Investment Research Project: AutoNation (NYSE: AN)

Business Description:

AutoNation Inc. is the 2nd largest automotive retailer in the United States that provides new and pre-owned vehicles along with associated services. The firm has an extensive presence throughout the U.S. with over 300 locations across 20 states. AutoNation has many offerings in their comprehensive business portfolio such as, new and used vehicle sales, parts and accessories distribution, maintenance and repair as well as financing services. The company operates under the traditional car dealership business model, and it primarily makes money through new car sales, and used car sales. As far as new car sales go AutoNation negotiates volume discounts with car manufacturers in order to purchase cars at a wholesale price and marks these cars up for sale by 10-15%. On the other hand, AutoNation also generates significant revenue through used car sales that it acquires from trade-ins, wholes auctions and direct sales which they then recondition/detail these cars and mark them up 20-30%. The two other segments of AutoNation's business include the financing/insurance division, and the maintenance division. AutoNation generates revenue in the finance/insurance division primarily through taking commissions from the lenders and insurance companies that provide these services.

Industry Analysis:

Overall, the retail automotive industry is a highly competitive industry because the car sales business is not controlled by a few large players, rather its highly fragmented. This fragmentation forces dealers to keep profit margins thin and constantly innovate their offerings as because these dealers sell the exact same product and are competing to attract the same customers. Furthermore, the industry has high barriers to entry as new dealerships require significant capital to purchase inventory, establish a location and run the operation. This capital requirement barrier makes it unlikely that smaller companies will be able to compete with established companies such as AutoNation, CarMax, and the Penske Automotive Group. Secular trends within the industry include the popularity of SUVs and crossovers compared to traditional minivans which can potentially be a challenge for AutoNation regarding maintaining adequate inventory levels. Another secular trend would be the electric vehicle revolution which poses both threats and opportunities for retailers such as AutoNation because as demand increases the firm will need to invest in infrastructure, training and marketing to market to this new segment. The third major secular trend within the industry is the surge in online car buying platforms like Carvana and Vroom which challenge AutoNation's traditional dealership model through their ease of accessibility and convenience. AutoNation has responded to this threat by innovating its online platform though methods such as offering virtual tours and implementing omnichannel strategies to create a fluid experience both online and in-person. The major competitors of AutoNation include CarMax, Carvana, and Penske Automotive group. CarMax is a leading retailer-chain focused primarily on used cars with their "haggle-free" business model which cars are sold at fixed price whereas AutoNation sells both new and used cars. Carvana is a online car dealer that is based on an online-only model which is different from AutoNation's primarily brick and mortar business model. Penske Automotive Group is a diversified retailer with a significant presence in various segments such as new and used car sales, truck rentals ad

commercial vehicle leasing which is a broader portfolio than AutoNation. AutoNation distinguishes itself from its competitors through various means such as having comprehensive offerings that include maintenance, repair, financing and insurance services in one stop shop operation. In addition to these comprehensive offerings, AutoNation boasts extensive network throughout the U.S. which boosts its competitive advantage by creating increased brand recognition. Furthermore, AutoNation's omnichannel experience integrates the retailers electronic and brick and mortar model allowing a seamless buying experience. The competitive position of AutoNation is characterized by its strong financial performance, established brand reputation and its ability to adapt to changing consumer preferences such as virtual car sales proves the firms resilience in the dynamic automotive retail sector

Financial Analysis

Income Statement Analysis

Revenue: Revenue underwent a consistent growth over the past three years increasing from $20.4 billion in 2020 to $27.0 billion in 2022. This growth can be seen as a result of rising new and used car sales sold at higher prices as well as a rebound from the pandemic fueled by high consumer demand.

- **Gross Profit:** Gross Profit has steadily increased from $3.6 billion in 2020 to $5.3 billion in 202 representing AutoNation's ability to maintain its profit margins on vehicles.
- **Operating Expenses:** Operating expenses have grown at a similar pace to revenue indicating that AutoNation's operational costs have not risen disproportionately to its revenue growth. Operating expenses in 2020 was $19.8 billion growing at a linear rate to $24.96 billion in 2022
- **Net Income:** Net Income steadily rose from $1.373 billion in 2021 to $1.377 billion in 2022. NI data from 2020 was $381.6 million but this drop is attributed solely to the COVID-19 Pandemic.

Balance Sheet Analysis

- **Current Assets/Liabilities:** AutoNation has a current ratio of 0.83 which may indicate the firm could have issues paying off its current obligations in the unlikely scenario that business were to cease.
- **Evaluation of Debt:** AutoNation has a very high debt to equity ratio of 3.43 which indicates that the firm has been aggressive in using debt financing to fund the company's business.
- **Shareholder's Equity:** AutoNation has an approximate shareholders equity of $2.048 billion

Statement of Cash Flows Analysis

AutoNation's statement of cash flow analysis reveals a positive operating cash flow of $1.67 billion which indicates that the company generates sufficient cash from its

operations to fund ongoing expenses and investments. Additionally, the firm has been active in share-repurchases which return capital to investors.

Comparison to CarMax

Revenue: CarMax generates slightly higher amounts of revenue than AutoNation with its revenue being $29.68 billion and AutoNation having a revenue of $26.99 billion.

Gross Profit: CarMax generates a significantly lower gross profit of $2.8 billion relative to AutoNation's gross profit of $5.3 billion which can be indicative that AutoNation has a stronger cost structure than CarMax.

Operating Expenses: CarMax's operating expenses are $29.05 billion which is much closer to its revenue leaving an operating margin of only 2.145% compared to AutoNation's 7.502%.

Net Profit Margin: CarMax has a significantly lower net profit margin of 1.633% compared to AutoNation's 5.105% which suggests that AutoNation is more efficient in turning its revenue into profits.

Valuation

Several metrics will be used to analyze the valuation of AutoNation as a firm

Price-to-Earnings Ratio TTM (P/E): AutoNation has a 12-month P/E ratio of 5.79 which indicated that the firm is trading at less than 6x earnings which is less than half of the automotive retail industry average of 12.5x price-to-earnings, suggesting that the shares of AutoNation may be undervalued.

Price-to-Book Ratio (P/B): AutoNation has a price to book ratio of 2.7x which is lower than the automotive retail industry average of 3.10x, suggesting that the market may be undervaluing the firm based on the metric of stock price in comparison to the company's book value per share.

Enterprise Value/EBITDA: When comparing AutoNation's enterprise value of $10.38 Billion to its earnings before interest, taxes, depreciation, and amortization (EBITDA) of $1.962 Billion it comes out to a ratio of 5.29x which is less than the industry average of 8.25x further suggesting that the stock may be undervalued.

Potential for Mispricing

AutoNation's shares may be seen as potentially mispriced as the stock underwent a significant correction from disappointing but still positive earnings in July of 2023. The stock has gone from a high of nearly $180 per share to a current trading price of $135 per share since the correction. Several macroeconomic factors may affect the mispricing of the stock, such as interest rate hikes and economic downturns. Rising interest rates may negatively impact consumer's ability to purchase more expensive vehicles along with the potential for recession

causing many to avoid purchasing a new car in general. From an industry specific perspective, the rise of online car retailers like Carvana pressures AutoNation to revalue its business model and may pose questions to investors on the firm's profitability and prospects. As far as company specific factors go the high debt levels about the firm's financial flexibility and ability to invest in new innovative ventures. Attached below is the trailing 6-month stock chart.



Risks and Vulnerabilities

The main risks and vulnerabilities of AutoNation are primarily related to innovation.

Failure to Adapt to the EV Revolution: The rapid transition towards electric vehicles represents potential challenge to AutoNation is the firm does not adapt its infrastructure, and expertise to cater towards the EV segment which is crucial for long term success, this may lower investor confidence and investor outlook.

Failure to Compete with Online Retailers: Retailers like Carvana and Vroom provide a seamless online-only platform where cars can be purchased entirely online and delivered. This is a revolutionary technology as it gives consumers a wide variety of inventory that AutoNation can not compete with in their brick-and-mortar stores without adaptation. If AutoNation does not continue to improve its online platform, it may lose market share.

High Debt Levels: The high debt levels AutoNation has carries the potential to burden the company and limits the ability for the firm to invest in new innovative initiatives.