AutoCanada (ACQ) – Group 6 – Thomas Chapman, Tim Schiappa, Sera Tee, Sarah Tan

Search Criteria:

We analyzed multiple criteria that could indicate the stock as a potential value stock. We believe the stock to be obscure as it is has declined 75% from its maximum value in 2014 and has yet to recover. Furthermore, ACQ is undesirable indicated by its low valuation metrics. ACQ has a10.5x P/E ratio (below the 13x threshold) and a M/B ratio of 1.2x (at the 1.2x threshold). We indicate the Company fits the value criteria and we will proceed with the valuation.

Industry & Company Analysis:

ACQ operates in the Canadian Automotive Retail Industry and it is the largest and only publicly listed automobile group in Canada. The industry is highly cyclical and directly linked to the economy. Furthermore, margins in the industry are thin due to high competition. Despite industry conditions, ACQ has achieved steady operating margins over the last 10 years (*Exhibit 1*), surviving two major economic downturns. Additionally, its size allows it to gain significant advantages in its higher margin operations of service and financial products. However, new car sales are the main driver of ACQ's revenue, which is the only segment the company does not have a competitive advantage in, and adverse market conditions directly hurt its profitability. Given the information above, we conclude **business risk to be medium.** Medium business risk implies an optimal capital structure of **30%-49%.** We calculated ACQ's **target capital structure of 63%** by taking last year's B/V ratio, as management recently took on $420mm extra debt in February. Target capital structure above the optimal, implies **high financial risk.** This implies an BBB-B credit rating, which is consistent with the BB- rating assigned to them through Standard and Poors and the BB rating found through ratio analysis (*Exhibit 2).* Given the credit rating, we assessed the Company's pre-tax cost of debt of 5.7% (Kd) by finding the market value of the company's bonds. We then multiplied Kd by the Company's 27% tax rate to get a 4.2% after tax Kd. Medium business risk and high financial risk implies an equity risk premium (ERP) of 5.9%. To arrive at the cost of equity (Ks) of 11.6% we added the ERP to the pre-tax Kd. To calculate WACC of 7.0% we used Kd, Ks, and B/V as inputs in the formula seen in (*Exhibit 3*). We calculated an average first pass ROIC of 17.4% over the last 10 years (*Exhibit 4).* ROIC is greater than WACC, leading us to expect a similar relationship between EPV/NAV. However, we found competitors average a higher ROIC and operating margin than ACQ (*Exhibit 5*) leading us to believe EPV may be lower than NAV.

NAV – EPV Calculations:

We found **NAV to be $39.67/share** and **EPV to be $24.46/share** *(Exhibits 6&7).* We calculated **second pass ROIC of 3.5%** (*Exhibit 8).* This pass is consistent with our intuition as well as the relationship between EPV and NAV. Additionally 2nd pass ROIC/WACC is 0.62x and NAV/EPV is 0.65x.

Strategic Analysis:

When conducting our strategic analysis, we found many problems with management that explain the difference between NAV and EPV. They have been focusing on growth despite ROIC < WACC which has destroyed value. Furthermore, serial acquisitions have led to a decline in both asset turnover and gross margins, which has negatively affected ROIC and EPV. We identified a possible catalyst as a management change. There is a **low possibility (20%)** this catalyst will occur as contracts with OEM's stipulate they must approve a change in management. Additionally, OEM's can cancel their contracts if any shareholder owns more than 10% of the company, discouraging outside investors from taking large positions to influence change.

Margin of Safety:

We will incorporate a 1/3 margin of safety to deal with uncertainties or unforeseen risk.

Decision:

IV = EPV + (NAV – EPV) * 20% = $24.46 + ($39.67 – $24.46) * 20% = $27.50
Entry Price = 2/3 * IV = 2/3 * = $18.34
As entry price is lower than the current share price of 22.21$, we will **WAIT** to buy this stock.