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Client Letter – Third Quarter 2018

The S&P 500 Index returned 7.71% in the quarter ended September 30, 2018.[1]

In our previous quarterly letter, we discussed our investment process, which essentially consists of two parts. First, we narrow the investment universe down to businesses we feel confident possess enduring pricing power and significant volume growth opportunities. Second, we attempt to construct a portfolio that is robust to both unexpected competitive disruption and volatile macroeconomic cycles. In theory, this process seems fairly clean and simple. In practice, it's messy and complex. Because of innovation's relentless pace and the market economy's myriad moving parts, no business is completely immune to the threats of disruption and recession. However, every business does exhibit unique strengths and weaknesses with respect to these two risks. Thus, the job of constructing a portfolio is to weigh all these elements and assemble a variety of businesses that, as a group, effectively combat these risks.

While we believe our existing portfolio accomplishes this risk mitigation objective, we always remain vigilant for opportunities to improve the portfolio's robustness even further. Last quarter, we believe the market gave us one such opportunity by overreacting to an earnings miss by Copart (CPRT), a company we've admiringly followed for a long time. In the pages that follow, we'll explain why we believe Copart is a great business, why we believe investors overreacted, and why we believe its addition to our portfolio is an enhancement.

Copart

Copart is the largest auto salvage company in the United States. We believe it is a great business because 1) its network-driven, recession-resistant business model creates high barriers-to-entry and attractive, stable returns on capital; 2) auto salvage has favorable growth tailwinds and reinvestment opportunities both domestically and internationally; and 3) Copart's culture, management, and ownership structure are aligned with long-term value creation.

The first reason we believe Copart is a great business is because its network-driven, recession-resistant business model creates high barriers-to-entry and attractive, stable returns on capital. To understand why, a quick overview of the auto salvage industry is necessary. In 2016, over seven million crashes were reported in the United States,[2] causing damage to over eleven million vehicles.[3] Of these, about 18%[4] (roughly two million) were deemed total losses. Including the totaled vehicles from the millions of

[1] For information on the performance of our separate account composite strategies, please visit www.ycginvestments.com/performance. For information about your specific account performance, please contact us at (512) 505-2347 or email info@ycgfunds.com.
[2] See page 2 of https://crashstats.nhtsa.dot.gov/Api/Public/ViewPublication/812580.
[3] See pages 19 and 20 of https://crashstats.nhtsa.dot.gov/Api/Public/ViewPublication/812554.
[4] See pages 85 and 87 of https://www.cccis.com/crash-course-2018/.

unreported crashes that also occurred in 2016[5] as well as some portion of the millions of vehicles that were scrapped due to mechanical failure, the total number of salvageable vehicles was likely around 3 million that year. This number has steadily grown over time and is now over 3.5 million per year.[6] The purpose of auto salvage is to sell these vehicles, mostly on behalf of insurance companies, to vehicle dismantlers, rebuilders, repair licensees, used vehicle dealers, exporters, and the general public. Because both the seller-base and buyer-base are quite fragmented, with hundreds of sellers and more than 750,000 buyers in over 170 countries, the most effective sales process is an online auction. An auction is a classic example of a two-sided network. As we have discussed before, the key attribute of two-sided networks is that they are more valuable to sellers the bigger the customer base and more valuable to buyers the bigger the seller base. These increasing returns to scale generally result in mature two-sided network industries being dominated by a small number of large platforms. The auto salvage industry is no different, with Copart and IAA each commanding roughly 40% of the salvage market and a large number of smaller competitors each possessing a mere fraction of this amount. Besides this auction network effect, Copart also possesses a distribution network effect. Similar to other retailers and distributors, Copart's network of over 200 salvage yards in 11 countries benefits from increasing economies of scale, with increasing location density resulting in reduced costs per vehicle for both Copart and its customers over time. Finally, Copart is protected from additional competition by a phenomenon called Not In My Back Yard (NIMBY). Because salvage yards contain many hazardous materials and chemicals from totaled cars, residents of neighboring communities fight hard to prevent new ones from being approved.[7] Thus, in order to compete against Copart and IAA, new entrants must fight expensive, lengthy battles to acquire new sites for salvage yards. In many cases, these battles can seem especially futile because 1) the choicest locations are often already taken by the big two and 2) communities can argue that salvage is already well-served by the existing yards. All these factors combine to result in high barriers to entry and returns on capital for the two largest auto salvage players.

Importantly, auto salvage is also quite recession-resistant, as an analysis of Copart's two main revenue drivers demonstrates. The first of these drivers, the number of cars Copart salvages each year, varies over time according to a simple formula: total miles driven x accidents per mile driven x vehicles per accident x salvage rate x Copart's market share. In a recession, total miles driven decreases, but not by much. Even in the 2008-2009 recession, total miles driven only fell by 3%.[8] Neither accidents per mile driven nor vehicles per accident is much affected by recessions. The salvage rate, all other things equal, actually increases in a recession because repair costs as a percentage of pre-accident values go up as used car prices go down. Copart's market share also tends to increase during recessions as some weaker players go out of business or sell to Copart. The net result is that the number of cars salvaged tends to rise even in most recessions. The second of Copart's revenue drivers, revenue per car, is more negatively impacted by recessionary environments. Revenue per car is tied to the auction value of the vehicle, the number of services consumed, the pricing of these services, and international exchange rates. Auction

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[5] Surveys suggest that anywhere from 30% to 47% of crashes go unreported. See https://crashstats.nhtsa.dot.gov/Api/Public/ViewPublication/812183.

[6] See https://www.iaai.com/about/aboutiaaiview.aspx.

[7] See https://toxicsaction.org/issues/waste/illegal-junkyards/.

[8] See https://money.cnn.com/2015/10/26/news/economy/americans-driving-all-time-high/index.html.

value generally decreases during recessions because consumers typically defer big-ticket purchases, pressuring new and used car prices. In the 2008-2009 recession, used car prices decreased by roughly 15%.[9] Amazingly, Copart was able to completely offset this price decline through some combination of increased services per car and increased price per service, leading to marginal growth in revenue per car in local currencies. However, the strengthening of the U.S. dollar relative to international currencies resulted in lower U.S. dollar revenue per car. Combining the increase in cars salvaged with the decrease in revenue per car, Copart's service revenues proved remarkably resilient in the 2008-2009 recession, decreasing by less than one percent. Even total revenues, which included a vehicle sales business acquired in connection with a UK acquisition that requires Copart to take ownership of certain totaled cars and then resell them, only decreased by 5% from 2008 to 2009.[10] Because of Copart's high operating margins and strong cost control, operating profits were also only down by 5%. In the deep recession of 2008-2009, this result was far better than average.

The second reason we believe Copart is a great business is because auto salvage has favorable growth tailwinds and reinvestment opportunities both domestically and internationally. On the domestic side, the best way to evaluate this growth potential is to return to Copart's revenue equation: total miles driven x accidents per mile driven x vehicles per accident x salvage rate x Copart market share x fee per vehicle, with the fee per vehicle being driven, at least in part, by the auction value of the vehicle. We believe the two most predictable of these drivers are total miles driven and growth in the auction value per car over time. We believe total miles driven will continue to grow at roughly the same rate as population at 0.5% to 1.5% per year. We believe auction values are likely to grow by 1.5% per year in real terms and 3.5% to 4.5% in nominal terms, which is similar to historical used car pricing growth, as measured by the Manheim index,[11] and new car pricing growth, as measured by the U.S Bureau of Economic Analysis.[12] In recent years, revenue growth has been accelerated by numerous other factors that we believe are likely to continue in the intermediate term. First, through scale advantages and bolt-on acquisitions, we believe Copart and IAA will continue supplementing underlying market growth with market share gains from competitors. Second, we believe salvage rates, which have risen over the last few years, will continue to increase. Vehicles are increasing in complexity with more and more electronics and safety features, causing the cost of repair to increase as a percentage of pre-accident vehicle values. Additionally, body shops are consolidating, further increasing repair costs. Moreover, the total stock of cars on the road is getting older as cars last longer. All of these trends put upward pressure on salvage rates over time. Third, while all of the new safety features in cars should, all things equal, help decrease accidents per miles driven over time, they are currently being more than offset by adverse changes in driver behavior such as increased texting while driving, meaning accident rates are also edging up, benefitting revenues. Lastly, because of the network-driven increasing returns to scale of Copart's business, this revenue growth has bolstered domestic margins over time and may continue to do so, further adding to profit growth.

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[9] See https://publish.manheim.com/content/dam/consulting/ManheimUsedVehicleValueIndex-LineGraph.png.

[10] This vehicle sales business represented 21% of total sales in 2008 versus only 12.5% in 2018, so we believe total sales and profits would be impacted by an even smaller amount in a comparably deep future recession.

[11] See https://publish.manheim.com/content/dam/consulting/ManheimUsedVehicleValueIndex-LineGraph.png.

[12] See https://blog.chron.com/carsandtrucks/2016/04/cost-of-a-car-in-the-year-you-were-born/.

Internationally, Copart's growth opportunity is even more exciting. In contrast to the United States, many international insurers reimburse their policyholder for the difference in value between the pre-damaged car and the damaged car and then the policyholder has to sell the damaged vehicle to recover the rest of the value. Copart's model is a win for policyholders and insurers because they get higher, faster, and more predictable value for the salvaged vehicle and a win for buyers because they get a steadier supply of inventory. This state of affairs, in which markets are relatively nascent, auto salvage services are highly desired by customers, and the competitive field is open with no strong incumbents, makes Copart's international division a promising place for investment. Even better, because Copart's U.S. online auctions draw so many international bidders (over 21% of the total in recent auctions),[13] Copart possesses a built-in buyer base that gives them an advantage over competitors and increases management's (and our) confidence in the return on incremental international investment. Because of these advantages and opportunities, Copart now has operations in the UK, UAE, Bahrain, Oman, Brazil, Spain, India, Ireland, and Germany, representing 17% of sales and 12% of operating profits. Copart's UK operations provide tantalizing indications of international's revenue and profit potential, with economics that are already comparable to the Copart's North American business despite being both newer and much smaller in size.[14] Accordingly, as the international markets mature, we believe they may be able to achieve similar operating margins to the US at 34.5% versus current margins of 22%.

Summing these growth drivers (growth in miles driven + growth in used car values + growth in accidents per mile + growth in salvage rates + organic market share gains + bolt-on acquisitions + international growth), we believe Copart can compound revenues by a high-single-digit percentage over the medium term, which, amazingly, would actually be a deceleration from the torrid 11% compound annual revenue growth they've generated over the last 12 years. As we cited earlier, because of increasing returns to scale, Copart may be able to grow operating profits even faster, though investments in new markets may end up offsetting the increasing returns of mature markets. Given the promise of many of these new markets, we'd actually prefer this more aggressive reinvestment scenario.

The third and final reason we believe Copart is a great business is because Copart's culture, management, and ownership structure are aligned with long-term value creation. Evidence for Copart's strong culture abounds. The company has invested more in technology than its main competitor, IAA, and now has fully online auctions. Additionally, the company has invested more aggressively in its international operations. Despite these margin-pressuring investments, Copart possesses higher operating margins than IAA, suggesting better cost discipline. The company's culture of ownership also shines through in its decision to own its salvage yards versus IAA choosing to lease them, its conservative capital structure with virtually no net debt (0.16x net debt/EBITDA), and, finally, its superlative capital allocation decisions. On that last point, Copart has raised debt and bought back big blocks of shares when management has judged the stock as cheap and bought back no stock at other times when buying back stock has appeared less attractive than business reinvestment. These decisions have proven very prescient over time, with the stock purchases generally occurring at low historical valuations and before big growth spurts. Given the high inside ownership of the company, with the

[13] See page 2 of https://www.sec.gov/Archives/edgar/data/900075/000090007518000048/cprt07312018-10k.htm.
[14] See page 19 of https://www.copart.com/Content/US/EN/PDFs/IR-SEC-Copart-InformationalSupplement-2016April.pdf.

founder and management combining to own 16.4% of shares outstanding, we believe this corporate excellence is both no surprise and quite likely to continue well into the future.

As you can probably tell from our discussion of Copart, we love this business. In our view, there are very few near-term risks to the business and many exciting opportunities. However, before moving on to our discussion of its valuation and the price decline that allowed us to take a position, we must deal with the key long-term risk to Copart's business model: vastly improved safety technologies and/or fully autonomous driving.

While safety technologies are currently being offset by driver behavior such as texting-while-driving, in the long run, we believe continued innovation will eventually cause declining accidents per mile. We believe slow declines are likely manageable given Copart's numerous growth drivers and the fact that new technologies that reduce accident frequencies also tend to increase repair costs and thus salvage rates. However, rapid deployment of fully-autonomous vehicles could cause accident rates to plummet, likely significantly impairing Copart's business model. While, as citizens, we are hoping for this future, we believe there are number of factors that will delay, probably by decades, full autonomy.

We believe full autonomy faces numerous technical and cultural challenges that many investors and commentators underestimate. First, while humans can be outclassed by computers in many narrow domains, driving is a very general-purpose task with a large number of edge cases such as traffic lights outages, strange behavior from other drivers and pedestrians, and weird weather conditions. It is unclear how long it will take for autonomy to supersede humans on these issues. The eventual solution may require car-to-car and car-to-infrastructure networked solutions, leading to the next issue with full autonomy. Even if fully functioning autonomous driving capabilities were available today, the deployment of these technologies would require massive investment by both governments and individuals. In some envisioned scenarios, governments would have to embed an untold number of chips in roads and individuals would have to choose to replace the stock of over 288 million cars currently registered in the United States.[15] Given that new car sales typically oscillate between 15 and 18 million cars per year,[16] car upgrades alone would likely take at least 15 years. Furthermore, while autonomy solves some problems, it also creates new ones, such as computer viruses and bugs. These will likely occur both accidentally and through premeditated, coordinated attacks. This new source of accidents could prove to be a source of more frequent small accidents than people currently anticipate, and it may also increase the risk of much larger and potentially more disastrous ones. Autonomy could also create new problems that we currently can't even imagine. After all, we've already seen an example of new solutions creating unanticipated new problems with increased safety technologies coinciding with the rise of the mobile phone, leading to higher accident rates.

Full autonomy must also deal with numerous cultural challenges. Many people enjoy driving and/or feel resistant to ceding full control of their safety to their car's computer either because of overconfidence or anxiety related to the black box nature of complex technology. Additionally, the algorithms that drive autonomous cars all possess an implicit or explicit ethical framework. Through a regulatory framework,

[15] See page 8 of https://crashstats.nhtsa.dot.gov/Api/Public/ViewPublication/812554.
[16] See https://www.statista.com/statistics/199983/us-vehicle-sales-since-1951/.

society must decide what this framework should look like. Should the autonomous car preference the driver's life, the passenger's life, or the pedestrian's? What if there are three pedestrians? What if one of the pedestrians is a child? This conundrum, commonly referred to as the Trolley Problem, has confounded philosophers since it was first introduced in 1905.[17] It will likely take society and its politicians years to decide on and institute a framework. Even if a significant portion of the population agrees on the answers, many individuals may fight for the right to opt out and choose their own ethical framework. Understandably, many would probably want their car to preference their own or their child's life.

Finally, when considering the risk of autonomous driving, we take comfort in two additional facts. First, because Copart's founder and top executives own such substantial stakes in the company, they are heavily incentivized to proactively react to autonomous driving developments in ways that will protect shareholder value, whether that means exiting or evolving or running-down the business if and when autonomy takes crashes down to levels that irreparably hurt the salvage industry's economics. Second, we own Google, which is the clear leader in autonomous driving technologies, so, if we're wrong on the timing of driverless car deployment, we're at least somewhat hedged through our ownership in Google.

Now that we've provided our thoughts on autonomous driving, let's finish up with a discussion of Copart's valuation and the opportunity the market gave us to purchase the stock. As we often mention, once we classify a business as great, we evaluate the forward risk-adjusted rate of return relative to the other stocks we own. If we decide the spread is not large enough to warrant a portfolio change, we put the business to the side and remain vigilant for spread-widening opportunities. The most common spread-widening opportunity occurs when the sidelined business experiences temporary problems, which we believe generally causes investors to overly discount the stock in a failed effort to market-time these problems. In our view, Copart's most recent earnings release provides a great example of this phenomenon. Copart reported higher costs than expected related to Hurricane Harvey, promptly causing a more than 20% sell-off and enabling us to purchase the stock at 23x next twelve months earnings. For a business that we believe can grow revenues at high single digits and earnings at low double digits over the medium term with low cyclical risk, we believe this valuation is attractive on an absolute basis and relative to a number of the stocks in our portfolio.

Concluding thoughts

While public equity investing is messy and complex, it's also incredibly rewarding. It provides a rich array of lessons on history, decision-making, organizational dynamics, and innovation that increase wisdom over time, and it also provides the opportunity to grow wealth at a pace that we believe few other asset classes can match, especially when adjusting for risk. We believe this opportunity is best captured by patiently owning a collection of great businesses, and we hope our discussions of investment process and our analyses of the businesses we own, such as the Copart review in this letter, help you understand why.

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[17] See https://en.wikipedia.org/wiki/Trolley_problem.

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Sincerely,

The YCG Team

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