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GLOBAL IDEAS

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AutoZone Inc.— Turbocharged growth $393.98

Investment thesis

AutoZone is the leading retailer of automotive replacement parts and accessories in the United States, with more than 5,000 stores in the US, Puerto Rico and Mexico. While logic would suggest that this business sells products that are by nature fairly commoditised, the metrics of the business suggest otherwise: the group has generated gross margins consistently above 50% over the past four years, translating into EBIT margins of 17-19% and climbing. At the same time, very little capital is employed in the business—stock and debtors is more than funded by suppliers' credit terms.

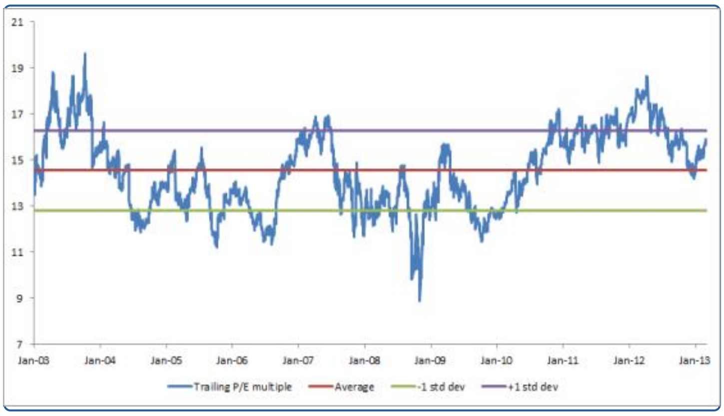
The above equation results in strong cash flows, and management's focus (and incentive structure) appears to be on returning cash to shareholders via share buybacks - ***between FY09-12, the group spent $4.6bn buying back its own shares, resulting in outstanding shares in issue declining by ~40% since end-FY08.***

Autozone Inc.				
August y/e	FY12	FY13	FY14	FY15
Diluted EPS ($)	23.5	26.7	31.0	36
% growth		*14%*	*16%*	*15%*
DPS	0	0	0	0
PE	16.8x	14.7x	12.7x	11.x
DY	0.0%	0.0%	0.0%	0.0%
Share price	$393.98			
12-mnth fwd PE	13.5x			

This reduction of shares in issue has leveraged 10% annual profit growth to 24% annual growth in EPS from FY08-12. Management has continued its buyback programme into FY13 and, despite a weak top-line performance in 2Q13, we expect the group to deliver 14% EPS growth in FY13—a rate of growth we believe can be sustained for some time given ongoing capital management initiatives.

The downside of this growth model is that the group is utilising all of its free cash flows (plus some gearing) to deliver its EPS growth—as a result, dividends will likely remain elusive for some time. Nevertheless, we think the stock looks attractive value at a **12-month rolling forward P/E multiple of 13.5x**—broadly in line with its 10-year average rating.

Figure 1: AutoZone Inc P/E multiple history



Source: Bloomberg

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We scan the globe looking for good opportunities. We provide our model portfolios, as well as news and views on our watch-list, which is continually reviewed and updated.

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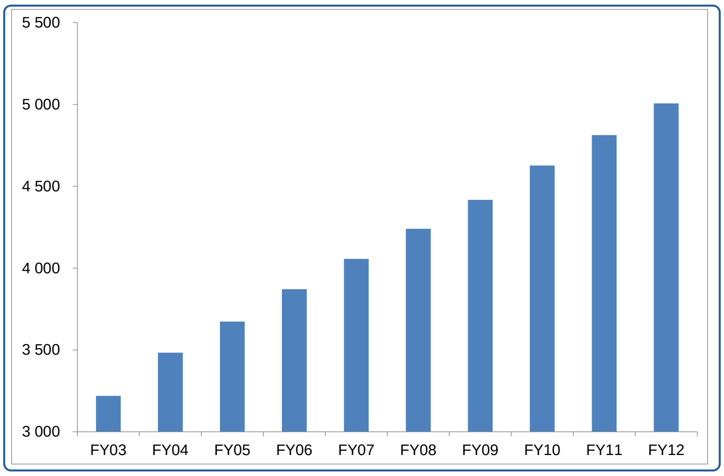
An impeccable track record of growth

In the charts that follow, we demonstrate the impressive metrics achieved by AutoZone over the past 5-10 years:

Figure 2: AutoZone share price—20% p.a. over 10 years

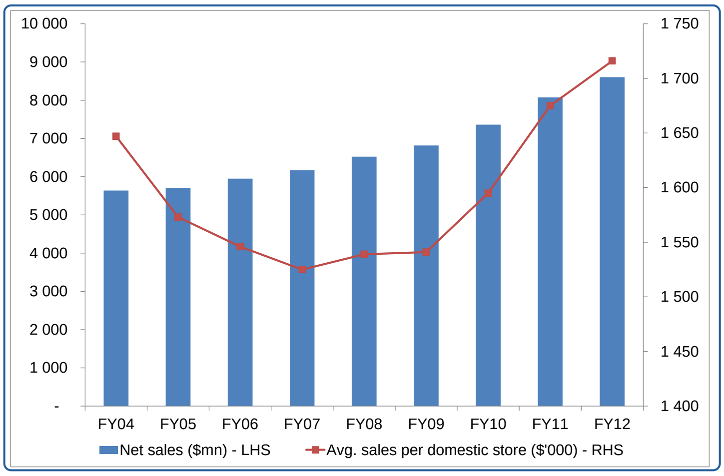
Source: Bloomberg

Figure 3: Solid new store growth—5% p.a. since FY03…



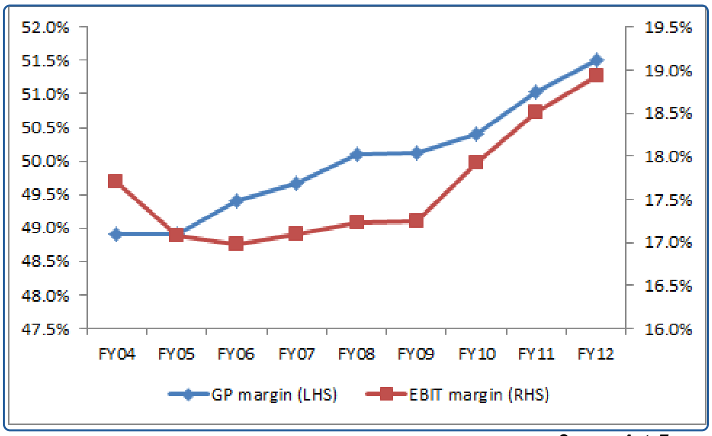
Source: Bloomberg

Figure 4: ...supporting 5.5% annual sales growth, despite a FY04-09 cycle of declining sales per domestic store



Source: AutoZone

Figure 5: High gross margins; sales leverage resulting in rising EBIT margins since FY05...



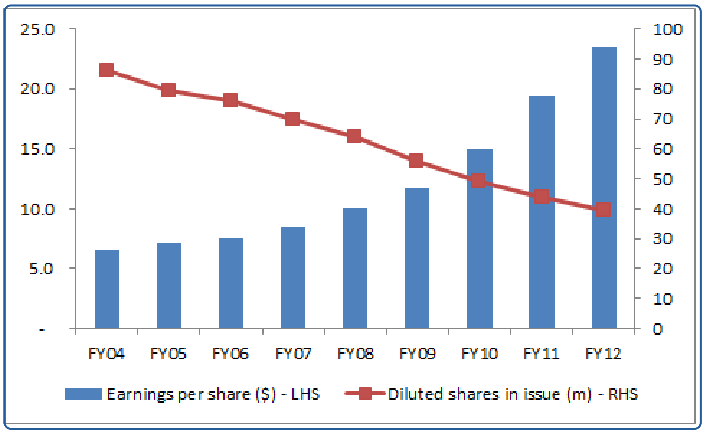
Source: AutoZone

Figure 6: Exceptional cash flows + the assumption of debt = deployed into share buybacks...

$'m	FY08	FY09	FY10	FY11	FY12
EBIT	**1 124**	**1 176**	**1 319**	**1 495**	**1 629**
add: depreciation & amort	184	171	199	205	220
Share based payments	19	18	19	27	33
Change in NWC	26	32	272	201	78
Tax / interest / other	-429	-477	-612	-636	-736
Cash from operating activities	**924**	**921**	**1 196**	**1 292**	**1 224**
Capex	-272	-244	-315	-322	-378
Free cash flow	**652**	**678**	**881**	**970**	**846**
Net earnings	642	657	738	849	930
FCF as % of earnings	102%	103%	119%	114%	91%
Net share buy-backs	**1 260**	**822**	**1 071**	**1 411**	**1 288**
Share buy backs minus FCF:	609	145	190	441	442
Net increase in debt	477	313	182	442	419
Difference	*132*	*-169*	*8*	*-1*	*23*

Source: AutoZone, Anchor Capital calculations

Figure 7: ...which has resulted in mid single-digit EBIT growth leveraged up to mid-teen EPS growth

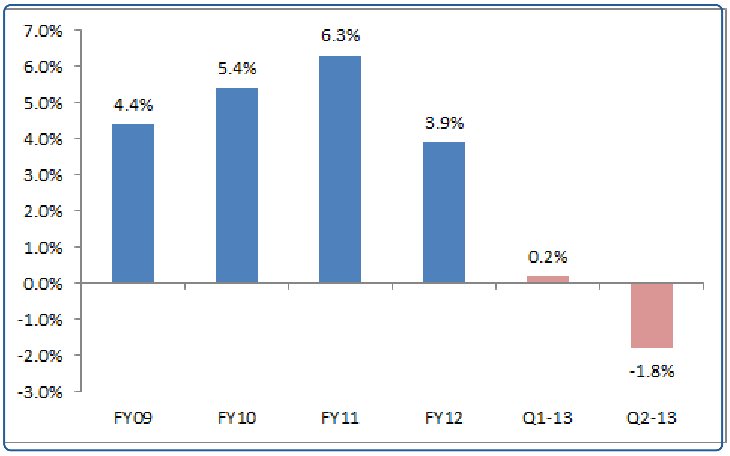


Source: AutoZone, Anchor Capital calculations

Recent US sales trends concerning, but the growth model should still deliver the goods in FY13

In the first quarter of FY13, the group delivered sales growth of 3.5%, with same store sales rising by 0.2%. Following this, the second quarter saw a 1.8% *decline* in same store sales (overall sales rose 2.8% in Q2). Management attributed the latter sales disappointment to an 8% decline in same store sales in the final two weeks of Q2, resulting from a two-week delay in the processing of income tax returns (we find this explanation curious). Management expects to see a normalisation of sales volumes—we interpret this to mean a resumption of positive same store sales growth.

Figure 7: Dramatic same-store sales growth slowdown



Source: AutoZone

Despite the sharp slowdown in sales in Q1-2, the group has managed to sustain mid-teen EPS growth over these quarters. This has been largely due to capital management: in Q1, the company repurchased 855,000 shares at $371 each and a further 513,000 during Q2 at an average of $361.

The net result in Q2 is that 5.6% EBIT growth translated into bottom-line EPS growth of 15% to $4.78:

Figure 8: Q2-13 AutoZone summarised results

	Q212	Q213	% ch
Net sales	1 804	1 855	3%
COGS	-878	-893	
GP	926	962	4%
EBIT	**301**	**318**	**6%**
Net income	167	176	6%
Diluted shares in issue	40.2	36.9	-8%
EPS	**4.15**	**4.78**	**15%**

Source: AutoZone

AutoZone disclosed in its 2Q13 results announcement that it still has $603mn of share buyback authorisation remaining; we anticipate this to be utilised over 6 months, whereafter the company will likely seek further buyback authorisation from shareholders.

Phenomenal returns on capital employed

Due in large part to the group's aggressive capital management initiatives mentioned above, AutoZone generates very high return on capital employed (the capital base does not grow much due to buybacks and stock funded by creditors). As a result of some debt being assumed to repurchase shares, the company now has a deficit on its balance sheet (i.e. more assets than liabilities) which makes calculations of RoE meaningless.

Figure 8: AutoZone return on capital employed

$'m	FY12
Equity / (deficit)	-1 548
add: net debt	3 665
Capital employed	**2 117**
FY12 EBIT	1 629
ROCE:	**77%**

Source: Anchor Capital calculations

AutoZone voluntarily provides its own version of return on capital which capitalises leases and may provide a fairer indication of returns. We note that this still amounts to an impressive 33% return *after* tax:

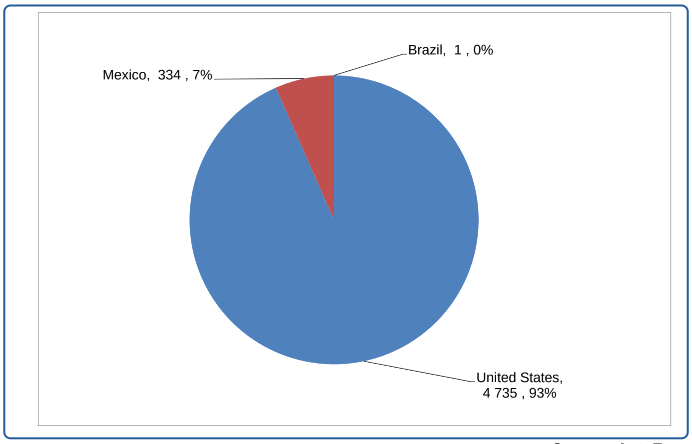
Figure 9: AutoZone FY12 RoCE—leases capitalised

Net income	**930**	**Avg. equity / (deficit)**	**-1 372**
add: Interest expense	176	add: rent capitalized	1 377
Rental expense	229	Avg. capital leases	96
less: tax effect of above	-146	Average debt	3 509
After tax return	**1 190**	**Invested capital**	**3 609**
		Return on invested capital	**33.0%**

Source: AutoZone

So, as can be seen above, AutoZone has an incredibly profitable business model where rolling out more stores makes a lot of sense. In this regard, the company currently has over 5,000 stores of which over 90% are in the US:

Figure 10: AutoZone store numbers and split



Source: AutoZone

As can be seen from Figure 3 above, AutoZone has sustained 5% p.a. growth in store numbers in recent years with most of this being due to US store growth. The company has 334 stores in Mexico and has recently opened its first store in Brazil. Management has communicated that it expects Brazil to be a market at least as big, if not bigger, than Mexico for them in time to come. However, the roll-out of new stores in that country could be slow as the group tests its business model there and as a result it won't likely be a big driver of returns for some time. Nevertheless, the potential certainly exists that Brazil could add 5-10% to the size of the group over a number of years. The company's current run rate of new store openings is 25-40 new stores per quarter (equivalent to 2-3% p.a. on current base).

Sean Ashton

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