Copart (CPRT) Investment Memo – Greg Blotnick – November 2016

Copart (CPRT) is the dominant player in the auto salvage auction industry and a textbook compounder. The business enjoys a host of sustainable competitive advantages and benefits from both supply and demand-side economies of scale, widening the firm's moat as the business grows. Copart has averaged 44% gross margins and 20% returns on invested capital over the past ten years while growing free cash flow per share at ~15% per annum. **This growth is set to continue as secular tailwinds are accelerating, and CPRT will continue to compound at a mid-teens clip for the next 3-5 years. On a probability-weighted basis, CPRT will trade to $70 (25% upside) in the next twelve months based on a blended average of free cash flow yield and P/E multiple. This assumes zero benefit from a corporate tax cut.**

CPRT
Dashboard Summary
$M, unless otherwise stated

TRADING STATISTICS			**21-Nov**
Share price ($)			$56.22
Shares outstanding (M)			109.0
Market cap			6,128.0
Net debt			563.2
Enterprise value			6,691.2
EPS Valuation	**Base**	**Upside**	**Downside**
EPS 2018	$2.99	$3.54	$2.39
P/E Multiple	22.5x	24.0x	19.0x
Implied Price	**$67.39**	**$84.85**	**$45.49**
Upside / Downside	*19.9%*	*50.9%*	*(19.1%)*
Probability	50.0%	35.0%	15.0%
FCF Valuation	**Base**	**Upside**	**Downside**
FCF/Share 2017	$3.05	$3.53	$2.49
FCF Yield %	4.0%	4.0%	5.5%
Implied Price	**$76.20**	**$88.18**	**$45.29**
Upside / Downside	*35.5%*	*56.9%*	*(19.4%)*
Probability	50.0%	35.0%	15.0%
Weighted Average Target			**$70.21**
Premium / (Discount)			*24.9%*

							Projected	
Valuation Overview (FY End: 7/31)	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017E**	**2018E**
Revenue	872.2	924.2	1,046.4	1,163.5	1,146.1	1,268.4	1,395.3	1,492.9
Consensus							1,397.9	1,485.5
EBITDA	310.9	334.5	339.7	328.7	393.3	455.0	535.8	582.6
Consensus							523.0	568.0
EPS	$1.09	$1.39	$1.39	$1.36	$1.67	$2.10	$2.66	$2.99
Consensus							$2.52	$2.81
FCF ($)	172.8	174.8	69.1	166.8	186.4	158.6	279.0	327.7
Diluted Shares Out	*153.3*	*131.4*	*129.8*	*131.2*	*131.4*	*118.6*	*112.2*	*107.5*
FCF/share	$1.13	$1.33	$0.53	$1.27	$1.42	$1.34	$2.49	$3.05
Revenue growth	*12.9%*	*6.0%*	*13.2%*	*11.2%*	*(1.5%)*	*10.7%*	*10.0%*	*7.0%*
Gross Profit Margin %	*44.3%*	*44.3%*	*40.2%*	*40.3%*	*42.2%*	*43.0%*	*44.6%*	*45.4%*
EBITDA margin	*35.6%*	*36.2%*	*32.5%*	*28.2%*	*34.3%*	*35.9%*	*38.4%*	*39.0%*
EV/EBITDA					17.0x	14.7x	12.5x	11.5x
P/EPS					33.6x	26.8x	21.2x	18.8x
FCF Yield %					*2.5%*	*2.4%*	*4.4%*	*5.4%*
Net debt	301.7	304.0	325.1	144.2	189.8	484.6	575.7	543.0
Net debt / EBITDA	1.0x	0.9x	1.0x	0.4x	0.5x	1.1x	1.1x	543.0
ROIC	*19.2%*	*21.2%*	*18.4%*	*15.9%*	*19.6%*	*22.6%*	*24.2%*	0.9x
ROIC (ex-goodwill & intangibles)	*24.9%*	*27.6%*	*24.2%*	*21.4%*	*26.2%*	*29.3%*	*30.6%*	*25.6%*

Copart's upside potential is paired with a recession-proof business model, formidable barriers to entry, and one of the most shareholder-aligned management compensation structures in the entire market.

- **2008-2009 Performance:** The salvage auction industry is stable and generally not dependent on new vehicle sales or the economic cycle. During the great financial crisis (2008-2009), revenue dropped 5% year-over-year and EBITDA less than 3%. This is a result of Copart's sticky and recurring revenue stream - 80% of sales are derived from long-term exclusive contracts with insurance giants such as Allstate and Nationwide.

- **Irreplaceable Assets Due to NIMBY Politics:** Local zoning laws provide a powerful and natural barrier to entry. To become a player in the salvage auction industry, a new entrant needs hundreds of acres of junkyard real estate to store "total loss" vehicles. Not only does this prevent technological disintermediation from threats like eBay, but municipal governments are highly reluctant to approve new zoning for junkyards due to unsightliness. As a result of this, the industry has evolved over time into a duopoly, with Copart and KAR Auction Services (KAR) holding 80% market share. The two are competitive yet rational and have recently pushed through fee increases. Both are continuing to take share at the expense of mom-and-pop operations.

- **Owner-Operator Structure + Aligned Incentives:** Chairman and former CEO Willis Johnson has instilled an owner-operator mentality at Copart. The current CEO Jay Adair is Johnson's son-in-law, and the two combined own $400m of stock or ~10% of the float. Most of the senior executives are paid a $1.00 annual salary with rest of their comp in the form of equity incentives. Management has proven to be talented at capital allocation and has opportunistically repurchased stock in market downturns, shrinking share count by 35% since 2006. In the past year alone, the firm took on a turn of debt to tender for 10% of shares outstanding. The firm's balance sheet is still under-levered (1.3x net leverage vs. KAR at 3.5x) and low maintenance capex requirements are conducive to further share cannibalization. Most importantly, Adair is long-term oriented and laser-focused on growing the business rather than pandering to Wall Street. Copart's IR presence is minimal and their financial disclosure, in the interest of protecting competitive advantages, is equally scant. Jay regularly shows his disdain for playing the Wall Street game on conference calls, refusing to give quarterly guidance or answer other short-term questions such as the timing of future share repurchases.

- This intense focus has benefitted loyal shareholders: CPRT has annualized 17% returns for the last 20 years.

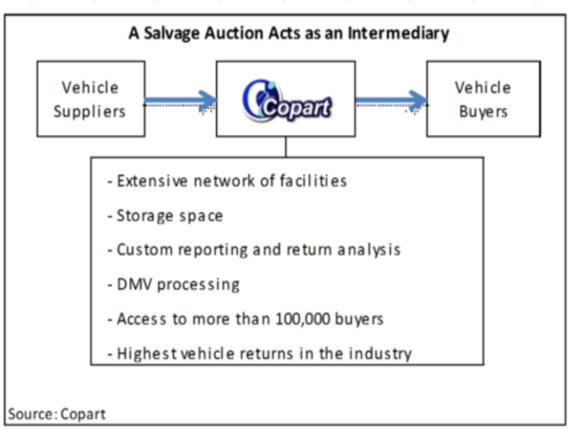
- **These are just a few of the highlights on what makes Copart a high-quality business.** While shares are not cheap on consensus numbers (21x forward EPS / 13x EBITDA), the business is entering cyclical expansion and margins and ROIC are set to inflect higher. Accelerating secular tailwinds and clear visibility into a multi-year period of double-digit free cash flow growth help to answer the question "why now?"

Company Background and Timeline

- Copart, Inc. is a provider of online auctions and vehicle remarketing services in the United States, Canada, the United Kingdom, the United Arab Emirates, Oman, Bahrain and Brazil. It provides vehicle sellers with services to process and sell vehicles primarily over the Internet through its virtual bidding third generation Internet auction-style sales technology (VB3). Sellers include insurance companies, banks, financial institutions, charities, car dealerships, fleet operators and vehicle rental companies. Buyers include licensed vehicle dismantlers, rebuilders, repair licensees, used vehicle dealers and exporters, and the general public.
- **Copart has humble roots beginning with one junkyard in San Francisco in 1982.** Willis Johnson, Copart's founder & former CEO, consolidated the industry took the firm public in 1994 while retaining a 31% stake. Today, CPRT has over 200+ junkyards with one in every state. JANA's Barry Rosenstein was a banker in the 1990's who helped line up financing to get the company off the ground, and his commentary illustrates the quality of Copart's management:

*"…I became curious about auto salvage after someone had mentioned that it could be attractive. So I started calling one participant in the industry after another, each more unsavory than the last. <u>I finally met a guy named Willis Johnson who had a little company called Copart.</u> At the time, Copart had one location in California, generated $8 million in revenue, and offered neither audited financials nor GAAP accounting. Copart was basically a dirt lot with a barbwire fence and dogs running around. The headquarters building was a temporary corrugated metal building, and Johnson fractured the English language regularly. The only thing that I could think of, as I was trudging around in the mud with the CEO was that I can't believe my career has fallen this far, this rapidly. Nevertheless, I probably spent four hours with Johnson. **I remember calling my wife on the phone on the way back to San Francisco and saying, "You know, I think I just met the smartest guy I have ever met in business."** [Source: 2013 Graham & Doddsville interview]*

- In 1998, Copart became the first vehicle auction company with physical locations that allowed buyers to bid over internet, and in 2001, they introduced Virtual Bidding (VB) to bid in real time. One long-term CPRT investor states that VB was *"…ballsy as hell – auctions used to have local collusion by buyers. You had to be there in person and they knew each other. This restrained prices. VB opened up the buyer base worldwide. So not only did you get the natural uplift of more buyers, but this reduced collusion. Now a huge % of sales that go to places like Estonia where rebuilders use the cars. <u>Higher price realization led to better ability to source supply and thus a virtuous circle evolved."</u>*



Key Service Offerings	
VB2	A global remarketing platform for vehicle sellers and buyers - features an open, competitive preliminary bidding process and a live open sale with Copart's Bid4U (Bid for You) feature.
Online Pay	Online payment options allow for simplicity and efficiency in the selling process.
Processing	Includes digital images of vehicle, vehicle's title and other documents such as body shop invoices as well as expedited DMV document and title processing.
Notifications	Potential buyers of vehicles can set desired vehicle characteristics and receive email notifications.
CoPartfinder	Vehicle parts locator provides vehicle dismantlers with greater resale opportunities for their purchases.
Specialty Sales	Allows buyers to focus only on motorcycles, heavy equipment, boats, recreational vehicles and rental cars.
ProQuote	A proprietary service that assists sellers in the vehicle claims evaluation process by providing online salvage value estimates - helps determine the repair / salvage decision.

Source: Copart

- Copart's technology has evolved over time and the firm has flywheeled an impressive array of value-added services into their core offering, such as interactive online counter-bidding which allows sellers to directly "bid-back" against buyers. As an intermediary, CPRT handles all administrative details of a purchase and simplifies the transaction for both buyers and sellers. <u>The firm takes very little inventory risk and this low capital intensity has combined with demand-side economies of scale (network effects) to produce sustainable high-teens returns on invested capital.</u>
- **Today, CPRT is the clear industry leader with close to 40% North America market share.** The firm is growing the business internationally by consolidating fragmented markets such as the UK, Brazil, Germany, and the Middle East.

Recent Events & Why Compelling Now?

- The four key drivers to track for Copart are vehicle miles traveled, average fleet age, scrap metal pricing, and used car prices. The former two are steady tailwinds and the latter two have been headwinds that appear to be reversing.

1. Vehicle Miles Traveled:

- Cheap gas and record-high SAAR has led to Americans hitting the open road as vehicle miles traveled hits new all-time highs. **Growth on a year-over-year basis accelerated to 3.6% at the end of last year,** the highest rate since the late 1990's according to FRED data (below). Unfortunately, a natural consequence of more miles traveled is more crashes. **This macabre "tailwind" is fantastic for CPRT's business,** with CEO Adair stating on their most recent earnings call "…we're now seeing an increase in accident frequency as lower fuel prices and higher employment trends are leading to an increase not only in the miles driven, but also the average speed of travel leading to more, and more severe, accidents. We also see this trend continuing."

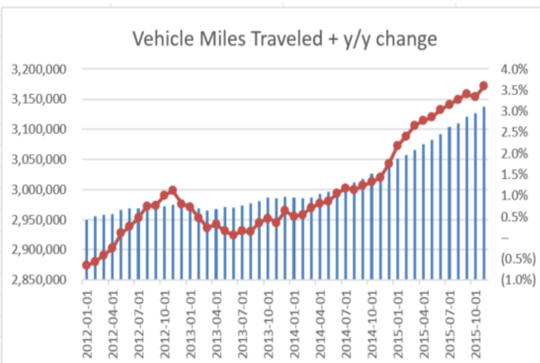
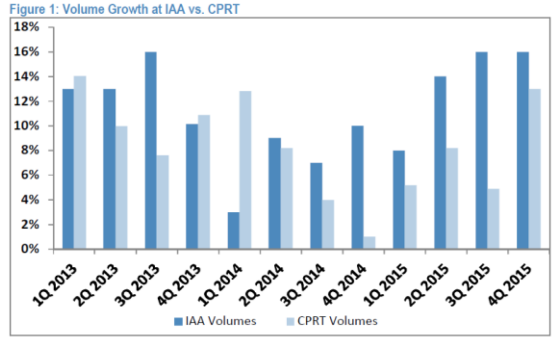


Figure 1: Volume Growth at IAA vs. CPRT

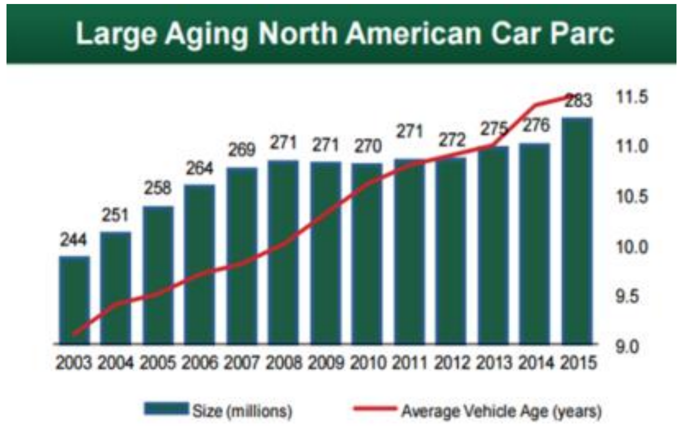


Source: Company reports and J.P. Morgan estimates. **NOTE: CPRT has a July year-end, while KAR has a December year-end**

- This is confirmed by accelerating volume growth in the most recent quarter (above-right: CY Q4'15 or CPRT's FY Q2'16) with North American volumes up 13.2% versus ~5% for the trailing four quarters. Note that IAA (KAR) is much smaller on a volume basis which distorts like-for-like growth comparisons.
- In response to this ramp-up in activity, Copart is opening an unprecedented 15 new scrapyards in the next twelve months along with expanding 18 existing facilities.

2. Average fleet age:

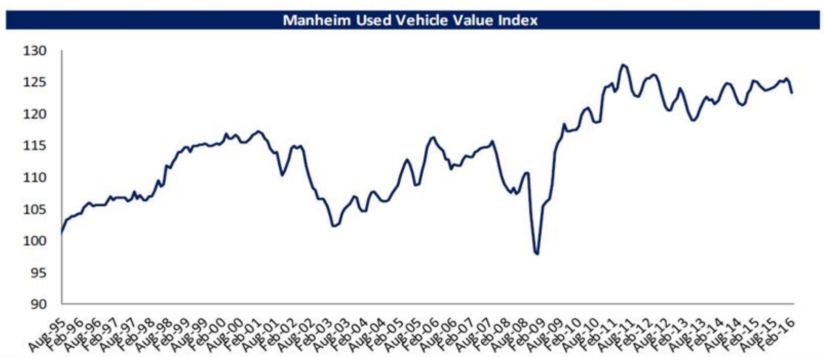
- Copart's revenue model is most easily explained by one simple equation. When your car gets into a wreck, it gets towed to a junkyard. Once there, your insurance company will send out an adjustor to determine whether or not it is economical to repair the car, or if it should be deemed a total loss.
  - The "scrap-or-sell" ratio that most insurers abide by: (**Estimated cost to repair / actual cash value) < 70%.** If the ratio is below 70%, the car will be repaired, if it is above 70%, the car will be scrapped.
  - By way of example, imagine two nearly identical salvaged cars, one with cash value of $10k and one with $12k. Both cost $8k to repair and would sell for $3k in an auction as scrap.
  - **Car A: $8,000 repair cost / $10,000 cash value = 80% ratio**. Since the repair cost is close to cash value, the car will be scrapped. The car is sold at auction for $3,000 and the insurance company pays out the $7,000 difference. Paying out $7,000 is more attractive than paying $8,000 for repairs.
  - **Car B: $8,000 repair cost / $12,000 cash value = 67%.** Since the repair cost is so far below cash value, the car will be repaired, and the insurance company will pay $8,000 in repairs. An $8,000 repair is more attractive than selling the car for $3,000 at auction and paying out $9,000.
- We see now why an older fleet age would be beneficial to Copart, as lower vehicle values lead to higher scrappage volumes. Today, the average vehicle age is now a record-breaking 11.5 years.
- This vehicle age tailwind (illustrated below) ensures many years of high volumes for Copart, especially when combined with the two following headwinds that are currently abating.



Source: Polk and Mitchell International.

3. Used car prices

- Logically, it follows that a glut of old vehicles would lead to lower used car prices. This in turn leads to higher scrappage rates as the "repair vs. scrap" decision becomes easier for insurers. For years, this has been a headwind for Copart as scrappage slowed due to increasing used car prices. This appears to finally be inflecting, with the Mannheim Used Vehicle Value index recording the steepest drop in three years in February.



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2011	124.9	124.9	124.9	124.9	124.9	124.9	124.9	124.9	124.9	124.9	124.9	124.9
2012	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7
2013	123.4	123.4	123.4	123.4	123.4	123.4	123.4	123.4	123.4	123.4	123.4	123.4
2014	122.3	122.3	124.4	124.9	124.7	124	122.7	121.8	121.4	121.8	123.3	123.9
2015	125.3	125.1	124.5	124.2	123.8	123.9	124.1	124.3	124.8	125.3	125.1	125.7
2016	125.2	123.3										

Source: Manheim Consulting

- Flowing this assumption through CPRT's P&L is difficult, as management gives no volume/ASP color except for vague directional guidance on conference calls. KAR provides better disclosure, but is much smaller than Copart on a volume basis thus making y/y % growth comparisons unreliable. Additionally, the two firms' fiscal years don't align and this introduces problems given the seasonality of the business - volumes are highest during the winter months as a result of inclement weather causing more accidents.
- However, there is other data we can look at to confirm that scrappage has been below trend.

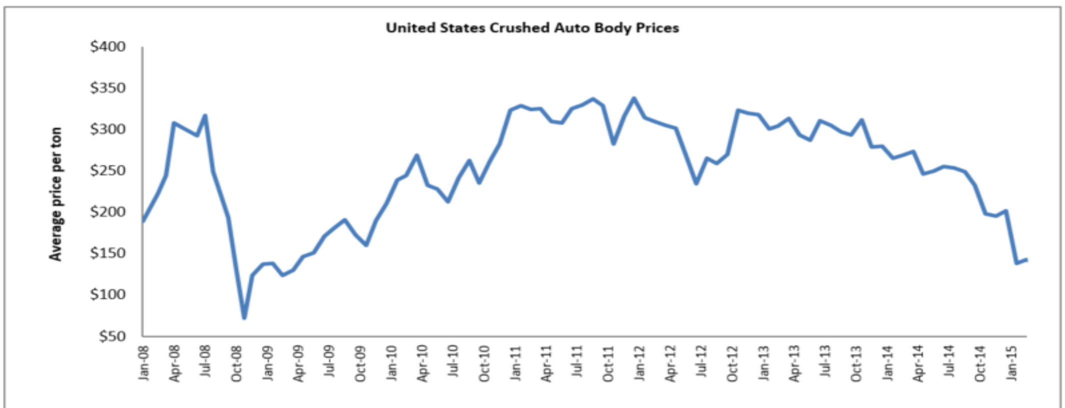
- Industry data shows that there has been a steep drop-off in scrappage in recent years (2013/2014), both as a percent of total vehicles (row D) and new vehicle registrations (row E). Even assuming a slow return to trend (roughly ~5% of total vehicles in use) from 2015-2017 provides Copart with powerful volume tailwinds (row F).

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016E	2017E
(A) Total Vehicles in Use	239.3	243.0	246.3	249.3	251.9	252.2	249.4	249.5	248.7	248.9	252.6	257.9	263.4	265.4
(B) New-Vehicle Registrations		16.8	16.6	16.0	13.2	10.4	11.5	12.7	14.3	15.4	16.4	17.5	15.0	14.0
(C) Scrappage	13.1	13.5	13.6	13.4	13.0	13.1	11.4	13.4	14.2	11.6	11.0	12.0	13.0	14.0
(D) Scrappage as % of Total Vehicles		*5.6%*	*5.6%*	*5.4%*	*5.2%*	*5.2%*	*4.6%*	*5.4%*	*5.7%*	***4.7%***	***4.4%***	*4.7%*	*5.0%*	*5.3%*
(E) Scrappage as % of Registrations		*80.3%*	*82.1%*	*83.9%*	*98.0%*	*126.3%*	*99.6%*	*105.9%*	*99.1%*	*75.6%*	*67.5%*	*68.6%*	*86.9%*	*100.1%*
(F) Growth in Scrappage		*3.0%*	*1.0%*	*(1.1%)*	*(3.6%)*	*1.0%*	*(12.5%)*	*17.2%*	*5.8%*	*(18.0%)*	*(5.0%)*	*8.6%*	*8.6%*	*7.5%*

- CPRT's business model also has operating leverage as ~60% of their cost structure is fixed. Combining this with high-single digit volume growth and conservative pricing + buyback assumptions yields low double-digit compounding.

4. Scrap metal pricing

- The fourth variable in the equation is scrap metal pricing, which has served as a headwind and led to revenue declines in four of the past five quarters. Scrap companies are facing "extreme challenges unseen since the early 1980's" according to the CEO of Sims Metal Management. While calling bottoms is dangerous, scrap pricing appears to have stabilized, with month-over-month growth for the first time in nearly a year. Year-over-year comps are picking up as well, with a -19% print in February after -46% in January and -40-50% for most of the trailing twelve months.

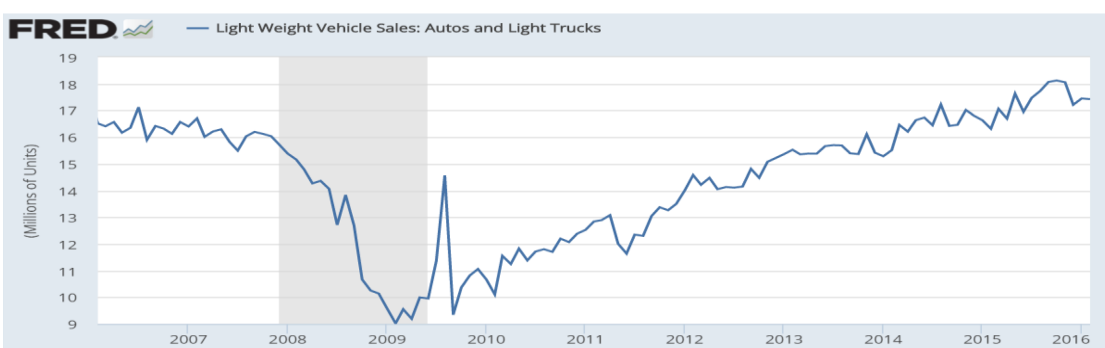


Source: American Recycler

- **How does scrap metal pricing affect earnings?** All things being equal, Copart would prefer high prices to low, as 50-60% of their fee revenue is based on a percentage of the final selling price of the vehicle (similar to eBay). However, one factor that makes Copart a high-quality business and deserving of a premium multiple is that they are "naturally hedged." Lower scrap prices tend to accompany higher volumes due to the glut of used cars, which describes the environment where we are today. **Perhaps most impressive is that Copart has been able to maintain their mid-30% EBITDA margins in the face of these dramatic ASP declines.**
- **How is this possible?** While management refuses to talk about pricing strategies on earnings calls, VAR reveals that they recently raised the price of their "per vehicle gating fee" from $30 to $59 (*Source: Wayback Machine / archive.org/web).* Reaching out to a third-party broker (http://go2auctionsnow.com) reveals that KAR raised price recently as well. <u>This is one of the best market structures for shareholders – a rational duopoly that doesn't compete on price.</u>
- **In sum, the four factors above are indicative of an inflection point as tailwinds line up in CPRT's favor. Combining this with 15 new junkyards coming online in the next year and the inherent operating leverage in the business, CPRT will witness outsized margin expansion and double-digit free cash flow growth in coming years.**

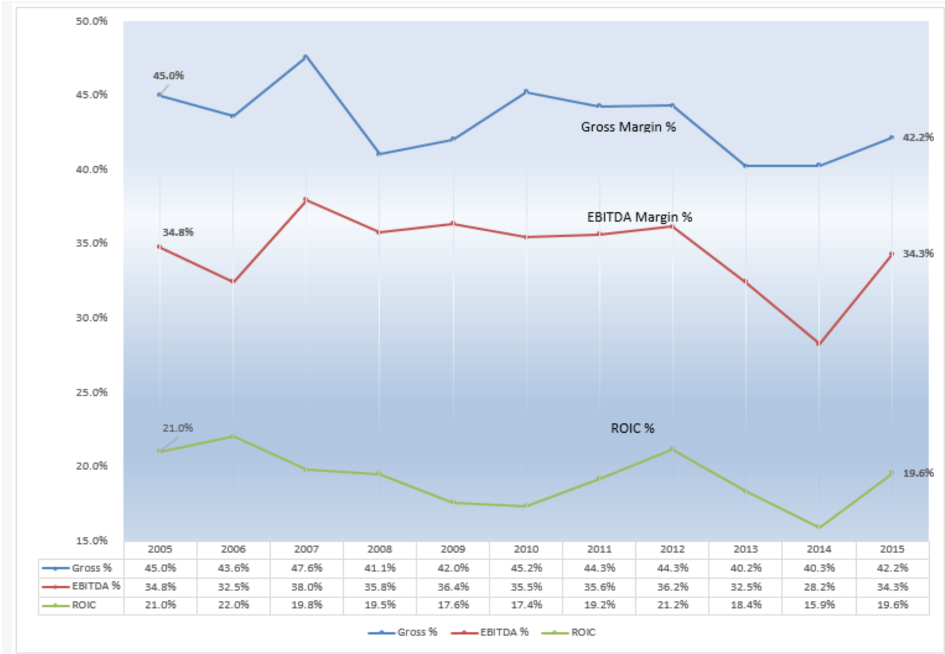
Industry Characteristics

- Before getting into the details of Copart's structurally advantaged business model, it is worth discussing three additional favorable industry tailwinds:
- **1. Repair costs are on the rise and growing well ahead of inflation:**
  - Average collision repair costs are expected to increase going forward. New cars are becoming more technologically complex as OEM's add features like unibody construction utilizing exotic metals, passenger safety cages with surrounding crumple zones to absorb impacts, ceramic components, adaptive headlights, computer systems, advanced cameras, and collision warning systems.
  - This requires new equipment, tools, and training at most body shops - driving up costs. **As a result, insurance companies are likely to favor scrapping vehicles versus repairing them – a benefit to Copart.**
  - One example: the new 2015 Ford F-150 is the first mass produced all-aluminum truck. This generated 500 lbs of weight savings, but is estimated by IHS to be 27% more expensive to repair than last year's model.
  - Another related tailwind for CPRT is that body shops are become an incrementally larger buyer of scrap metal. Utilizing used parts for collision repair is preferable to buying new whenever possible. **Alternative parts utilization as a % of total parts spend has grown from 23% in 2000 to 36% today.**
- **2. Sticky relationships with insurance companies has led to consolidation:**
  - CPRT and KAR have a fairly even split amongst the large insurance companies. Contracts are long-term and exclusive and this works to both parties' benefit, as firms like Allstate have no interest in dealing with fragmented mom-and-pop salvage operations. As a result, both CPRT & KAR have continued gaining share.
  - CEO Adair has an excellent quote from Q2'14 when asked if scale is an advantage in winning large contracts: *"Yes, there's no question that, that's the case. As I said in some of the earlier remarks, when you're a small player in this market, you just can't get the scale.* ***You don't have the revenues to generate or to invest in technology, you don't have the ability to generate in facility improvements, you don't have the ability to bring the buyers in. You can't get enough eyes to look at your product, you can't generate the returns.*** *So yes, by and large, there may be a tiny, tiny contingent of clients that don't see that. But I'm not aware of who they are. Everybody recognizes at this point that scale is critical to generating returns and having the best products."*
  - **This scale advantage has showed up in recent quarters**. In Q1'16, Copart landed an exclusive agreement with a "top-five carrier." Multiple sell-side analysts indicate that they've spoken to Farmers Insurance, who has openly confirmed the contract. Farmers used to be a 50%-50% split with KAR and now that business will go entirely to Copart. Management stated on the most recent conference call that they booked many of the associated costs with this RFP win in the current quarter but that the revenue from the auction sales will be a few months behind – a tailwind to margins in upcoming quarters.
- **3. Record-high SAAR provides lasting tailwinds for CPRT well beyond the time horizon of this investment.**

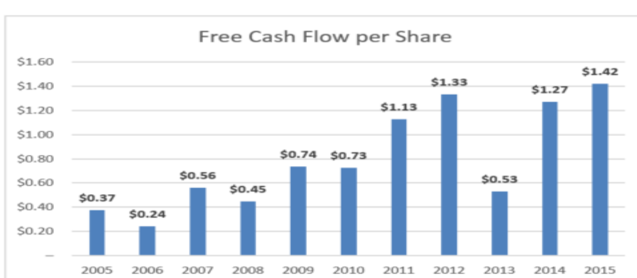


Structurally Advantaged Business Model

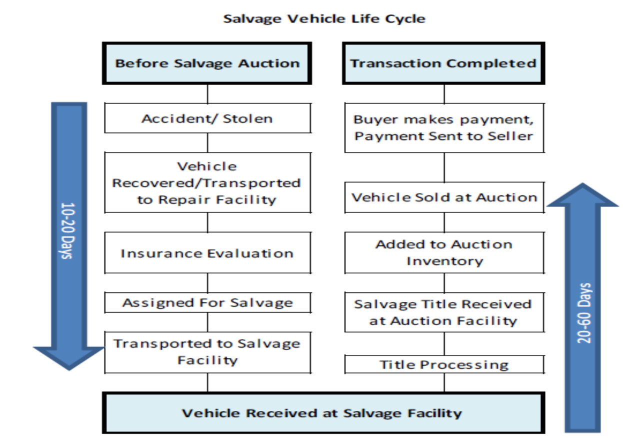
- Copart's business model is remarkably durable and unaffected by the vicissitudes of the economic cycle. Stable 40%+ gross margins, 35% EBITDA margins, and sustainable high-teens returns on capital speak to the quality of the business.



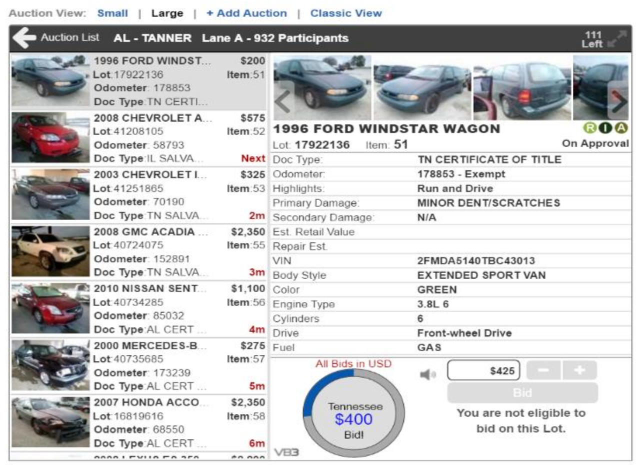
- **2013/2014 margin impact:** The drop-off during 2013/14 was as a result of two factors: Hurricane Sandy and an acquisition they made (QCSA). Opex was impacted by 150-250 bps per year and normalizing both revenues and costs for these one-off items results in margins and ROIC in-line with historical averages.
  - **The impact of Sandy:** Copart's ability to quickly react to natural disasters is one of their sustainable competitive advantages and explains why insurance companies are willing to sign long-term exclusive agreements. CPRT's team can get to disaster areas with a custom-built Caterpillar trailer featuring computers and satellite links to rapidly process vehicles. During Hurricane Katrina (2005), Copart mobilized a catastrophe response team and assembled a temporary salvage facility that processed over 75k vehicles. This had little impact on returns – typically the benefit to top-line is large enough where the increase in costs is offset by volume growth. Sandy, however, was more powerful than anticipated and CPRT was caught unprepared. The scale of the disaster was so large that Copart had to rent an airstrip in New Jersey to run salvage auctions. To quote Adair, *"The northeast usually does 80,000 cars in 2 years. They did 80,000 cars in one month."*
- **Low capital intensity drives free cash flow generation and ROIC:** Copart's entire North American business is online and utilizes an agency model, meaning CPRT takes on little to no inventory risk. Maintenance capex runs at just 3-4% of sales - once an auction footprint has been established, ongoing capex associated with property and facilities is minimal. Copart regularly converts 90-100% of net income into free cash flow, which has compounded per share at 14% since 2005:



- **Counter-cyclical hedges**: Copart's business model is "all-weather" and built to perform in any macro environment, with price and volume serving to offset one another. CEO Adair describes it best:
  - "There's a lot of natural hedges at Copart. So if the dollar was to weaken, ASPs would go up. Fuel prices typically would be higher in a weakened dollar state. **So, we make more per car but we process less volume. Right now, it's the exact opposite of that. So, we're processing a lot more volume as a company, making less on a per unit basis but in absolute terms making more.** So, yeah, things are good."
- **Key Relationships (Suppliers and Customers)**
  - Copart has become an indispensable intermediary in what would otherwise be a convoluted process:



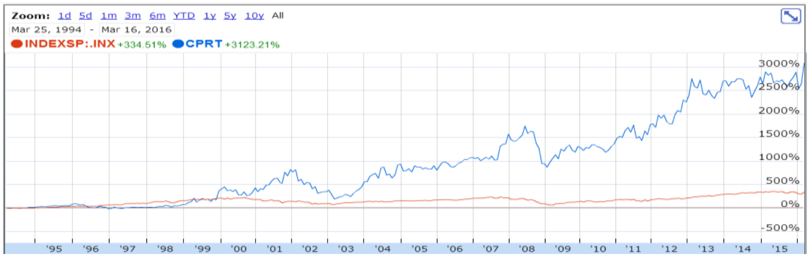
Source: KAR Auction Services & Copart Company Reports



- **Supplier relationship:** While large insurers make up the majority of Copart's revenue base and thus hold more power of the two, there are mitigants to this in the nature of Copart's long-term supply agreements. Switching costs are high and no competitor except KAR would be able to handle such high scrappage volumes.
- **Customer relationship**: Copart's buyer base is fragmented and captive, with no one buyer at more than 10% of volume. From lowest to highest ASP, these include scrap dealers, dismantlers, and rebuilders/resellers.
  - Scrappers (10-20% of buyer base) buy low end scrap for recycling or to melt down for metal value. A typical purchase runs at $100-200 and buying habits are directly influenced by scrap price. This is the segment that has been affected recently, but is the lowest ASP and has been offset by volume growth.
  - Dismantlers (60% - i.e. LKQ) acquire mid-tier, fairly new vehicles (5-8 years old) with limited damage. They sell or reuse individual parts like steering columns or bumpers and spend anywhere from $200-$2,000.
  - Resellers/rebuilders (20%) spend $2,000+ and buy lightly damaged vehicles for repair or rebuild.
  - **Customers face a similar lack of choices as suppliers and are also subject to powerful network effects.**
- **Revenue model:** Sales transaction fees are charged to both vehicle sellers and buyers, with buyers shouldering the majority of the load. Half of CPRT's US revenue is on a "fixed-fee" basis and the other half is as a % of final selling price. This equates to 60% of consolidated sales derived on a % basis (UK/International is run entirely on this model).
- **Buyer fees** are determined on a sliding scale, with sub-$100 fees for the cheapest purchases ranging up to $750-$1,500 (or a flat 2%) for expensive ones. Part of the variance is determined by payment method, as large penalties (doubled fixed-fees or percent fees as high as 15%) are added for using credit cards instead of bank account or check.
- **Copart has kindly tacked on plenty of other fees along the way:** a $59 mandatory "Gate Fee" (up from $30), $20 per day Storage Fee, $20-30 per day late fees, a $39 charge for using a third-party broker, and a $30-$80 dollar "Internet Bid Fee" despite their entire business being on the Internet. These mandatory fees are on top of a host of other "value-added" services that buyers and sellers can voluntarily purchase.
- **Both Copart and KAR may have untapped pricing power.** Provided that both players continue to behave rationally, price hikes in excess of cost inflation are not out of the question given the industry's duopoly structure. This industry is VAR-friendly and it should be reasonably easy to gain conviction in customer demand elasticity.

How do the stocks perform?

- Shareholders have annualized ~17% returns per year for the last 20 years, far outpacing the S&P:



- Similar to the business itself, the stock is resilient and rarely sells off for long. CPRT declined earlier this year from $38 to $33 as the broad indices corrected, but quickly rebounded 25%+ and has continued to make all-time highs, breaking out of a multi-year base as the industry enters the early innings of a cyclical expansion.
- Sharp capital allocation by Copart's management has fueled per-share returns, with cumulative share shrink of 35% since 2006. KAR has performed admirably as well, up 212% since their IPO in late 2009 versus the S&P's 82% gain.

Historical Valuation

- **10-year average multiples:** 20-22x EPS, 12x EBITDA, 3-4% free cash flow yield. The stock has always been expensive, as evidenced by a 2005 Forbes article on Copart titled "The Sotheby's of Scrap":
  - *"…Wall Street has responded by chasing Copart to an exhilarating 26-times trailing earnings–not quite a nose-bleed, high-tech level, but a long, long way from the seven times multiples going on clunky automobile builders like Ford Motor. What would old Henry say to that?"* [CPRT has quadrupled since this article].

Historical Multiples	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Avg.
Stock Prices (Split-Adjusted)												
High	$13.37	$13.44	$13.86	$15.69	$24.22	$23.21	$19.18	$23.90	$27.95	$38.09	$37.16	
Low	$4.22	$8.93	$11.22	$13.30	$14.12	$11.64	$17.26	$16.10	$18.52	$23.51	$30.99	
Close	$11.13	$12.23	$13.32	$14.07	$21.93	$17.66	$18.22	$21.73	$27.95	$32.51	$33.84	
P/E (NTM)												
High	31.1x	24.5x	22.8x	21.5x	27.7x	27.8x	21.7x	21.8x	19.5x	26.3x	24.6x	**24.5x**
Low	9.8x	16.3x	18.5x	18.2x	16.1x	13.9x	19.5x	14.7x	13.0x	16.3x	20.5x	**16.1x**
Close	25.9x	22.3x	21.9x	19.3x	25.1x	21.1x	20.6x	19.9x	19.5x	22.5x	22.4x	**21.9x**
CapIQ Ests (FY1 forward)				20.9x	22.2x	17.6x	18.7x	18.8x	18.0x	21.3x	22.0x	**19.9x**
CapIQ Ests (FY2 forward)				18.5x	19.3x	15.3x	15.9x	16.2x	16.1x	18.4x	18.9x	**17.3x**
FCF Yield												
High	*2.1%*	*3.1%*	*1.3%*	*3.7%*	*1.6%*	*3.2%*	*3.5%*	*4.3%*	*4.7%*	*1.4%*	*3.0%*	***2.9%***
Low	*6.6%*	*4.6%*	*1.7%*	*4.3%*	*2.7%*	*6.4%*	*3.9%*	*6.4%*	*7.1%*	*2.2%*	*3.6%*	***4.5%***
Close	*2.5%*	*3.4%*	*1.4%*	*4.1%*	*1.7%*	*4.2%*	*3.7%*	*4.8%*	*4.7%*	*1.6%*	*3.3%*	***3.2%***
EV/EBITDA (forward)												
High	15.4x	11.8x	12.4x	11.8x	15.1x	13.9x	10.5x	12.6x	11.5x	14.8x	13.9x	**13.0x**
Low	4.8x	7.4x	9.9x	9.9x	8.8x	6.7x	9.4x	8.8x	7.9x	9.5x	11.7x	**8.6x**
Close	12.8x	10.6x	11.9x	10.5x	13.7x	10.4x	9.9x	11.5x	11.5x	12.8x	12.7x	**11.7x**

Base Case Model

Copart (CPRT)
Earnings Model

FY End: 7/31	31-Jul-09	31-Jul-10	31-Jul-11	31-Jul-12	31-Jul-13	31-Jul-14	31-Jul-15	31-Oct-15	31-Jan-16	30-Apr-16	31-Jul-16	31-Jul-16	31-Jul-17	31-Jul-18
Line Items $m, except where noted	2009A	2010A	2011A	2012A	2013A	2014A	2015A	Q1	Q2	Q3	Q4	2016A	2017E	2018E
INCOME STATEMENT														
Service Revenue	615.4	642.1	714.5	766.3	849.7	958.4	985.4	251.0	260.4	303.5	289.5	1,104.4	1,214.8	1,299.8
Vehicle Sales Revenue	127.7	130.7	146.8	157.9	196.7	205.1	160.7	37.9	39.3	43.7	43.2	164.1	180.5	193.1
Total Revenue	**743.1**	**772.9**	**872.2**	**924.2**	**1,046.4**	**1,163.5**	**1,146.1**	**288.8**	**299.7**	**347.2**	**332.7**	**1,268.4**	**1,395.3**	**1,492.9**
(-) Yard operations	292.0	283.7	323.9	344.6	417.5	484.2	490.8	127.6	132.7	142.8	145.5	548.5	586.0	616.6
(-) Yard D&A	32.8	34.9	37.0	33.0	40.8	36.2	35.5	8.3	8.2	8.3	8.7	33.7	40.0	45.0
(-) Cost of Vehicle Sales	106.0	104.7	125.2	137.0	167.2	174.5	136.4	32.1	34.1	37.7	37.0	141.0	146.5	153.8
Gross Profit	312.3	349.6	386.2	409.6	420.9	468.6	483.4	120.9	124.6	158.4	141.5	545.3	622.8	677.6
(-) General and Administrative	74.7	100.6	99.2	99.4	122.0	147.0	103.4	31.4	29.1	31.7	31.0	123.2	127.0	140.0
(-) General and Administrative D&A	9.0	8.3	8.7	15.1	16.0	17.5	17.1	3.2	3.4	4.0	4.3	14.9	20.0	25.0
Total Operating Expenses	**514.6**	**532.2**	**594.0**	**629.1**	**763.4**	**859.5**	**783.2**	**202.6**	**207.6**	**225.3**	**226.5**	**862.0**	**919.5**	**980.4**
EBIT	**228.5**	**230.8**	**265.2**	**286.3**	**283.0**	**274.9**	**344.4**	**86.2**	**92.1**	**122.0**	**106.2**	**406.5**	**475.8**	**512.6**
EBITDA	**270.4**	**274.0**	**310.9**	**334.5**	**339.7**	**328.7**	**393.3**	**97.8**	**103.8**	**134.3**	**119.2**	**455.0**	**535.8**	**582.6**
(-) Net Interest Income (Expense)	1.4	(0.0)	(3.6)	(11.0)	(9.6)	(8.3)	(17.3)	(5.5)	(5.0)	(5.4)	(6.3)	(22.2)	(22.2)	(22.2)
(-) Other Income, net	1.0	1.2	2.2	2.7	3.5	3.4	5.0	1.0	4.4	–	6.1	11.5	5.0	5.0
PBT	**230.9**	**232.0**	**263.8**	**278.0**	**276.9**	**270.0**	**332.1**	**81.7**	**91.5**	**116.5**	**106.0**	**395.8**	**458.6**	**495.4**
(-) Taxes	89.4	87.9	97.5	95.9	96.8	91.3	112.3	29.3	32.6	42.6	21.9	126.4	160.5	173.4
Net Income	**141.5**	**143.3**	**166.3**	**182.1**	**180.0**	**178.7**	**219.8**	**52.4**	**58.9**	**74.0**	**84.1**	**269.4**	**298.1**	**322.0**
Fully Diluted Shares Outstanding	169.3	170.1	153.3	131.4	129.8	131.2	131.4	125.6	122.9	116.4	109.6	118.6	112.2	107.5
Diluted EPS	**$0.84**	**$0.84**	**$1.09**	**$1.39**	**$1.39**	**$1.36**	**$1.67**	**$0.42**	**$0.48**	**$0.64**	**$0.77**	**$2.10**	**$2.66**	**$2.99**
Margins														
Gross Margin %	*42.0%*	*45.2%*	*44.3%*	*44.3%*	*40.2%*	*40.3%*	*42.2%*	*41.8%*	*41.6%*	*45.6%*	*42.5%*	*43.0%*	*44.6%*	*45.4%*
Operating Margin %	*30.8%*	*29.9%*	*30.4%*	*31.0%*	*27.0%*	*23.6%*	*30.1%*	*29.9%*	*30.7%*	*35.1%*	*31.9%*	*32.0%*	*34.1%*	*34.3%*
EBITDA Margin %	*36.4%*	*35.5%*	*35.6%*	*36.2%*	*32.5%*	*28.2%*	*34.3%*	*33.8%*	*34.6%*	*38.7%*	*35.8%*	*35.9%*	*38.4%*	*39.0%*
% of Sales														
Yard Operations / Sales %	*39.3%*	*36.7%*	*37.1%*	*37.3%*	*39.9%*	*41.6%*	*42.8%*	*44.2%*	*44.3%*	*41.1%*	*43.7%*	*43.2%*	*42.0%*	*41.3%*
G&A / Sales %	*10.1%*	*13.0%*	*11.4%*	*10.8%*	*11.7%*	*12.6%*	*9.0%*	*10.9%*	*9.7%*	*9.1%*	*9.3%*	*9.7%*	*9.1%*	*9.4%*
Cost of Vehicle Sales / Sales %	*14.3%*	*13.5%*	*14.4%*	*14.8%*	*16.0%*	*15.0%*	*11.9%*	*11.1%*	*11.4%*	*10.9%*	*11.1%*	*11.1%*	*10.5%*	*10.3%*
Tax Rate	*38.7%*	*37.9%*	*37.0%*	*34.5%*	*35.0%*	*33.8%*	*33.8%*	*35.9%*	*35.6%*	*36.5%*	*20.6%*	*31.9%*	*35.0%*	*35.0%*
Growth Rates														
Service Revenue Growth y/y %	*(0.7%)*	*4.4%*	*11.3%*	*7.2%*	*10.9%*	*12.8%*	*2.8%*	*1.8%*	*9.2%*	*18.3%*	*18.8%*	*12.1%*	*10.0%*	*7.0%*
Vehicle Sales Revenue Growth y/y %	*(22.6%)*	*2.4%*	*12.3%*	*7.5%*	*24.6%*	*4.2%*	*(21.6%)*	*(13.5%)*	*4.1%*	*7.8%*	*11.8%*	*2.1%*	*10.0%*	*7.0%*
Revenue growth y/y %	*(5.3%)*	*4.0%*	*12.9%*	*6.0%*	*13.2%*	*11.2%*	*(1.5%)*	*(0.5%)*	*8.5%*	*16.9%*	*17.8%*	*10.7%*	*10.0%*	*7.0%*
Gross Profit growth y/y %	*(3.1%)*	*12.0%*	*10.5%*	*6.1%*	*2.8%*	*11.3%*	*3.2%*	*(1.2%)*	*8.5%*	*24.3%*	*19.1%*	*12.8%*	*14.2%*	*8.8%*
EBITDA growth y/y %	*(3.7%)*	*1.3%*	*13.5%*	*7.6%*	*1.6%*	*(3.3%)*	*19.7%*	*1.5%*	*12.9%*	*25.6%*	*21.5%*	*15.7%*	*17.7%*	*8.7%*
EPS growth y/y %	*(4.3%)*	*0.8%*	*28.7%*	*27.7%*	*0.1%*	*(1.8%)*	*22.8%*	*4.3%*	*21.1%*	*44.5%*	*74.5%*	*25.6%*	*26.5%*	*12.7%*
FCF growth y/y %	*54.2%*	*(0.7%)*	*39.8%*	*1.2%*	*(60.5%)*	*141.5%*	*11.8%*	*(3.5%)*	*292.3%*	*(36.9%)*	*238.4%*	*(14.9%)*	*75.9%*	*17.5%*
FCF/Share growth y/y %	*63.6%*	*(1.2%)*	*55.1%*	*18.0%*	*(60.0%)*	*138.8%*	*11.6%*	*1.1%*	*320.9%*	*(29.0%)*	*303.0%*	*(5.7%)*	*86.0%*	*22.5%*
Free Cash Flow (OCF - Capex)	**124.5**	**123.6**	**172.8**	**174.8**	**69.1**	**166.8**	**186.4**	**55.4**	**(52.2)**	**60.4**	**94.9**	**158.6**	**279.0**	**327.7**
FCF / Diluted Share	$0.74	$0.73	$1.13	$1.33	$0.53	$1.27	$1.42	$0.44	($0.42)	$0.52	$0.87	$1.34	$2.49	$3.05
FCF / Net Income %	*99.5%*	*69.8%*	*100.7%*	*83.9%*	*32.2%*	*74.8%*	*74.8%*	*148.2%*	*(142.9%)*	*92.1%*	*62.0%*	*42.2%*	*85.6%*	*94.4%*
SUMMARY METRICS														
Leverage Metrics														
Net Debt (Cash)	(162.7)	(268.2)	301.7	304.0	325.1	144.2	189.8	131.9	516.8	563.2	484.6	484.6	575.7	543.0
Net Debt / TTM EBITDA	(0.6x)	(1.0x)	1.0x	0.9x	1.0x	0.4x	0.5x	0.3x	1.3x	1.3x	1.1x	1.1x	1.1x	0.9x
Gross Debt / TTM EBITDA	–	–	1.2x	1.3x	1.1x	0.9x	1.6x	1.5x	1.7x	1.6x	1.4x	1.4x	1.1x	1.0x
Book Value Per Share ($)	$5.44	$6.39	$3.62	$4.27	$5.87	$7.65	$7.34	$8.10	$5.95	$6.16	$7.07	$6.53	$6.45	$7.17
Working Capital														
AR Days	53.7	51.5	51.4	54.9	63.7	61.8	68.7	72.9	85.4	69.0	72.8	76.6	70.0	70.0
Inventory Days	28.3	30.1	18.8	17.2	18.2	16.6	18.5	19.3	20.3	19.9	18.6	19.7	19.8	20.1
AP Days	70.1	80.8	76.4	73.0	79.7	79.9	81.2	79.8	76.8	72.4	91.6	97.1	90.0	90.0
Average Balances														
Total Assets	989.1	1,143.4	1,156.6	1,119.8	1,244.8	1,420.6	1,653.3	1,827.7	1,730.0	1,614.3	1,637.0	1,724.8	1,601.3	1,568.8
Total Equity	860.2	1,004.3	821.2	558.1	661.8	883.0	983.8	990.4	874.0	724.0	745.5	869.3	748.9	747.4
Total Invested Capital	772.3	822.6	873.8	898.5	1,013.7	1,154.1	1,183.9	1,181.8	1,229.5	1,296.4	1,302.3	1,237.8	1,303.7	1,325.2
Total Invested Capital ex-goodwill/intangibles	582.0	637.4	673.7	690.6	768.9	857.0	884.5	893.6	946.9	1,016.8	1,026.0	957.0	1,031.8	1,053.3
Return Metrics														
ROA	14.3%	12.5%	14.4%	16.3%	14.5%	12.6%	13.3%	11.5%	13.6%	18.3%	20.6%	15.6%	18.6%	20.5%
ROE	16.5%	14.3%	20.2%	32.6%	27.2%	20.2%	22.3%	21.2%	27.0%	40.9%	45.1%	31.0%	39.8%	43.1%
ROIC	18.0%	17.4%	19.2%	21.2%	18.4%	15.9%	19.6%	19.3%	19.3%	24.5%	25.9%	22.6%	24.2%	25.6%
ROIC (ex-goodwill/intangibles)	23.9%	22.4%	24.9%	27.6%	24.2%	21.4%	26.2%	25.5%	25.1%	31.2%	32.9%	29.3%	30.6%	32.2%

Private Market Value (PMV)

- Copart's business model is likely amenable to an LBO. Private equity regularly dabbles in the space, which is logical given durable free cash flow generation, ability to support leverage, and sustainable competitive advantages which keep out new competition and prevent technological disintermediation.
- In 2004, Kelso paid $400m ($28.25/share) in cash for KAR's salvage auction business, or 19x TTM EBIT. **This would approximate an ~$8B purchase price today or $70-75 per share (25%+ premium).**

<u>Key Investment Factors</u>

<u>1. Best-In-Class Compounder With Opportunities To Reinvest</u>

- Copart's base business will benefit from increased volume growth, potential price hikes, operating leverage and buybacks. Beyond that, the firm also has other avenues for growth and reinvestment of excess free cash.
    - **Non-insurance volume is growing** and is now up to 20% of total volume from 19.4% a year ago. This segment is a competitive advantage versus KAR, who serves strictly insurance providers. Copart's non-insurance business is made up of charities, financial institutions, banks, rental car companies, dealerships, and the general public. <u>These cars garner a higher selling price and take less time to process, driving asset turns and freeing up capacity.</u>
    - **UK/International:** 20% of Copart's revenue is from outside of North America, with the vast majority from the UK. Copart has quickly become the dominant player with estimated ~40% market share, although the business is run on a principal rather than agency basis – CPRT takes inventory risk in buying and selling scrap vehicles.
- The international story is still early innings and management has voiced their frustration with the difficulty of European markets, where deals constantly seem to be on the verge of closing until management finds out they didn't have the right zoning and have to start over. <u>However, the long-term opportunity is clear as international markets are fragmented and ripe for consolidation.</u> Near-term benefits exist in penetrating markets such as Mexico and Eastern Europe, where regulation is less onerous. Growing awareness in said markets provides another outlet for Copart's domestic sellers, boosting prices paid and thus CPRT's cut. Below is a list of Copart's recent expansion and acquisition activity:

Recent Expansion Activity

Location	Acquisition or Greenfield	Date	Geographic Service Area
Louisville, Kentucky	Greenfield	Sep-08	Southern Indiana
Richmond, Virginia	Greenfield	Oct-08	Central Virginia
Montgomery, Alabama	Greenfield	Feb-09	Central Alabama
Greer, South Carolina	Greenfield	Feb-09	Northwest South Carolina
Warren, Massachusetts	Greenfield	Jun-09	Central Massachusetts
Bristol, England	Acquisition	Jan-10	United Kingdom
Bedford, England	Acquisition	Jan-10	United Kingdom
Colchester, England	Acquisition	Jan-10	United Kingdom
Gainsborough, England	Acquisition	Jan-10	United Kingdom
Luton, England	Acquisition	Jan-10	United Kingdom
Scranton, Pennsylvania	Greenfield	Feb-10	Central Pennsylvania
Homestead, Florida	Greenfield	Sep-10	Southern Florida
Hartford City, Indiana	Acquisition	Mar-11	Central Indiana
Wolverhampton, England	Acquisition	Mar-11	United Kingdom
Atlanta, Georgia	Greenfield	Aug-11	Northern Georgia
Calgary, Alberta	Acquisition	May-12	Alberta
Edmonton, Alberta	Acquisition	May-12	Alberta
Mebane, North Carolina	Acquisition	Jul-12	Central North Carolina
Dubai, UAE	Acquisition	Aug-12	Dubai
Webster, New Hampshire	Acquisition	Sep-12	New Hampshire - Vermont
Sao Paulo, Brazil (5 locations)	Acquisition	Nov-12	Sao Paulo, Brazil
Ettlingen, Germany	Acquisition	Nov-12	Germany

Source: Copart

Table 2: Trailing Three Year Facility Expansion by Location

Facility	Type	Date	Location
Dubai, U.A.E.	Acquisition	Aug-12	United Arab Emirates
Webster, New Hampshire	Greenfield	Sep-12	United States
Embu, Brazil	Acquisition	Nov-12	Brazil
Pirapora, Brazil	Acquisition	Nov-12	Brazil
Osasco, Brazil	Acquisition	Nov-12	Brazil
Castelo Branco, Brazil	Acquisition	Nov-12	Brazil
Vila Jaguara, Brazil	Acquisition	Nov-12	Brazil
Ettlingen, Germany	Acquisition	Nov-12	Germany
Gainesville, Georgia	Acquisition	May-13	United States
Davison, Michigan	Acquisition	May-13	United States
Ionia, Michigan	Acquisition	May-13	United States
Kincheloe, Michigan	Acquisition	May-13	United States
Salvage Parent, Inc.*	Acquisition	May-13	United States
Cordoba, Spain	Acquisition	Jun-13	Spain
Montreal, Quebec	Acquisition	Nov-13	Canada
Itaquaquecetuba, Brazil	Greenfield	Jan-14	Brazil
Seaford, Delaware	Greenfield	Jul-14	United States
Manama, Bahrain	Greenfield	May-15	Bahrain
Muscat, Oman	Greenfield	Jun-15	Oman
Moncton, New Brunswick	Greenfield	Jul-15	Canada

Source: Jefferies, Company data

<u>2. Owner/Operator Management + Capital Allocation</u>

- **Copart's management team and incentive structure are exceptional.** The long-term focus of Willis Johnson and Jay Adair has been instrumental in driving decades of excess returns for shareholders. Whereas most managers succumb to empire building, CPRT is perfectly willing to hold large amounts of market cap in cash (10% or more) in case of a rainy day:
    - Adair, Q2'15: "So I will give you an example back in 2008. Fiscal '08, we went out into the market and bought back stock, split adjusted off the top of my head. That's my qualifier there. I think it was in the 20s. And subsequent to the financial crisis our stock was in the 12s. We were sitting with a very low cash position and we reached out to the banks, and as you can appreciate, nobody was willing to loan money at that time. **So having cash on our balance sheet is part of our thought process in terms of a fiscally prudent approach to the market."**
    - Copart has a standing authorization to repurchase another 48 million shares, or 40% of the float.

- The "family-owned" aspect is a competitive advantage, with research showing that family-owned businesses tend to outperform the market over time. Tom Gayner is a 1% holder in the stock and has commented often on why he prefers family-owned businesses:
  - ***"…Families often times tend to have a longer time horizons than the next quarter or what their next bonus payment is going to be. It's their legacy. There's a cultural, mental ownership that's different than just pure financial ownership."*** (*2012 GuruFocus interview)*
- **One aspect not mentioned previously is the hiring of a new "Wall Street-friendly" CFO, Jeffrey Liaw**. Liaw was hired in January after spending the past ten years in private equity at TPG. His past three years were spent managing a portfolio company called FleetPride, the national's largest retailer of heavy-duty truck and and trailer parts. Recent commentary from Adair indicates that he is doing an excellent job taking out costs, which has shown up in the P&L: <u>run-rate quarterly G&A is down to $30m from $36m last year.</u>
  - **There are further implications to the hire beyond his operational expertise.** First, the firm's disclosure and communication with the street is historically poor at best and may keep new investors out of the name. However, Liaw has opened up to investors in recent private conversations, with statements to the effect of "when you're generating 40%+ gross margins and 20% returns on capital, you don't go crowing about it in public and getting attention." He plans to get in front of Wall Street more but doesn't expect huge changes – no guidance and no sell-side shoulder taps. They view their job as "building a 20-30 year empire" and focusing on the short-term only distracts them from that goal.
  - **Second, one could make a cogent argument that management is positioning the business for an LBO.** Adair takes all his comp in stock and has been aggressively reducing share count via tenders. The business model is clearly capable of supporting an extra 3-4 turns of leverage and may as well be privately ran given Adair's reticence and general disposition towards Wall Street. While M&A spec is a flimsy tenet of any thesis, it bears mentioning that private equity is sitting on over $1.3 trillion in record dry powder and Copart's recent hire may be a form of signaling.

<u>**3. Mistaken Bear Case: Self-Driving Cars**</u>

- Technology, or the colloquial "disruption," is loosely thrown around as being a threat to Copart and the greater salvage auction/collision space. In short, autonomous vehicles and other collision avoidance technology will drastically reduce the amount of accidents and scrappage volumes will plummet. While this marvel will eventually come to pass and save a lot of lives in the process, it simply isn't relevant given the target time horizon for this investment (3-5 years).
- CEO Jay Adair offers some useful commentary; industry operators have seen this argument before.
  - *"So, there's a number of moving parts here. We don't subscribe to the belief that vehicles are going to be self-driving, at least not in my future. I can't see how that's going to happen. That's too far out. As for a collision avoidance, for sure there's going to be more of that. But it's very analogous to anti-lock brakes in the 1980s.*
  - *We saw anti-lock brakes installed in cars. At the same time anti-lock brakes went in, it reduced the number of accidents. They put airbags in cars.* ***And when the airbags went in, they increased the total loss frequency.*** *So, to Will's point, there's going to be a lot of additions to the vehicle that is causing the cost of repair to go up. It will be offsetting that collision avoidance." (Q2'15 Call)*
- **Adair's statement is supported by recent data.**
  - Last weeks' edition of Barron's ran a feature: an appalling 61% of people text while driving, 27% use Facebook, 11% use Snapchat, and 10% use video chats. 38,300 people died in automobile crashes in 2015, up 8% from a year ago and the biggest year-over-year spike in 50 years. **Collision avoidance technology is being developed, but not quickly enough to offset the evolution of human stupidity.**
  - Separately, NHTSA estimates that cell-phone related "distraction crashes" have increased by 240% since 2006. 26% of crashes are related to cell phone usage - 5% from texting, and 21% from calls.
- **With innovations like Sirius' "connected car" and Tesla's giant center-console touch screen, it's difficult to imagine drivers become less distracted anytime soon – thus ensuring visibility into CPRT's sustainable returns.**

Preliminary Areas of Diligence / To-Do list

- Extremely VAR-friendly business – fragmented buyer base, many small/medium auction participants who regularly do business on both IAAI (KAR) and CPRT platforms. Also non-insurance company sellers (charities, dealerships, rental companies).
- Recast KAR's financials for comparability
- Junkyard unit economics and capacity utilization
- Acquisition economics / multiples paid
- VAR on new CFO

Thinking Backward – Why Shouldn't We Own This Stock?

- Global disinflation weighs on scrap pricing and drives down vehicle ASP
    - **Mitigant:** Volume increase has served as an offset and it appears Copart can take price as an offset. However, there is a limit to pricing power and margins would suffer if ASP's were to continue lower.
- Self-driving cars
    - **Mitigant:** Outside of investing time horizon along with increasing repair costs as an offset. Additionally, could find ways to hedge out industry-specific risks (shorting auto OEM's?).
- FX headwinds if dollar continues to make new highs
    - **Mitigant:** 20% of their business is in the UK where revenues and costs are affected equally. However, there is a decrease in purchasing power from foreign buyers which could weigh on auction volumes.
- Poor capital allocation weighs on returns on incremental invested capital (ROIIC)
    - **Mitigant:** Unlikely given long CEO track record as talented operator, but international expansion could fail for reasons outside of their control. Getting approval for junkyards in Europe is harder than the US.
- International expansion fails
    - **Mitigant:** This is probably the biggest concern, in that if international expansion fails or CPRT runs out of bolt-on M&A opportunities then, then the multiple will compress as growth slows. On the other hand, CPRT investors would have the "high-class problem" of owning a business where management can't find suitable reinvestment opportunities and thus accelerates capital return via buybacks or special dividends.
- Loss of market share to KAR
    - **Mitigant:** Possibility, but the two generally have segmented their respective customer bases (KAR is more focused on physical auctions) and industry tailwinds are powerful enough for both to profitably grow.
- Natural disasters such as Sandy occur and weigh on near-term earnings
    - **Mitigant:** None. Disasters will inevitably occur but are temporary in nature.
- Insurance companies lean on CPRT and KAR, depressing margins
    - **Mitigant:** Long-term supply contracts should help offset this risk. Outside of that, while the insurance companies are powerful, the two parties heavily rely on one another and CPRT could find ways to make their life difficult in exchange.
- Copart's valuation is challenging
    - **Mitigant:** None. The stock has always been expensive and it's tough to make a case for multiple expansion.
- **Invert:** Could Copart be a short?
    - **Answer:** Not a fantastic choice due to upside risk from tenders, under-levered balance sheet, takeout potential, and downside protection in value of real estate and irreplaceable assets. Valuation is challenging but in line with historical averages and short sellers are fighting powerful industry tailwinds.
- **Invert:** Why not own KAR instead?
    - **Answer:** KAR is cheaper but has non-salvage segments that tend to be more cyclical (i.e. used car auctions). Both could potentially be longs given tailwinds, along with others up or down the value chain from CPRT.

Shareholder Overview

Holdings

Filer	Shares Held	Market Value	% of Portfolio	Prior % of Portfolio	Ranking	Change in Shares	% Owners
LAZARD ASSET MANAGEMENT LLC	7,676,299	$ 411,142,000	0.90%	0.78%	32	↑ 740,773	6.3886%
VANGUARD GROUP INC	7,411,374	$ 396,953,000	0.02%	0.02%	722	↑ 9,301	6.1681%
PRINCIPAL FINANCIAL GROUP INC	3,680,433	$ 197,125,000	0.26%	0.25%	97	↑ 95,287	3.0630%
BLACKROCK FUND ADVISORS	3,565,895	$ 190,989,000	0.04%	0.04%	567	↑ 80,384	2.9677%
WASATCH ADVISORS INC	3,430,615	$ 183,744,000	2.74%	2.52%	3	↑ 66,774	2.8551%
BLACKROCK INSTITUTIONAL TRUST COMPANY, N.A.	2,887,383	$ 154,648,000	0.02%	0.02%	665	↓ 51,941	2.4030%
STATE STREET CORP	2,717,508	$ 145,548,000	0.02%	0.02%	708	↓ 125,418	2.2616%
KAYNE ANDERSON RUDNICK INVESTMENT MANAGEMENT LLC	2,575,559	$ 137,947,000	1.72%	1.82%	10	↑ 119,649	2.1435%
ATLANTA CAPITAL MANAGEMENT COMPANY L L C	2,491,577	$ 133,449,000	0.89%	0.82%	41	↓ 13,651	2.0736%
JENNISON ASSOCIATES LLC	2,393,555	$ 128,199,000	0.14%	0.17%	129	↓ 782,043	1.9920%
ROYCE & ASSOCIATES LP	2,375,972	$ 127,257,000	0.84%	0.78%	5	↓ 30,900	1.9774%
WILLIAM BLAIR INVESTMENT MANAGEMENT, LLC	2,177,620	$ 116,633,000	0.44%	0.42%	75	↓ 4,083	1.8123%
LONDON COMPANY OF VIRGINIA	1,677,853	$ 89,866,000	0.67%	0.63%	62	↓ 2,047	1.3964%
BANK OF NEW YORK MELLON CORP	1,583,242	$ 84,799,000	0.03%	0.03%	611	↓ 289,789	1.3176%
SNYDER CAPITAL MANAGEMENT L P	1,579,803	$ 84,614,000	5.30%	5.13%	1	↓ 28,594	1.3148%

Balance Sheet and Liquidity

- **Leverage ratios: 1.3x net, 1.7x gross**
    - Gross debt of $676m, cash/equivalents of $159m, net debt $517m.
- **Capital structure / liquidity:**
    - $68m outstanding on $300m facility ($232m available).
    - $206m outstanding on amortizing term loan.
    - $300m outstanding (fully drawn) on term loan facility.
    - Weighted average interest rate of ~4%.
- **Balance sheet optionality:** Assuming target leverage of 2.5x, CPRT could add $500m of leverage – enough to repurchase 11-12% of market cap. KAR is levered 3.5x despite having a more cyclical business model.
- **Potential floor in liquidation value:** Irreplaceable assets due to NIMBY politics. Book value distorted due to magnitude of share repurchases. Net PP&E includes ~$500m of land which is likely understated.

Catalysts

- Earnings surprise from margin expansion
- Corporate actions (bolt-on M&A, share shrink, PE takeout)
- Commodity tailwinds (scrap pricing, FX)

Appendix – Balance Sheet and Cash Flow Statement

BALANCE SHEET	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017E	2018E
Total Cash & Short-term investments	178.3	252.5	275.3	201.0	39.0	162.7	268.2	74.0	140.1	63.6	158.7	456.0	155.8	34.8	37.5
Accounts Receivable	81.6	91.3	100.0	109.9	111.7	109.2	109.1	122.9	139.0	182.7	197.0	215.6	266.3	267.6	286.3
Vehicle Pooling Costs / Inventory						33.4	34.9	25.0	24.2	31.2	31.7	33.5	39.0	42.0	45.0
Income taxes receivable	–	–	2.1	3.2	19.0	5.4	11.0	5.1	2.3	11.6	4.1	6.1	18.8	20.6	22.1
Prepaid expenses & other	5.4	6.8	4.9	5.5	6.9	5.2	14.3	14.8	12.8	15.3	19.5	19.8	18.0	19.8	21.2
Other Assets	3.8	–	–	–	–	–	–	–	3.9	1.9	1.3	3.0	1.4	–	–
Current Assets	**269.1**	**350.7**	**382.2**	**319.6**	**176.6**	**315.9**	**437.4**	**241.9**	**322.3**	**306.5**	**412.3**	**734.1**	**499.3**	**384.8**	**412.1**
Property & Equipment, net	257.7	292.9	341.9	420.7	510.3	530.9	573.5	600.4	587.2	677.5	692.4	700.4	816.8	831.8	836.8
Intangibles, net	2.9	1.9	1.9	27.4	21.9	15.2	13.0	12.7	8.0	17.7	25.4	17.9	11.8	11.8	11.8
Goodwill	112.7	116.4	112.3	161.6	177.2	166.3	175.9	198.6	196.4	267.5	283.6	271.9	260.2	260.2	260.2
Deferred Income Taxes	–	–	5.1	7.8	6.9	7.8	10.2	9.4	22.3	30.1	36.7	28.8	23.5	25.9	25.9
Other Assets	6.6	6.1	22.1	33.3	27.2	21.9	18.8	21.4	18.9	35.2	56.4	46.7	38.3	38.3	38.3
Total Assets	**649.1**	**768.1**	**865.6**	**970.5**	**920.1**	**1,058.0**	**1,228.8**	**1,084.4**	**1,155.1**	**1,334.5**	**1,506.8**	**1,799.7**	**1,649.8**	**1,552.7**	**1,585.0**
Accounts payable & accrued liabilities	44.1	57.0	60.6	85.1	88.9	82.8	93.7	101.7	103.0	136.6	152.2	147.5	192.4	190.5	201.0
Deferred revenue	9.7	12.5	15.4	13.9	14.5	13.2	10.6	5.6	5.4	4.8	4.2	3.7	4.6	5.1	5.4
Income taxes payable	3.8	7.2	–	3.9	4.0	5.3	1.3	3.5	3.1	4.7	8.3	8.3	5.6	6.2	6.6
Current portion of LTD	–	–	–	–	–	–	–	50.4	75.2	92.3	79.7	53.7	76.2	76.2	76.2
Other current liabilities	0.2	0.1	0.1	0.5	18.1	0.4	0.4	4.9	0.8	–	–	–	–	–	–
Current Liabilities	**63.2**	**80.1**	**83.3**	**106.6**	**128.3**	**103.6**	**107.2**	**166.6**	**187.4**	**238.6**	**244.3**	**213.1**	**278.8**	**277.9**	**289.3**
Deferred income taxes	6.4	2.9	–	14.0	14.0	11.0	9.7	10.1	7.2	8.1	7.4	5.3	3.8	4.2	4.2
Income taxes payable	–	–	–	–	12.2	20.3	23.4	24.8	22.5	23.1	23.8	21.2	25.6	28.2	28.2
Long-term debt, less current portion	0.0	–	–	–	–	–	–	325.4	369.0	296.4	223.2	592.1	564.3	534.3	504.3
Other liabilities	1.2	1.2	1.4	3.9	2.7	1.7	1.2	2.4	7.9	5.9	4.7	3.7	2.8	5.0	5.0
Total Liabilities	**70.8**	**84.1**	**84.7**	**124.5**	**157.3**	**136.6**	**141.6**	**529.3**	**593.9**	**572.1**	**503.3**	**835.5**	**875.4**	**849.7**	**831.0**
Total Equity	602.3	709.4	810.0	880.9	799.0	921.5	1,087.2	555.2	561.1	762.4	1,003.5	964.2	774.5	723.4	771.4
Total Liabilities and Equity	**673.0**	**793.5**	**894.7**	**1,005.3**	**956.2**	**1,058.0**	**1,228.8**	**1,084.4**	**1,155.1**	**1,334.5**	**1,506.8**	**1,799.7**	**1,649.8**	**1,573.1**	**1,602.4**

CASH FLOW	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017E	2018E
Net Income	**79.2**	**102.1**	**96.9**	**136.3**	**156.9**	**141.1**	**151.6**	**166.4**	**182.1**	**180.0**	**178.7**	**219.8**	**270.4**	**298.1**	**322.0**
Depreciation & Amortization	30.8	31.3	31.5	37.1	42.8	41.4	43.2	45.7	48.2	56.7	53.7	48.9	49.6	60.0	70.0
Allowance for doubtful accounts	0.8	(0.5)	0.5	0.4	0.3	(0.2)	0.4	0.3	(0.2)	(0.4)	1.1	–	1.2	–	–
Share-based compensation	–	–	3.5	3.4	6.4	9.4	18.0	19.0	21.8	19.6	22.1	18.2	20.9	20.9	20.9
Excess tax benefits from SBC	–	–	–	–	–	(4.6)	(5.6)	(3.5)	(4.4)	(6.1)	(2.3)	(3.0)	–	–	–
(Gain) loss on sale of PP&E	(1.2)	(0.8)	18.7	0.2	0.1	0.6	0.7	1.9	(0.1)	(1.0)	(1.5)	(0.9)	–	–	–
Deferred Income taxes	(0.1)	(5.6)	(4.1)	(8.9)	5.7	(4.8)	(4.5)	(2.1)	(17.6)	(3.6)	(10.8)	4.4	5.7	–	–
Changes in op. assets & liabilities	5.8	9.5	(12.0)	11.1	(17.7)	21.6	(3.9)	15.8	(8.9)	(46.0)	(7.5)	(21.7)	(15.8)	(25.0)	(10.2)
Cash from Operating Activities	**115.2**	**136.0**	**142.0**	**182.1**	**194.1**	**203.4**	**199.4**	**242.9**	**229.7**	**199.3**	**262.6**	**265.6**	**332.5**	**354.0**	**402.7**
Purchase of short-term investments	–	(755.4)	(717.1)	(921.8)	(154.4)	–	–	–	–	–	–	–	0.4	–	–
Purchases of PP&E	(64.6)	(66.3)	(97.0)	(76.8)	(113.4)	(78.9)	(75.8)	(70.2)	(54.8)	(130.3)	(95.8)	(79.2)	(173.9)	(100.0)	(100.0)
Proceeds from the sale of PP&E	19.9	5.6	9.6	26.6	7.2	7.0	2.5	20.6	9.3	6.3	3.7	1.5	0.3	–	–
Acquisitons	(4.7)	(4.5)	(23.0)	(120.0)	(38.2)	–	(21.4)	(34.9)	(2.6)	(84.0)	–	0.2	0.1	–	–
Cash from Investing Activities	**(49.3)**	**107.4**	**(267.9)**	**(135.6)**	**(32.6)**	**(59.9)**	**(96.0)**	**(84.5)**	**(48.1)**	**(208.0)**	**(92.1)**	**(81.9)**	**(172.9)**	**(100.0)**	**(100.0)**
Proceeds from the exercise of stock options	5.1	1.8	5.4	10.9	12.7	3.1	6.3	7.1	13.7	21.4	10.4	3.6	13.2	5.0	5.0
Issuance of employee shares	1.3	1.4	1.6	1.5	1.7	1.9	2.0	2.0	2.0	1.9	–	3.0	–	–	–
Repurchase of common stock	(10.7)	–	(8.9)	(89.6)	(269.3)	(9.8)	(12.7)	(739.6)	(203.3)	(15.0)	(0.6)	(237.3)	(457.9)	(375.0)	(300.0)
Issuance of debt	–	–	–	–	–	–	–	373.0	124.7	–	–	698.9	331.5	–	–
Excess tax benefit from SBC	–	–	2.3	3.8	16.9	4.6	5.6	3.5	4.4	6.1	4.6	3.1	0.2	–	–
Change in book overdraft	–	–	–	–	8.2	(17.5)	–	–	–	16.3	(16.3)	(1.0)	–	–	–
Repayment of Debt	(0.1)	–	–	(2.0)	–	–	–	–	(56.3)	(96.7)	(75.0)	(350.0)	(337.5)	(30.0)	(30.0)
Cash from Financing Activities	**(4.4)**	**3.2**	**0.5**	**(75.4)**	**(229.7)**	**(17.6)**	**1.3**	**(354.1)**	**(114.9)**	**(65.9)**	**(76.9)**	**120.4**	**(448.4)**	**(400.0)**	**(325.0)**
FX Effect	0.1	0.2	(0.5)	0.7	(0.5)	(2.1)	0.8	1.4	(0.6)	(1.9)	1.4	(6.2)	(11.3)	–	–
Change in cash	61.6	246.8	(125.9)	(28.2)	(68.7)	123.8	105.5	(194.2)	66.1	(76.5)	95.0	297.9	(300.0)	(146.0)	(22.3)
Beginning cash	116.5	178.3	252.5	275.3	201.0	39.0	162.7	268.2	74.0	140.1	63.6	158.7	456.0	155.8	9.8
Ending cash	178.3	252.5	275.3	201.0	39.0	162.7	268.2	74.0	140.1	63.6	158.7	456.0	155.8	9.8	(12.5)
Cash interest paid	0.0	0.1	–	0.0	0.1	0.4	0.2	3.9	11.3	10.3	8.8	18.1	23.6	20.0	20.0
Cash taxes paid	41.8	64.7	71.5	84.2	85.0	71.9	94.0	85.1	106.6	95.2	82.8	109.9	128.0	160.5	173.4
Capex/Sales %	*16.1%*	*14.7%*	*18.4%*	*13.7%*	*14.4%*	*10.6%*	*9.8%*	*8.0%*	*5.9%*	*12.4%*	*8.2%*	*6.9%*	*13.7%*	*7.2%*	*6.7%*
Capex/D&A %	*209.5%*	*211.7%*	*308.5%*	*207.2%*	*264.8%*	*190.8%*	*175.4%*	*153.6%*	*113.8%*	*229.6%*	*178.3%*	*161.9%*	*350.3%*	*166.7%*	*142.9%*