest rates and affordable financing are incentivizing consumers. These factors provide the framework on which demand for automobiles will continue. As a result, AutoNation is delivering remarkable growth across key metrics. The macro environment coupled with favorable supply/demand dynamics, will continue to drive AutoNation's outperformance in 2021 and beyond.

Supply chains ground to a halt in 2020 and left a deep gap in auto inventories Without access to semiconductors and chips, automakers were forced to delay the production of new vehicles. And the visibility as to the normalization of new vehicle production and deliveries remains unclear as it takes a long time to bring new chip capacity online. And so used cars are being purchased a rate never before seen, making it is hard for companies to secure more. The supply-side pressure creates more inelastic demand, which provides AutoNation pricing power.

The shortfall in manufacturing capacity for semiconductors, and subsequent global chip shortage has seriously impaired the supply of automotive chips. And the damage to the automotive sector with new vehicle shipments delayed, and other uncertainties have put the industry into a supply crisis. In spite of the stream of negative news flows, auto retailers have been delivering consistent record-breaking financial performance. The auto sector is simultaneously facing booming consumer demand paired with a shortage of new and used vehicles. The pandemic along with the ongoing migration out of dense urban centers has tilted consider preference away from shared mobility to personal transportation. In addition, historically low interest rates and affordable financing are also fueling auto loan demand. These factors, along with some others are behind AutoNation's best financial results in the history of the company. AutoNation is the industry's retail leader, and it is capitalizing on its experienced leadership team, operations strategy, and powerful brand. The stock is on track to achieve a 100%+ gain in 2021 and as of the time of this writing is up 62.9% YTD.

The company plans to open a minimum of 95 more used-vehicle stores across the US by 2030. This translates into a nine-year growth runway

Of course, massive fiscal stimulus and low rates on purchases are also helping to fuel demand while the disruption of supply chains caused by the semiconductor shortage has resulted in a short supply of new vehicles. That means that prices for the available new and used vehicles have skyrocketed, and this has proved a boon for AutoNation. Moreover, the upside potential for its AutoNation USA used-vehicle stores is huge. And even though there are presently only five AutoNation USA used-vehicle stores, the company plans to open a minimum of 95 more across the US by 2030. This translates into a nine-year growth runway. More used-vehicle stores enables the company to sell more of its used-vehicle trade-ins at retail instead funneling them to lossmaking auctions.

2Q was an all-time quarterly record high for AutoNation. Earnings skyrocketed 243% YoY on an adjusted

basis and were far higher than 2Q19's adjusted EPS of USD1.20. Same-store new vehicle unit volume was up 42% YoY and used vehicle revenue rose 32% vs. 2Q19. Indeed, SSS hit a record of USD7bn, beating the Street estimate by nearly USD1bn. Gross profit per new vehicle jumped 89% in 2Q, and the gross profit per used vehicle advanced 24%. In short, AutoNation is firing on all cylinders and is poised to capture the lion's share of the ongoing boom in demand for vehicles, related products, and services. Going forward, AutoNation has substantial upside as tremendous consumer demand and a severe shortage of both new and used vehicles act as a driver for sustained growth. Indeed, most estimates call for the backlog of new vehicle supply to last well into 2022, and so pricing for available vehicles should remain strong provided the demand growth trend continues. And with this, AutoNation can boost its revenues and margins even with low supply. One of AutoNation's core competencies is its ability to obtain additional inventory in the used car market. The company purchases used vehicles and had a seamless process for consumers to trade-in vehicles. Pricing power and the ability to add inventory are just a couple of the key advantages that give AutoNation an edge over its competitors.

AutoNation's earnings power, growing revenues, same-store sales (SSS), along with its repurchases and an attractive valuation alone are all reasons enough to buy shares in a growing company---and AutoNation possesses all of them. Indeed, 2Q revenue hit a record of nearly USD7bn. SSS of around USD7.0bn or 54% jump YoY to the same period a year ago and increased 33% compared to 2Q19. Both new and used cars sold at rapid rate. New car sales expanded 42% YoY and 12% compared to 2Q19. Used car revenue rose 37% YoY and increased 32% compared to 2Q19. And we think this trend is sustainable with strong double-digit sales growth continuing for the remainder of 2021 and through 2022, at minimum. And while consumers lean toward new vehicles with the economic recovery, both business lines are robust, and the company wins in either case. AutoNation also enjoys very healthy margins and total gross profit reached USD1.3bn, up 68% from last year. New vehicles recorded a gross profit per vehicle average of USD4,157, up 89% YoY, and up 130% from 2Q19. Used vehicles recorded an average profit of USD2,240, a 24% YoY gain, and up 53% from 2Q19.

Virtuous sales cycle for used and new vehicles

The new car shortage is impacting rental car companies as well, as they are finding it difficult to obtain new vehicles for their fleets and so are purchasing used vehicles to ensure sufficient stock on hand

Consumers today are receiving better prices to trade-in and sell their used vehicles. The gap between the price paid for a new vehicle and price received for trade-in lowers the total cost of a new purchase, providing consumers the belief they are getting a better value. And AutoNation's well-trained sales staff is fully making use of current conditions to secure more used inventory and generate more sales. And the new car shortage is impacting rental car companies as well, as they are finding it difficult to obtain new vehicles for their fleets and so are purchasing used vehicles to ensure sufficient stock on hand. According to White House data, more than half of all Americans have been fully vaccinated against Covid. Accordingly, travel is returning to normal and with it demand in related industries like car rental companies. As such car rental companies are going all out to add capacity. And AutoNation is perfectly positioned to grow its used-vehicle revenue with this massive commercial buyer market.

AutoNation's Parts & Services business is also reaping the gains from consumers who postponed the

purchase of a new vehicle in 2021 due to delivery delays and are spending on the maintenance of their existing vehicles. In 2020, the business accounted for 41% of the gross profit to the bottom line and only 16% of the revenue. It is a high-margin business and should continue to benefit from stronger demand due to supply constraints for new vehicles. Moreover, vehicle maintenance is essential, meaning that it is not up to the consumer's discretion to spend. Vehicles must have ongoing maintenance for a variety of reasons. And we believe many investors are overlooking the Parts & Services business, for now. Moreover, we expect earnings to expand and beat estimates for the remainder of the year, at minimum, on the back of the growth of this business.

Less driving and lower fuel costs makes vehicle ownership more attractive and economical

The widespread adoption of telecommuting means that consumers are not driving as much, lowering their monthly fuel consumption, which in turn is making vehicle ownership more attractive and economical. Commuting has plummeted due to the broad acceptance of telecommuting by employers. Many US companies plan to offer telecommuting options beyond the pandemic as employees prefer to work from home and companies have seen increased productivity and so this trend should continue as technology enables us to drive less. As owning a vehicle is now more economical to own and operate, AutoNation should benefit from more customer, and this should help drive sustained long-term demand.

America's ongoing urban exodus and shift away from shared mobility fueling sales growth

Personal mobility is back, and consumers are thinking differently about mobility due to the pandemic. Overall auto sales are very strong as consumers are avoiding public transportation.

Personal mobility is back, and consumers are thinking differently about mobility due to the pandemic. Overall auto sales are very strong as consumers are avoiding public transportation. Covid's impact on consumer psychology will be long-lasting with consumers pivoting away from shared mobility such as rideshare and mass transit and increasingly wanting to own personal transportation. Consumers want personal transportation, that is individual personal vehicles so that they can decide where and when they go, who is with them, who's in the vehicle before and after them.

In addition, the migration of populations from urban centers to less densely populated suburbs and rural areas is also fueling vehicle sales. As the distance from urban centers increases, so do the limitations and inconvenience of public transit, as well as the cost of ridesharing. And so personal transportation is the optimal solution for the pandemic era and behind much of the demand for vehicles. Furthermore, the Millennial and Gen Z generations are also leaving cities to raise families in neighborhoods with more living space, making public transit even less attractive.

Fully charged for America's transition to EVs

AutoNation plays a key role in facilitating the US transition to EVs as it is the channel between the OEMs and the end consumer. With the exception of Tesla (TSLA), OEMs rely on the company as a key partner for their EVs to penetrate and achieve broad market adoption. And these OEMs, which make up the majority of the automotive market, will launch their EVs through dealerships. Most consumers still want a test drive and consultation before making purchase. In addition, there are the servicing requirements

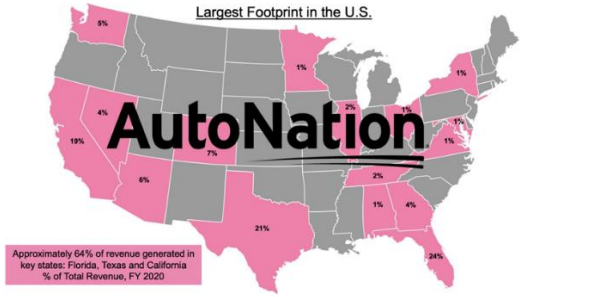
long after the purchase. And while AutoNation does not, at first glance, look like an EV play, the company will be a major beneficiary of this growing secular trend.

Low interest rates, massive stimulus and high demand make for a winning mix

The auto sector is capturing consumer spending that normally went to dining, entertainment, experiences, and travel.

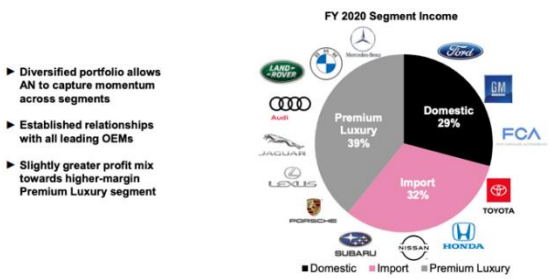
Record-low interest rates and attractive financing conditions are driving strong retail demand. Consumers are aware that currently low interest rates may come to end soon, and this is driving them to obtain low financing now while they can, which can be seen in the data from the Federal Reserve. Low rates correlate with stronger demand for auto loans and greater auto sales. The current consensus view is that the Federal Reserve will not raise interest rates before 2H22, which benefits the automotive sector as it should continue to fuel demand going forward. In addition to the low interest rate environment, massive fiscal stimulus, extended unemployment benefits, and lower consumption during the pandemic lockdown means there is vastly more disposable income available for big-ticket purchases. The auto sector is capturing consumer spending that normally went to dining, entertainment, experiences, and travel.

Fig 1. Focused on major metro areas in the fast-growing Sunbelt



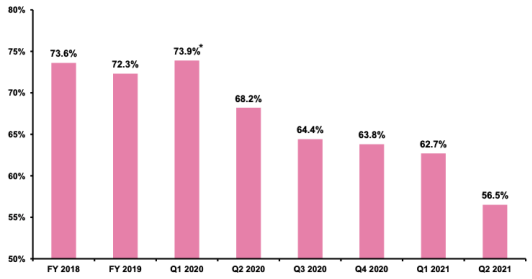
Source: AutoNation, Hyundai Motor Securities

Fig 2. Brand positioning within diversified portfolio



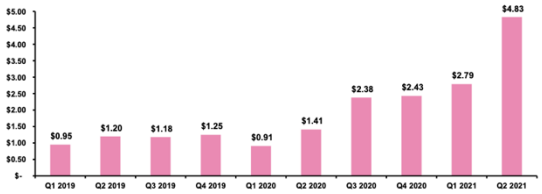
Source: AutoNation, Hyundai Motor Securities

Fig 3. Adjusted SG&A / gross profit



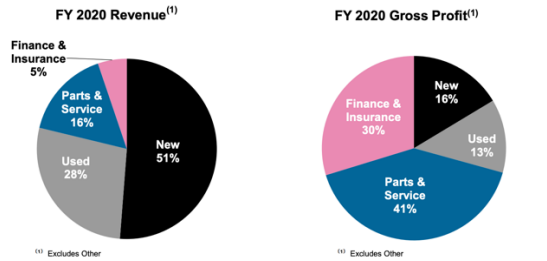
Source: AutoNation, Hyundai Motor Securities

Fig 4. Adjusted EPS from continuing operations



Source: AutoNation, Hyundai Motor Securities

Fig 5. Diversified revenue mix drives profitability



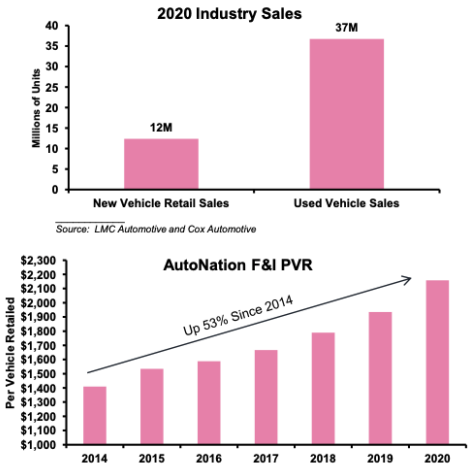
- ► Vehicle sales generate 29% of gross profit and create broader profit opportunities in Finance and Insurance (F&I)
- ► Resilient Parts & Service business contributes 41% of gross profit

Source: AutoNation, Hyundai Motor Securities

Fig 6. Robust data and analytics tools, provide a customized experience as well as additional sales and service opportunities

Source: AutoNation, Hyundai Motor Securities

Fig 7. Variable operations - new/used/F&I



- ► Vehicle demand remains strong, supported by low interest rates and consumer desire for personal transportation
- ► Large used vehicle opportunity with industry sales of approximately 37 million units/year
- ► AutoNation USA pre-owned vehicle stores provide opportunity to increase Used vehicle market share
- ► AutoNation continues to drive strong Finance & Insurance ("F&I") sales, supported by sales of AutoNation Vehicle Protection Plan
  - ► Approximately 2/3 of F&I gross profit generated by vehicle protection products

Source: AutoNation, Hyundai Motor Securities

Fig 8. AutoNation USA rollout plan

- ► Provides opportunity to expand geographic footprint and gain pre-owned market share
- ► Leverages experience from original 5 profitable pilot stores
- ► 6th store opened in May 2021 in San Antonio
- ► 4 additional stores targeted to be completed by late 2021
- ► 12 additional stores targeted to be completed in 2022
- ► Over 130 total stores targeted to be in operation by the end of 2026 (includes 5 original stores)
- ► 18 months from store opening to operating at initial run rate
- ► Next stores planned in Austin, Denver (2 stores), and Phoenix

Source: AutoNation, Hyundai Motor Securities

Fig 9. USA store economics

- Initial capital investment of $10 million to $11 million per store
- AutoNation USA stores expected to reach break-even in approximately 12 months from opening, and reach initial run rate in 18 months
- Model store projected to generate $200K per month or $2.4M annually at initial run rate

Forecasted Monthly Average per Store at Initial Run Rate	
Retail Units	200
Used PVR	$1,350
F&I PVR	$1,725
Revenue	$5,500,000
Variable Gross Profit	$610,000
Fixed Gross Profit	$70,000
Total Gross Profit	**$680,000**
SG&A	$470,000
SG&A/Gross Profit	*69%*
Floorplan	$10,000
Pre-Tax Profit	**$200,000**
$10M - $11M Investment/Store	

Source: AutoNation, Hyundai Motor Securities

Valuation and risks

AutoNation trades at a discount to investment alternatives.

AutoNation is in the Specialty Retail Industry and has positive earnings, so P/E and P/B are the most appropriate valuation measures. As such, AutoNation is inexpensive with a P/E of 10.01x, vs. the Specialty Retail Industry median P/E of 13.72x. AutoNation is efficient relative to peers with an RPE, RoE, and RoA of USD1,114,454, 31.98%, and 10.75% respectively. Of note, the company is above average at managing its resources and at managing OE. It is among the best at generating revenues from employees relative to other companies in the Specialty Retail Industry. For additional comparison, its P/B of 2.96 indicates a deep discount vs. the S&P 500 average of 4.69 and a significant discount vs. the Specialty Retail Industry average of 106. The P/S is well below both the S&P 500 average and the Specialty Retail Industry average, also indicating a discount. Accordingly, our assessment of these and other key valuation criteria, show that AutoNation trades at a discount to investment alternatives.

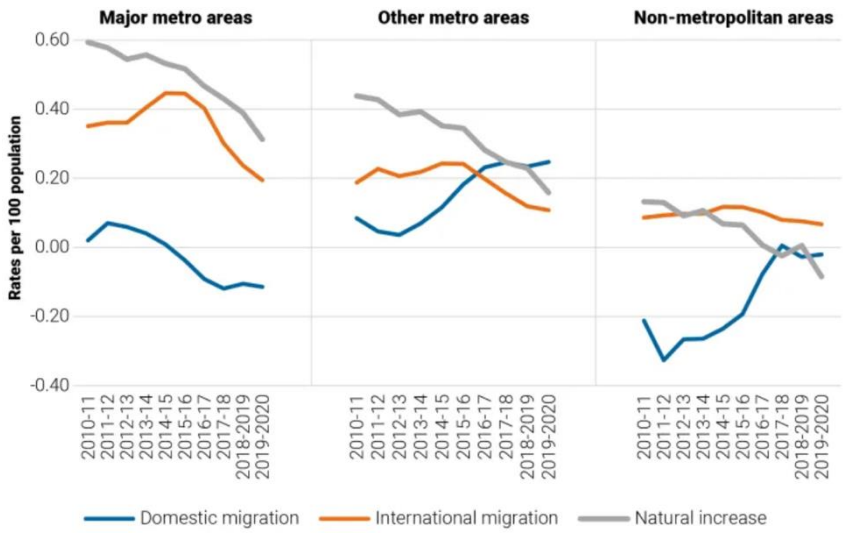
Risks include lower valuation multiples for auto retailers, increased dealer incentive spending, fluctuating gasoline prices and interest rates, vehicle demand, and pricing for new and used vehicles.

The bottom line

Our positive view of AutoNation is based on convergence of favorable investment measures, which should help the company outperform the Specialty Retail Industry as well as the broader market going forward. The company's strengths can be seen in multiple areas, such as its attractive valuation levels, robust revenue growth, solid stock price performance, impressive EPS growth, and solid ROE. The stock should continue to head northwards despite its impressive gain over the past year. The company's ROE greatly increased YoY, which is an indication of strength. The company reported significant EPS improvement YoY and is poised for EPS growth in the coming year. Going forward, the company should continue to grow on the combination of strong demand for new and used vehicles due to changes in consumer behavior, low interest rates and favorable financing, continued expansion in the fastest-

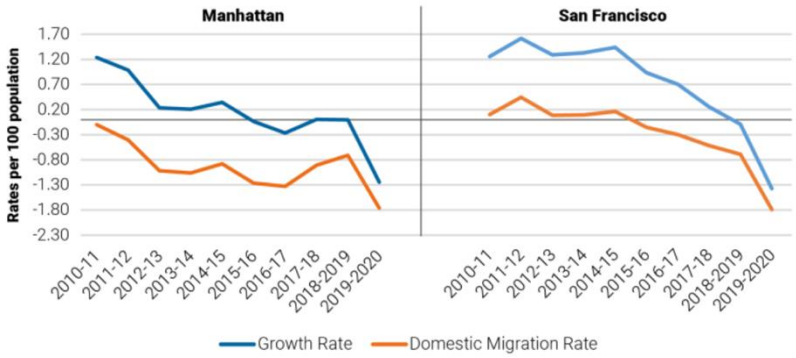
growing US markets, and ability to leverage its strong digital capabilities to grow sales. In sum, we believe that when taking all of the positives into account, shares have a long runway for considerable appreciation.

Fig 10. Annual net domestic migration, international migration, and natural increase (2010-20)



Source: Brookings, Hyundai Motor Securities

Fig 11. Annual growth rates and net domestic migration: 2010-20



Source: Brookings, Hyundai Motor Securities

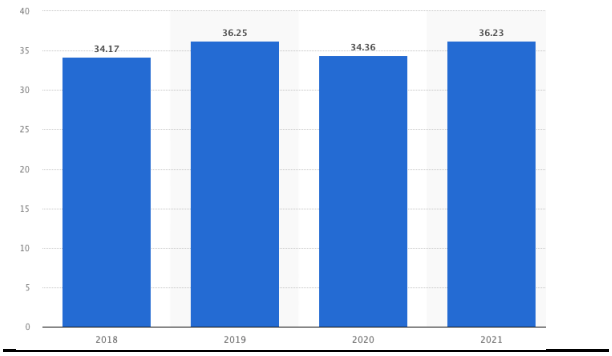
Fig 12. AutoNation Express Omnichannel Capabilities

Source: AutoNation, Hyundai Motor Securities

Fig 13. AutoNation Express Omnichannel Capabilities

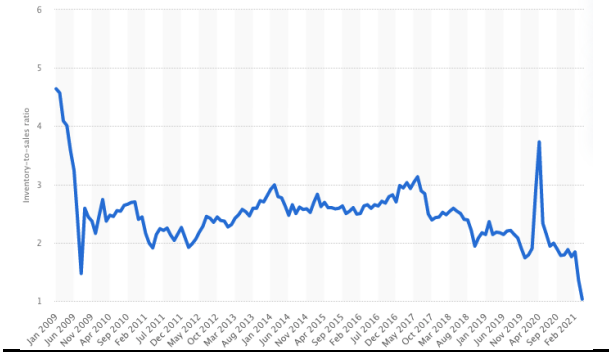
Source: AutoNation, Hyundai Motor Securities

Fig 14. S mkt. size of online car dealers 2018-21(USD bn)



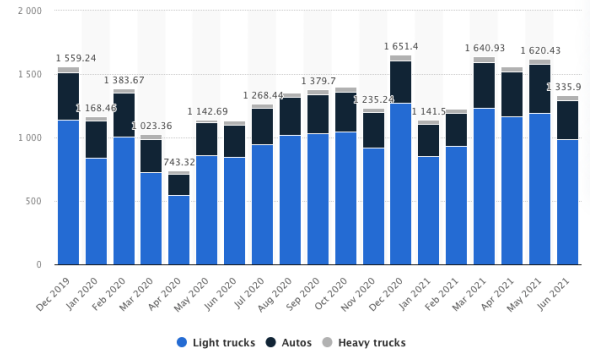
Source: ibisworld, Hyundai Motor Securities

Fig 15. Monthly US auto industry inventory-to-sales ratio Jan 2009-Apr 2021



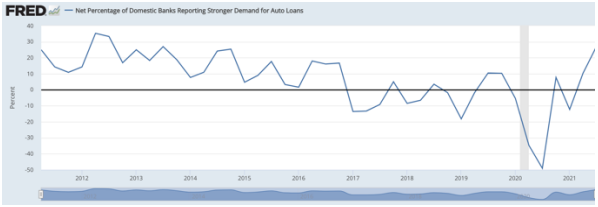
Source: AutoNation, Hyundai Motor Securities

Fig 16. US vehicle sales Dec 2019-Jun 2021, by vehicle type



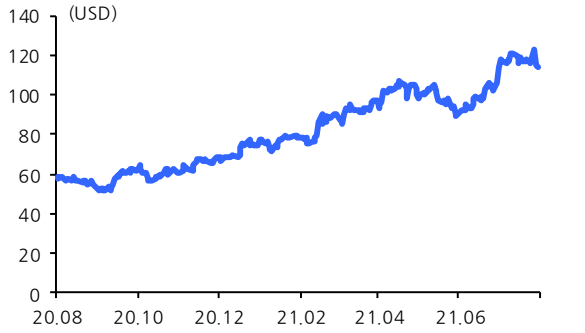
Source: US Federal Reserve, Hyundai Motor Securities

Fig 17. Net % of banks reporting stronger demand for auto loans



Source: US Federal Reserve, Hyundai Motor Securities

Fig 18. AN Stock Price



Source: Bloomberg, Hyundai Motor Securities

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