

The Perspective

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Investment Case Study: Lithia Motors

April 2016

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We utilize a rational and rigorous
process to find, analyze, and select
investments for our clients.



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Unlike some other money managers, Silver Heights tends not to talk about the specifics of what we own in our portfolios, since we view this as our “secret sauce”. Because we are, over the long term, net buyers of stock, we have no desire to be out promoting our holdings, as we prefer them to be as cheap as possible when we acquire our next share.

That being said, one of the most important things we do at Silver Heights is to look back at our investments over time to learn what we did right, and what we did wrong. Without wanting to use clichés, continuous learning is critical to our success and it’s an exercise we take very seriously. We keep extensive records on our companies to monitor their operational and strategic progress, and to make sure management lives up to commitments they’ve made. We also look back at intrinsic value calculations we’ve made over time for all of our companies to see if we have systemic biases – both positive and negative – in an effort to improve our processes for the future.



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Typically, these are internal discussions and reviews. However, we thought it might be interesting to share the ins-and-outs of one of our investments, from beginning to end.

Lithia Motors¹

Our investment process consists of finding quality businesses – regardless of their current price – and waiting patiently for the stock market to give us the opportunity to purchase these franchises for less than our estimate of their intrinsic value. We never know what the market will offer us on any given day, week, or month, but history tells us that the stock market does not always price businesses according to their value as an ongoing enterprise. Our edge at Silver Heights is our ability to maintain our focus on the business' value, even when market pricing swings to extremes, occasionally severely underpricing businesses during pessimistic times, and dramatically overpricing businesses during euphoric times.

Auto retailing is an attractive business which, over a business cycle, generates good profitability and cash flows. Although most would think of these retailers' businesses as being highly cyclical, they are much less volatile than common perceptions would lead one to believe. Don't get us wrong, auto retailers' sales – by virtue of their big-ticket nature – are certainly influenced by the economy, but their *profitability* is surprisingly resilient, with significant profit margin dollars coming from a steady parts and service business. The table below illustrates Lithia's 2015 financial results. New car sales are the majority of revenues, but a far lower percentage of profits. The service department is the opposite, generating a small percentage of revenues, but a significant part of profits.

	2015 Revenue Mix	2015 Gross Profit Mix
New vehicles	58%	24%
Used vehicles	28%	21%
Service, body and parts	9%	31%
F&I and other*	5%	24%

* Finance, insurance, warranty

Source: Lithia Motors

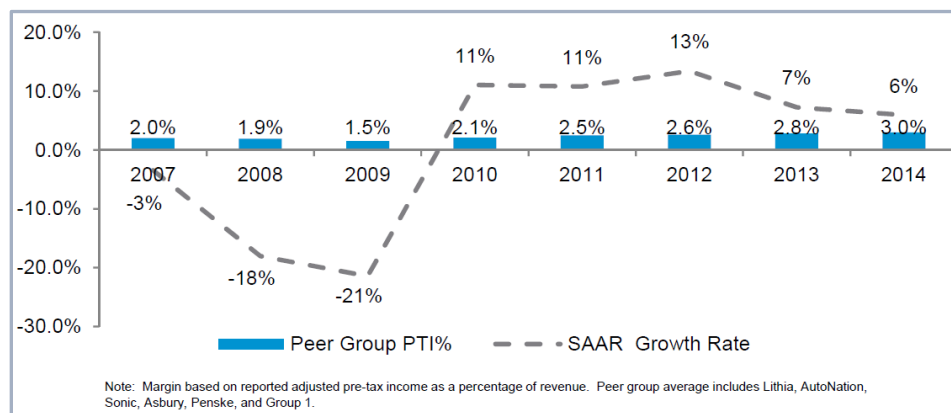
¹ All figures in USD.

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In tougher economic times, when the numbers of new cars sold may decline, the service business may actually increase as people who want to purchase a new car are forced to squeeze an extra few years out of their older vehicle. Although this might not fully offset the decline in new car sales, it does act as a meaningful buffer.

The following chart shows how new car sales, represented in the graph by the dotted line, “SAAR” (seasonally-adjusted annual rate), are far more volatile than dealers’ profit margins, “PTI” (pre-tax income margin).



Source: Lithia Motors

Despite a 35% drop in new car sales volumes from 2007 to 2009, the auto *retailers* remained profitable, while the auto *manufacturers* suffered significant losses.

It’s likely that wherever you live, there is at least one major auto retailing group in your city or town. It’s no coincidence that these owners like controlling a variety of brands in a particular geographic location. It enables them to better maintain pricing, purchase advertising at more attractive bulk rates, and share some common corporate costs.

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These business characteristics were – and still are – attractive to us as investors, and so we placed a number of the auto retailers on our “Watch List”. In particular, Lithia was appealing because they had a strategy of targeting “mid-sized and rural markets”. While other dealer groups were aggressively bidding to buy, say, the 5th Lexus dealer in Los Angeles, Lithia was quietly scouring the country for less competitive, and far less exotic, locations like Bend, Oregon, and Grand Forks, North Dakota, where they could buy a leading dealership for much lower multiples than in large, urban centres.

We first came across, and met with, Lithia in 2005. We were immediately attracted to the business characteristics listed above, but with the stock trading between \$25 and \$35 for most of the year, the price did not offer us our required margin of safety, given our estimate of its intrinsic value of \$25 to \$30. However, we were pleased to have found another company for our Watch List. We kept up-to-date on their story, seeing them again in 2006 and 2007, but the stock price remained higher than what we were prepared to pay.

Two years later, in 2007, oil prices skyrocketed. (While not the topic of this *Perspective*, the dramatic decline in the price of oil since 2007 is a great reminder that the prices of many goods can, and do, change dramatically, far beyond what virtually any macro-market prognosticator would envision.) Recall that Lithia’s strategy was to focus on non-metropolitan areas. With this came an increased exposure to pickup trucks and SUVs. In addition, these vehicles were largely the domain of the U.S. automakers, Ford, Chrysler, and GM.

By early March 2008, the stock had fallen dramatically, losing *two-thirds* of its value compared to a year earlier. We had the opportunity to meet with them (twice) again in early March 2008. We came away with the impression that the fundamental economics of the auto retailing business were not impaired, but rather, the macroeconomic environment was the main challenge facing the company. **In a nutshell, this is the crux of investing:**

Is a stock’s price decline due to a permanent change in the characteristics of the business, or is it due to cyclical or temporary conditions?

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As many of you know, we try to “think like owners” when we are investing. And, like in a private business, we prefer to see our partners – the management of the companies we own – having a material stake in their enterprise. It’s no different than our clients’ desire to see us at Silver Heights with our own personal wealth invested in the same stocks we buy for them. During one of our meetings with Sid DeBoer, the son of the founder of the company (started in 1946), he made a comment that stuck with us. He said,

“We’ve got to make this work. This is my baby. I have no other assets.”

Sid DeBoer
CEO, Lithia Motors

While financial alignment is no guarantee of success, it sure beats having a management team with no equity stake other than options, which pay them handsomely if things go right, but cost them almost nothing if things go wrong. Some have characterized options as being lottery tickets for management, and it’s an analogy we wouldn’t argue with.

Near the end of March 2008, we added Lithia to our portfolios, paying \$10.52 per share. We felt pretty good about this purchase, given that we thought the company was still worth more than \$20 per share, far more than the price we paid. Our comfort was quickly tested as we all know how the rest of 2008 unfolded. The financial crisis spread around the world and panic consumed investors.

In June 2008, we added materially to our position at \$6.80 per share, more than 35% less than we had paid just three short months earlier. Q4 of that year provided no relief, and was an environment we may not see for a long time (famous last words!). We added again to our position in October 2008 at the unbelievable-to-us price of \$2.81.

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Lithia Stock Price 2005 through 2008



Source: Capital IQ

Only two-and-a-half weeks after that final purchase, Lithia's shares touched a low of \$1.53. At that point, the stock was *85% less than our initial purchase price*. This certainly raised a few eyebrows during client meetings.

To highlight the extreme pricing, \$1.53 was $1/7^{\text{th}}$ of Lithia's tangible book value per share. Here are a few companies you may be familiar with and what their stock prices would be if they were valued at $1/7^{\text{th}}$ of their tangible book value:

<u>Company</u>	<u>Recent Price*</u>	<u>Price, if valued at 1/7th of Tangible Book Value</u>
Amazon	\$598.69	\$2.69
Apple	\$109.56	\$3.07
CN Rail	\$81.27	\$2.61
Disney	\$98.91	\$0.76
Loblaw	\$73.81	\$0.14
Royal Bank	\$75.44	\$4.44

* Prices as at March 30, 2016

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Throughout this entire period, we kept our focus on the business and could hardly believe the disconnect between how the business was performing and the company's stock price. Yes, new car sales were falling dramatically, but the stock market was pricing Lithia as if it were going bankrupt. As we noted above, the majority of the profits came not from car sales, but from the service department. We thought Lithia would be able to reduce costs and generate enough cash to weather the storm. We also believed that auto sales, while they may have been weak at the time, were temporarily so. There is a natural minimum number of vehicles that needs replacement each year due to accidents and just plain wearing-out. You can defer the purchase of a car for a while, but eventually, it will need to be replaced. We estimated this replacement number to be about 12 million a year (in the U.S.). During the crisis, the annual run-rate of cars sold fell as low as 9 million units. With these slowing new car sales, the average age of the existing fleet of cars on the road hit all-time highs and we thought to ourselves, "The longer the downturn, the more dramatic would be the recovery."

Intuitively, that thesis on the business makes sense, but what were the investment parameters we faced in 2008 as we were accumulating our position?

Protecting the Downside

One major concern that the stock market had regarding Lithia was the amount of debt on its balance sheet. They had over \$1 billion of total liabilities and \$258 million of equity. Given the macro environment, people were concerned that Lithia would not be able to pay off its debt and/or the lenders would get nervous and "pull the plug". How did we gain the comfort that these outcomes were not as likely as others felt they were?

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Let's take a closer look at their balance sheet. Key components of their liabilities were:

<u>As at June 30, 2008</u>	
<i>(\$millions)</i>	
Floorplan notes payable	342.7
Floorplan notes payable (non-trade)	137.1
Convertible debenture	85.0
Other long-term debt	83.6
Used vehicle credit facility	121.7
Real estate debt	173.0
	\$943.1

Source: Lithia Motors' Q2 2008 10-Q

Half of the debt was for floorplan financing. This is debt used to pay for the new vehicles that the dealerships held for sale. Over two-thirds of this debt came from the auto manufacturers themselves (*i.e.*, Ford, GM, Chrysler). Putting ourselves in the shoes of the various stakeholders, we asked ourselves, “If we’re GM, or one of GM’s creditors, what is the best way to maximize the value of the debt that Lithia owes us?” As a lender, the manufacturers had the option of calling in the debt and taking back the collateral. This is akin to a bank’s ability to repossess your house and sell it to recoup the money you owe them if you default on your mortgage. In this case, we felt that the conditions were much different than that of a typical mortgage client of a bank.

In the auto business, the auto manufacturers rely heavily – almost exclusively in many cases – on a third-party distribution channel to get their products to market. The world may be slowly changing (*e.g.*, Tesla’s direct-to-consumer model) but for the foreseeable future, the GMs of the world need the traditional auto retailing chains to help them sell their product. It would be a herculean task for the biggest of the manufacturers to go direct. We would not want to be tasked with sorting through all the regulatory and political aspects of such an evolution in auto distribution.

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Back to the question of, “How likely is it that the auto manufacturers call in their debt?” Given that Detroit’s *Big Three* had no other distribution channel, and every one of their retailing partners was facing the same challenging macro conditions, we felt it highly unlikely that they would call in their debt. From a practical perspective, what would they do with all the new unsold cars? Taking them back and giving them to another retailer doesn’t solve your problem. The other retailer would likely need financing anyways so what’s the point of calling in one loan to give another one to another party who faces the same soft economy? This shuffling of the deck would yield no benefit for the manufacturers. In the end, we came to the conclusion that this “debt” wasn’t really as dangerous as the leverage ratios might lead one to believe.

Another liability that the market feared greatly was the \$85 million convertible debenture that was due in May 2009. In mid-to-late 2008, Lithia’s *market capitalization* was what Wall Street would call microcap, bottoming out at \$31 million. Stop and think about this for a minute:

The stock market was attributing a value of \$31 million to a business that had revenues of \$2.6 billion and net income of \$24 million in 2007.

Just in case you think we’re cherry-picking a great year as a reference point, their earnings in the five prior years were:

	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Net Earnings (\$millions)	\$33	\$37	\$47	\$57	\$35

Source: Capital IQ

For many market participants, \$85 million of debt against a market cap of \$31 million is simply too scary a ratio. But, keep in mind that market cap is merely just the clearing price between buyers and sellers of a particular stock *at a single point in time*. Unfortunately, far too many investors take the market cap as a reasonable proxy for the underlying business’ value.

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Rather than look at the market cap, we thought about the \$85 million debenture in the overall context of Lithia's business (remember that its annual revenues were north of \$2 billion). In our opinion, that amount of maturing debt was more than manageable relative to the overall scale of their balance sheet. The prevailing market fear caused the debentures to trade at a discount, and the company was buying back all that it could get its hands on, eventually redeeming the debt for significantly less than its face value of \$85 million.

After the write-off of goodwill, Lithia's book value per share was \$12.90 at the end of Q2 2008. Their tangible book value per share was \$10.63. This is an interesting reference figure to keep in mind as it is, at least theoretically, the value that shareholders would have remaining if the business were shut down, all tangible assets were sold at their carrying cost, and all liabilities paid off. In Lithia's case, a large component of their assets was made up of the land upon which the dealerships were located. Much of this land – about only half of which was mortgaged – had been on Lithia's books for decades. We felt that if we were wrong about the business and it were wound down, this land would likely sell for an amount in excess of its book value, notwithstanding the real estate crisis that was unfolding. This provided yet another layer of downside protection for our investment.

As we illustrated earlier, it is rare for a company's stock to trade below tangible book value as this means that investors think that the company is worth more dead than alive. With the stock trading at less than \$5 per share in the summer of 2008, we thought that we had a significant margin of safety and that the likelihood of permanent capital impairment was extremely low.

Once we came to the conclusion that the business would survive and that the weak operating environment was temporary, we needed to estimate what the future profitability of the business might look like, to get to an estimate of its intrinsic value. From this exercise, we could then estimate our expected return over the next 5 to 10 years.

Our starting point for gauging the future profitability of Lithia begins by taking a look at its historical profitability. That may sound like a cop-out, but if we think that a business' future profitability is moderately at risk of an adverse secular change, we're likely not going to get enough comfort to invest. It's a very simple chain of logic:

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If we can't get comfort – even approximately – on what a business will look like 5 or 10 years from now, we can't value the business. If we can't value the business, how in the world can we know if today's stock price is cheap or expensive?

As outlined above, we came to the conclusion that in the future, the traditional new car retailing business would look similar to what it's looked like in the past. Looking back (from 2008), Lithia generated an average ROE of 9.4% in the past five years (2003-2007) and 11.9% in the past ten (1998-2007). These are not heroic numbers, and one of our underlying thoughts was that Lithia's profitability could and should be higher, especially as they acquired more dealerships and grew in size.

It's also worth noting that in Q2 2008, Lithia wrote off over \$300 million of goodwill, nearly two-thirds of their shareholders' equity at the time. We won't bore you with the accounting rules regarding these write-offs, but this is a non-cash charge and in certain instances, may *not* be a true reflection of a reduction in value in the business. But, let's be conservative and assume that the write-down was the result of a true impairment in the value of the underlying business.

If we were right about the continuation of auto retailing, we could estimate that Lithia would earn a 10% return on equity, roughly what they had made in the past. *Even with its drastically-reduced book value of ~\$13 per share, that would mean earnings per share of \$1.30. And even if it took a few years to get back to this level of profitability, and even if the stock traded at a modest multiple, the return would be very satisfactory.*

The more we protect the downside, the better the upside seems to be.

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Saying goodbye

We had no insights into how the crisis would eventually unfold. However, we felt that certain businesses, like auto retailing, would – over time – emerge largely unscathed in form.

Lithia, not surprisingly, had a tough 2008, doing a little better than break-even (excluding the non-cash impact of the goodwill write down). Over the ensuing years, the U.S. auto market went on to achieve record sales. During the crisis, Lithia was forced to cut costs and streamline their operations to survive, so when this recovery did come, the new and more efficient Lithia earned more than the company had ever earned prior to the crisis.

	2009	2010	2011	2012	2013	2014	2015
Net earnings (\$millions)	\$7	\$14	\$55	\$79	\$105	\$136	\$183
Earnings per share	\$0.52	\$0.89	\$2.10	\$3.06	\$4.10	\$5.17	\$6.67
Return on equity	2.4%	4.3%	16.1%	20.0%	21.9%	22.4%	24.4%

Source: Capital IQ

By 2013, the company was fully back on its feet. In 2008, if you had told anyone you thought Lithia was a company that could earn 20% returns on equity, you would have risked being locked up and having the key thrown away. Instead, the same stock market that had been predicting Lithia's imminent demise five years earlier was now forecasting never-ending growth and top-tier profitability.

It was our view that the reward-to-risk tradeoff wasn't in our favour any more. In order to see an increase in the stock price from 2013 levels, everything *had to* continue to go well. If it didn't, the risk of permanent capital impairment was material. Contrast this with what we faced in 2008, when our *downside* scenario was a double-digit return (*i.e.*, tangible book value was in excess of twice the stock price).

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In late July 2013, we sold our last shares of Lithia for just shy of \$60 per share, (making nearly 10x our money), which we thought was a rich price. With full credit to Lithia, the company has continued to operate admirably and the industry has not skipped a beat. After we sold our position, the stock (only!) appreciated by a further 100%. However, in the past few months, Lithia's stock as declined by 30% from its highs due to global economic fears.

Here we go again...

Sincerely,



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