Auto Trader: Finding opportunities amongst the Brexit wreckage

16/07/2019 | **Will Dowd**, *Fairlight Asset Management*

Auto Trader is the UK's dominant online used car marketplace, connecting consumers with 13,000+ used car retailers as well as manufacturers and direct consumer to consumer sales. The business employs a subscription-based business model, with retailers paying monthly subscriptions to list vehicles on the website.

Auto Trader embodies many of the quality characteristics Fairlight is searching for; recurring revenues, excellent cash flow conversion and strong organic growth. Although quality is paramount when assessing businesses, Fairlight is not willing to pay any price for quality. Instead we look for underappreciated quality, opportunities where the market may misunderstand the competitive advantages of the business or be paying undue attention to certain risks our analysis indicates are overstated. One avenue to finding underappreciated quality is in industries the market has pigeonholed as 'no-growth' or structurally challenged. Auto Trader is a high-quality business operating in a challenged industry facing Brexit-related headwinds, however it has several levers at its disposal to generate growth despite being in a 'no-growth' industry:

"Great companies in cold, non-growth industries are consistent big winners." – Peter Lynch's Golden Rules for Investing

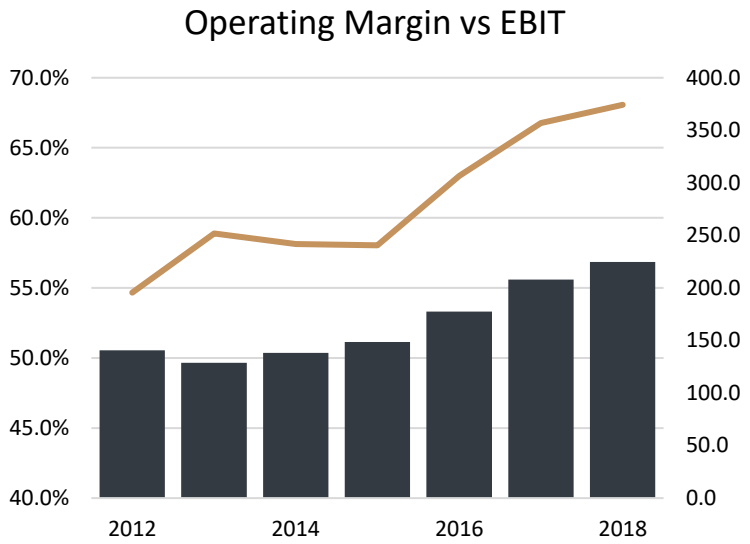
Dominant market position in a profitable niche

Auto Trader has an unusual history for an online classifieds business, beginning as a magazine in 1977, it successfully transitioned from print to purely online in 2013. This long history and first mover advantage have created an incredibly strong brand and a dominant market position. Today, Auto Trader is the number one 'most trusted' automotive brand, boasts 93% brand recognition amongst UK consumers and captures 75% of all automotive-related online minutes - 5x more than its next nearest competitor. Pleasingly, this is a competitive moat that will strengthen over time due to its self-reinforcing nature; the largest selection of trusted car stock feeds the best car-buying experience for consumers and thus delivers the largest consumer audience, which in-turn, creates the most effective sales channel for retailers and drives increased stock on the website. And on the flywheel spins.

Exceptional profitability

Auto Trader's dominant market position and deep competitive advantages result in enviable financial characteristics:

- Operating margins of 70%, steadily expanding from 58% at the time of the IPO in 2015 (see Figure 1);
- The business requires effectively no capital investment, returning close to 100% of earnings each year to shareholders via dividends and buybacks;
- Despite this, the business has still grown revenues organically at 8.5% p.a since the IPO and operating profit at 13.5% p.a.



Industry challenges

The primary macro factor that drives Auto Trader's business is the volume of used car transactions. This can be broken down into three key variables:

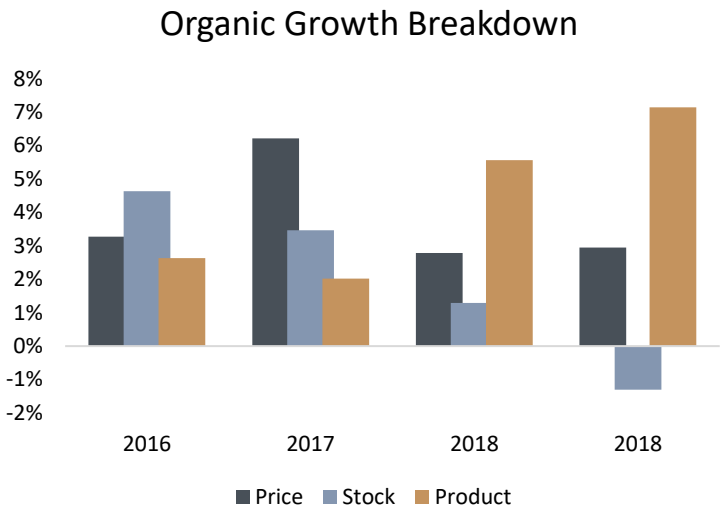
1. Volume of new cars sold: After a period of heightened activity, new car sales are slowing
2. Volume of cars scrapped: Over time the lifecycle of used cars tends to extend as they become more reliable
3. Frequency of transactions: Brexit driven economic uncertainty has weighed on consumers' willingness to change vehicles

With two of the three variables currently headwinds, the volume of used car transactions declined in 2017 and 2018 and is expected to decline again in 2019. Despite this, Auto Trader has generated organic revenue growth of 8% p.a over this period.

Multiple growth levers

Underpinning Auto Trader's ability to grow in a difficult industry is its multiple levers for growth (see Figure 2), two of which are independent of macro factors:

- Price: Auto Trader's dominant market position gives it strong pricing power - prices are raised 2% - 3% p.a
- Stock: Stock relates to the number of vehicles listed on site, which is directly related to used car transactions
- Product: Auto Trader is continuously developing new products to improve the buying and selling experience; as products are released they are used to incentivise retailers to upgrade to more expensive premium subscription tiers



The Fairlight View

When evaluating high quality growth investments, Fairlight seeks to find misunderstood and underappreciated quality. Auto Trader's proven track record of generating organic growth despite a difficult macroeconomic environment underpins its ability to continue to compound value for shareholders over the long term.

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