BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Copart (CPRT) EQ Review

Current EQ Rating*	Previous EQ Rating
4-	na

6- "Exceptionally Strong"
5- "Strong"
4- "Acceptable"
3- "Minor Concern"
2- "Weak"
1- "Strong Concerns"

Note that a "+" sign indicates the earnings quality improved in the most recent quarter while a "–" sign indicates deterioration

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of CPRT with a 4- (Acceptable) rating.

While beyond the scope of an earnings quality review we do have some concerns with the sustainability of the company's growth rate given factors such as the saturation of the US market, risks inherent in international expansion, and weakness in miles driven. However, the aging fleet and rising total loss rates work in the company's favor. We may do more work in this area in the future, but for now, we do not have any major concerns with CPRT's earnings quality. We note the following factors impacting results which we will monitor in future quarters:

- Historically, CPRT was able to grow partly through acquiring existing auction operations. However, with the market essentially now a duopoly with CPRT and IAA jointly controlling 80%, there are less attractive acquisition candidates that can "move the needle" for growth. The 2017 Cycle Express deal was the last major acquisition the company has made. Over the last three

years, the company's cash spending has shifted from acquiring companies to investing in building operational facilities from scratch. The company already has over 150 locations in the US with major metropolitan geographies well covered. Also, with most bidding done online, geography matters less to the buyers than it used to. In fact, roughly 20% of winning bids in the US markets were placed by overseas bidders. We question how long the company can build new facilities in the US without seeing a negative impact on ROIC. With tons of cash flow, the company could easily pay an attractive dividend, but at over 30 times forward earnings, current investors want earnings growth more than a return of capital.

- The dramatic increase in capital spending to build out new facilities has predictably led to a jump in depreciation expense. The company's depreciation periods appear reasonable. However, it is benefitting slightly from intangible assets becoming fully amortized, namely the trade names picked up in the 2017 Cycle Express deal. We do note that according to the FY 2019 10-K, the company extended the useful lives on trade names from 1 year to 7. However, given that the bulk of the trade names were likely already amortized, the impact has been immaterial on profit growth.

- CPRT incurs multiple costs in the process of preparing a car for auction such as the cost to bring the car to its facilities, titling the car, cleaning, valuing, and processing. These costs will ultimately be reimbursed by the seller, so the company defers them and recognizes them at the time the car is sold. While some costs such as transport and titling match easily on a per car basis, others are more subjective. It is therefore important to monitor pooling costs relative to sales to watch for signs that costs are being deferred longer. We currently see no points of concern with the account, although we do observe that with the adoption of ASC 606 in the 10/18 quarter, pooling costs more than doubled as the company began deferred transport and titling costs where it had previously expensed them as incurred.

- The company capitalizes the cost to develop internal-use software and amortizes it. We estimate the average amortization period is about 5 years which is not especially unreasonable. However, we caution that in 2017, the company had to write off $19.4 million in impaired software development costs, and two quarters later it retired $15.5 million of fully amortized software which was no longer being used.

- The company also capitalizes the cost to obtain a contract and amortizes it over the expected life of the customer relationship. We note that there appeared to be an unusual increase in the amortization period in the 7/19 quarter from approximately 1.5 years to 3 years. However, the decline in amortization expense was not material to results. Nevertheless, this account should be monitored going forward for any material changes

A Quick Look at Growth Drivers

From an accounting perspective, we have very little concern with the company's current quality of earnings. While beyond the scope of an initial EQ Review, we believe it is helpful to take a look at the drivers of the company's growth and begin to consider the sustainability of each.

CPRT's revenue is highly dependent on the volume of cars run through its auctions, the average selling price per car, as well as the price of scrap steel. Let's look at the main factors that impact these three drivers:

Volume of Cars

80% of the company's car volume comes from insurance companies selling vehicles that have been deemed total losses. These cars are purchased by rebuilders who repair and resell the cars and dismantlers who part them out and/or sell them for scrap. Any factor that increases the supply of cars available for auction will drive revenue growth for CPRT. Short-term impacts such as hurricanes can result in a sudden surge in totaled cars. Miles driven and accident frequency are key longer-term trends impacting the number of cars that will be available for auction. Miles driven was declining in the mid-2000s but has experienced a small comeback in the last few years. COVID has reversed this and any sustained increase in telecommuting could put miles driven back on a negative trend.

We also remember years ago that some onlookers hypothesized that improving accident avoidance systems on newer cars would reduce the number of cars going to auctions. Unfortunately, the advent of these safety systems coincided with the advent

of cell phones which more than offset the positive impact of accident avoidance systems. However, we believe it is reasonable to expect continued improvements in technology to eventually overcome the impact of the distracted teenager and push the accident rate down.

Another driver of cars available for auction is the cost of repairs. New features on cars (such as accident avoidance systems) make them more expensive to repair and increase the likelihood that an insurance company will declare a car a total loss. This is a trend we would expect to continue. Also, the average age of the fleet of cars on the road is currently near an all-time high of over 11 years. This increases the likelihood that a car will be totaled which should be a positive for the supply of actionable cars.

Finally, we wonder what the impact of electric cars will be on the salvage industry. While the mechanical components of electric cars should fit well in the company's model, the handling and disposal of damaged batteries brings a new set of problems requiring the industry to adopt.

Selling Price per Car

Most of the company's fees are based on the final auction price, so any factor increasing the value of auctioned cars is a boost to revenue growth. Increasing complexity and the value of parts is a positive contributor. Also, scrap steel prices have also been a key driver in the distant past, but scrap steel prices currently being at a 10-year low is working against the company.

Market Saturation

CPRT and Insurance Auto Auctions (IAA) each control about 40% of the US auto auction market. The company has multiple locations near most major cities and its online bidding capability means that the location of the servicing centers is not important to the average buyer. In fact, the company disclosed in a 2015 investor presentation that 20% of the cars auctioned in the US were actually bid on by non-US buyers. While there is still some market share the company can take from smaller players, it will likely be less meaningful moving forward than it has in the past ten years.

Overseas Expansion

Less room to grow in the US-led CPRT to expand its operations overseas years ago. While the company has been able to generate growth there, it brings a new set of risks including the fact that each market has differing practices for used cars. For example, in the UK, the company typically has to purchase cars from insurance companies rather than simply acting as an agent. This adds a whole new level of inventory risk not present in its US operations.

Switch from Acquisitions to Greenfield Development

As noted above, CPRT's growth has been partly dependent on expanding its operations either by acquisition or opening new yards (greenfield expansion). Prior to 2017, the company relied more on acquiring other companies for growth. However, the 2017 acquisition of Cycle Express for $193 million marked the last sizeable deal the company has done. In place of the cash acquisition spending, the company has dramatically ramped up its spending on opening and developing its own locations. For example, here is a summary of openings versus acquisitions for the last three fiscal years (ended July):

2017

Acquired:
-Cycle Express

Opened
- 1 operational facility in Germany
-1 operational facility in Brazil
-9 new operational facilities in the US

2018

Acquired:
-smaller operational facilities in Finland

Opened
-3 operational facilities in the US
-1 operational facility in the UK
-1 operational facility in Germany

2019

Acquired:
-1 operational facility in US

Opened
-1 operational facility in Brazil
-7 operational facilities in Germany
-11 operational facilities in the US

This shift from acquisitions to greenfield development can be seen in the following table which calculates free cash flow as operating cash flow less capex (including greenfield development) less cash spent on acquisitions for the last three trailing 12 month periods ended April 30th:

	4/30/2020	4/30/2019	4/30/2018
T12 Operating Cash Flow	$844.118	$611.368	$521.428
T12 Capex	$602.277	$367.551	$227.163
T12 Acquisitions	$3.268	$0.745	$159.599
T12 Free Cash Flow	$238.573	$243.072	$134.666

We can see that as cash acquisition spending has fallen, capital spending on developing new facilities from scratch has almost tripled in the last three years. PRGO has only been disclosing quarterly depreciation expense by itself for the last couple of quarters. However, it regularly discloses depreciation and amortization of assets which is shown in the table below:

	4/30/2020	1/31/2020	10/31/2019	7/31/2019
Depreciation and Amortization	$26.715	$24.282	$23.014	$21.515
Depreciation	$24.500	$22.000	na	na
Implied Amortization Expense	$2.215	$2.282	na	na

	4/30/2019	1/31/2019	10/31/2018	7/31/2018
Depreciation and Amortization	$21.112	$20.399	$21.869	$28.252
Depreciation	$18.600	$17.800	na	na
Implied Amortization Expense	$2.512	$2.599	na	na

CPRT has been enjoying lower amortization of intangibles as over 20% of intangibles consisted of trade names. Most of which were picked up in the 2017 Cycle Express deal. These were being amortized over 2 years which would have resulted in them becoming almost fully amortized during fiscal year 2019. However, the estimated useful lives to remaining unamortized trade names were also suddenly extended in 2019 according to the 10-K disclosure, which would have further reduced amortization expense. While the spike in useful lives for trade names is peculiar, given the relatively immaterial size of amortization we are not overly concerned with the decline. The main thing to take away from amortization in the above table is that it is a relatively small component to the depreciation and amortization total.

We can see from the above table that depreciation jumped by almost $6 million year-over-year in the 4/20 quarter after jumping over $4 million in the previous quarter. A jump in depreciation is to be expected from such an aggressive capital spending push.

With regards to the company's depreciation policy, it utilizes the straight-line method and amortizes the asset classes as follows:

	Gross Value	Avg. Useful Life
Land	$1,149	
Buildings and Improvements	$902	7-40 yrs
Transportation and Other	$269	3-20 yrs
Office Furniture and Equipment	$68	3-5 yrs.
Internally Developed Software	$49	3-7 yrs.

The buildings and improvement disclosed range is quite wide which gives little useful information by itself. The "transportation and other" period of 3-20 years seems somewhat long. Depreciating a truck over 20 years is obviously unrealistic, but the category title is broad so it is unclear what assets are included in the range. If we

annualize the quarterly depreciation rate from the 4/20 quarter of $24.5 million and compare it to the gross depreciable asset base (gross PPE ex. land) of $1.3 billion, we get an average depreciation period of approximately 13 years. Just playing with the numbers, a 30-year average life for buildings and improvements, a 7-year average life for transportation and other, a 5-year life for office equipment and a 3-year life for software, would generate the observed depreciation rate seen in the 4/20 quarter. These are not outrageously long periods. Also, as a reasonableness test, we compared competitor Insurance Auto Auctions (IAA) depreciation expense to depreciable assets and arrived at an estimated average depreciation period of about 14 years which is comparable to CPRT.

Vehicle Pooling Costs

CPRT incurs multiple costs in the process of preparing a car for auction such as the cost to bring the car to its facilities, titling the car, cleaning, valuing, and processing. These costs will ultimately be reimbursed by the seller, so the company defers them and recognizes them at the time the car is sold. CPRT describes its method of deferring these costs in its financial footnotes as follows:

> *"The Company defers costs that relate directly to the fulfillment of its contracts associated with vehicles consigned to and received by the Company, but not sold as of the end of the period.* ***The Company quantifies the deferred costs using a calculation that includes the number of vehicles at its facilities at the beginning and end of the period, the number of vehicles sold during the period and an allocation of certain yard operation costs of the period. The primary expenses allocated and deferred are inbound transportation costs, titling fees, certain facility costs, labor, and vehicle processing. If the allocation factors change, then yard operation expenses could increase or decrease correspondingly in the future.*** *These costs are expensed into yard operations expenses as vehicles are sold in subsequent periods on an average cost basis."*

Some of the deferred expenses such as transportation and titling fees can be closely identified with individual cars and lend themselves well to a per-unit cost estimation. However, there seems to be more subjectivity in assigning costs such as "certain facility costs", labor, and vehicle processing. It is also worth noting that prior to the adoption of ASC 606 at the beginning of the 10/18 quarter, the company did not defer

the cost of transportation or titling but expensed those costs as incurred. However, beginning in the 10/18 quarter, the company also began deferred transportation and titling expenses which doubled the pooling costs balance.

Given the subjectivity involved, it is important to monitor the vehicle pooling account for unusual increases. It would be most informative if we could compare it to the number of cars processed during a period, but this information is not available. We see the best available option as being simply to compare it to current period sales. The following table shows the calculation of vehicle pooling costs on a days of sales basis for the last eight quarters:

	4/30/2020	1/31/2020	10/31/2019	7/31/2019
Revenue	$550.360	$575.140	$554.424	$542.575
Vehicle Pooling Costs	$75.357	$90.595	$86.035	$76.548
Vehicle Pooling Costs Days of Sales	12.3	14.5	14.3	13.0

	4/30/2019	1/31/2019	10/31/2018	7/31/2018
Revenue	$553.116	$484.898	$461.368	$449.223
Other Accrued Liabilities Days	$75.289	$80.610	$70.598	$34.284
Vehicle Pooling Costs Days of Sales	12.1	15.3	14.1	7.0

Other than the ASC 606-driven jump in the 7/19 quarter, the year-over-year increase in pooling costs days of sales has been fairly consistent. As such, we are not currently concerned and will monitor the trends going forward.

Capitalized Software Development Costs

CPRT has developed a proprietary management information system to conduct its auction processes. It allows the company to collect, process, value, and sell the thousands of cars it runs through its system every year. The company capitalizes the cost of developing its internal-use software and amortizes it over its estimated useful life when placed into service. CPRT discloses the gross capitalized software balance and the accumulated amortization every quarter, although it does not disclose the actual amortization expense or the amount capitalized. However, we estimated amortization expense by taking the periodic change in accumulated amortization and determined an estimate for the amount capitalized as a plug number. We realize that this does not consider changes in FX or small write-offs, but we believe it is still informative. The results are shown in the below table:

	4/30/2020	1/31/2020	10/31/2019	7/31/2019
Beginning Net Capitalized Software	$17.800	$16.700	$15.800	$15.400
Estimated Amortization*	-$2.200	-$2.600	-$2.300	-$2.300
Implied Capitalized Software Development Costs**	$2.700	$3.700	$3.200	$2.700
Ending Net Capitalized Software	$18.300	$17.800	$16.700	$15.800

	4/30/2019	1/31/2019	10/31/2018	7/31/2018
Beginning Net Capitalized Software	$15.000	$16.400	$14.700	$13.200
Estimated Amortization*	-$2.000	-$3.000	-$0.300	-$1.300
Implied Capitalized Software Development Costs**	$2.400	$1.600	$2.000	$2.800
Ending Net Capitalized Software	$15.400	$15.000	$16.400	$14.700

*Estimated by taking the change in accumulated amortization from quarter to quarter

**Estimated as the plug number necessary to reconcile the known beginning and ending net capitalized balances which are known with the estimated periodic amortization amount.

We can estimate the implied amortization period by annualizing the quarterly estimated amortization expense and comparing it to the beginning gross capitalized balance. This yields an estimate of around 5 years which is consistent with the company's disclosed amortization range for software of 3-7 years. Amortization expense has been relatively consistent. (We suspect that the unusual amount in the 10/18 quarter may be related to a write-off.) Also, amortization typically matches closely with the amount capitalized which is a good sign for earnings quality. This account should be monitored going forward for a sustained increase in capitalized amounts or an increase in the implied amortization period.

While we see no immediate red flags with the account, we would draw attention to the fact that in the 7/17 quarter, the company took a $19.4 million write-down to the value of capitalized software account which more than cut its value in half. Then two quarters later, CPRT retired another $15.5 million of fully amortized software assets which were no longer being utilized. While the latter action had no earnings or equity impact given the assets were fully amortized, both events highlight the possibility that the value of these assets can be questionable. Also, the rationale behind capitalizing these assets is that the company has invested in something new, such as a proprietary system to run its auction processes. However, in our mind, once such as system is developed it comes into question how much of the expenditures are to build a new system or to simply maintain and roll out the existing system at new locations. It is questionable if such costs are more capital or maintenance in nature

which could make them more at risk of eventually being written off. With a current net balance of less than $16 million, even a complete write off is not crippling. However, these are factors to keep in mind while analyzing the account going forward.

Capitalized Contract Costs

CPRT capitalizes certain costs associated with obtaining contracts with customers and amortizes them over the expected life of the customer relationship. The company began disclosing the activity in this account with the adoption of ASC 606 at the beginning of FY 2019:

	4/30/2020	1/31/2020	10/31/2019	7/31/2019
Beginning Balance	$9.282	$10.131	$10.574	$8.124
Capitalized Contracts During Period	$2.775	$0.100	$0.000	$2.777
Costs Amortized During the Period	-$0.809	-$0.873	-$0.875	$0.148
Effect of FX	-$0.512	-$0.076	$0.432	-$0.475
Ending Balance	$10.736	$9.282	$10.131	$10.574

	4/30/2019	1/31/2019	10/31/2018
Beginning Balance	$8.472	$9.990	$11.840
Capitalized Contracts During Period	$1.353	$0.000	$0.000
Costs Amortized During the Period	-$1.701	-$1.653	-$1.669
Effect of FX	$0.000	$0.135	-$0.181
Ending Balance	$8.124	$8.472	$9.990

The amount capitalized every quarter is lumpy, so we do not have a problem conceptually with smoothing them out over time for the purpose of analyzing profit growth. However, we do observe that there appeared to be an unusual change in the amortization period in the 7/19 quarter. If we annualize the quarterly amortization expense each period and compare it to the beginning capitalized cost balance, we can get a rough estimate of the rate at which these costs are being amortized. The following table shows the calculation of this figure for the quarters available:

	4/30/2020	1/31/2020	10/31/2019	7/31/2019
Quarterly Amortization	$0.809	$0.873	$0.875	-$0.148
Annualized Amortization	$3.236	$3.492	$3.500	**-$0.592**
Beginning Capitalized Balance	$9.282	$10.131	$10.574	$8.124
Implied Amortization Period	2.9	2.9	3.0	NM

	4/30/2019	1/31/2019	10/31/2018
Quarterly Amortization	$1.701	$1.653	$1.669
Annualized Amortization	$6.804	$6.612	$6.676
Beginning Capitalized Balance	$8.472	$9.990	$11.840
Implied Amortization Period	1.3	1.5	1.8

We see that before the 7/19 quarter, the amortization period was running in the 1.5-year range. However, the data indicates that in the 7/19 quarter, there was an amortization credit rather than an expense and in the quarters that followed, the implied amortization period jumped to 3 years. This could be an indication that the company changed the period over which is was amortizing contract assets in the fourth quarter of FY 2019 although we have not seen any disclosure indicating this was the case. Keep in mind that the amortization period is not an objective contract term, but rather a very subjective estimate of how long the customer relationship will last. The boost from lower contract amortization expense in the 4/20 quarter was less than half a cent per share. While we don't have amortization expense data for the 7/18 quarter, if we assume it was approximately $2 million, then even the amortization credit in the 7/19 quarter generated less than a penny per share boost in that period, so this is not a material manipulation generated by the company to keep the illusion of growth alive or to mask a material earnings miss in a quarter. Still, we believe this account warrants monitoring for any material changes going forward.

Explanation of EQ Rating Scale

Rating	Description
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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