BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

BTN Research

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Anheuser-Busch InBev (BUD) EQ Review

Current EQ Rating*	Previous EQ Rating
3-	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 BUD with a 3- (Minor Concern) rating.

BUD is one of the Large-cap stocks that has not seen a nearly full price recovery since May. Some of the reasons behind that are the continued focus on its debt level and just how quickly will business recover for bars and sporting events. We have followed this from afar as a large investment for Altria (MO), which has yet to write down the carrying value of its BUD investment to fair market value. We thought the

SABMiller deal may have been a Bridge Too Far in terms of debt load and lack of cash flow to sustain the dividend, which now has been cut twice.

We are looking at BUD on pre-COVID results and the assumption that it can return to that level of business over time. Interestingly, BUD's accounting appears conservative in several areas regarding the income statement. For a company with adjusted EPS of $3.99, we aren't complaining about the adjustments. We found another 22-cents of items that helped EPS that investors may want to be aware of.

The bigger issues with BUD are balance sheet related in our view. Debt reduction is largely coming from asset sales, which in turn lowers cash flow. It may take several more years for BUD to approach the goal of Net Debt/EBITDA at 2.0x. The level of free cash flow is simply very small even after the dividend cuts. That means a modest return of capital to shareholders for some time too. The balance sheet and cash flow are also supporting a huge intangible asset figure on an ROI of about 9% pre-COVID.

- **Normalized EPS is actually just adding back one-time items like restructuring charges, legal issues, and asset write-downs. BUD is not adjusting EPS to add back stock compensation, amortization, and other recurring items. That is a positive in our view.**

- **We still have some issues with EPS as BUD earned 6-cents of its $3.99 in 2019 from gains on assets sold. It added another 16-cents from cutting marketing expenses in dollar terms as it focuses on raising prices.**

- **Lack of amortization of intangibles is another complaint for the income statement. There is $170 billion in intangible assets an only $2.4 billion are being amortized.**

- **BUD does a great job with FX and Hyperinflation discussion and disclosure. It breaks this down in revenue, costs, income, and EPS. EPS was hurt by 27-cents in 2019 from FX which included 6-cents from Argentina's hyperinflation.** BUD also singles out the South American segment where investors can clearly see FX is hurting revenues and squeezing margins.

- **Our minor issue on FX and hyperinflation is BUD still claims total organic growth is 4.3% on 1.1% volume growth to point to its efforts to boost prices are**

working well. Pulling South America and its hyperinflationary price hike out of the mix, lowers the 4.3% figure to 3.1%.

- **Debt reduction has come almost exclusively from asset sales. Asset sales cut the debt figure, but also cut cash flow. The net ratio is still about 4x EBITDA. After the SABMiller deal, free cash flow was $13-$15 billion with $5 billion in capital spending. The dividend was consuming $9 billion.**

- **The cash flow figures include $3 billion in synergies and BUD cut the dividend to $5 billion – and reduced it again in 2Q20 to maybe $2.5-$3.0 billion). There just isn't much cash flow left to cover debt reduction.**

- **Investors may want to focus on this area. Even with another dividend cut, it may take years to reach the debt paydown target –** before factoring in COVID. That means less cash for shareholders as dividends and stock repurchases. We also see that BUD is not close to its initial goals on growth or total sales since the merger, which is another reason the cash flow isn't here to retire debt rapidly.

- **We found another $21 billion in contingencies facing BUD too.** These include deferred consideration for acquisitions, the underfunding pension fund, and several tax disputes. **We do not believe BUD will have to fund all of this at once or even the full $21 billion ever. However, we think investors should view some of this a possibility and it would need to be paid out of the smaller free cash flow figure – not EBITDA.**

- **The intangibles have not had an impairment, but ROI is only about 9% pre-COVID at BUD.** It considers units where goodwill is under 9x EBITDA to be unlikely candidates for a write-down. **However, 51% of Goodwill is for Columbia, South Africa, and the rest of Africa and Middle Americas. It is using hurdle rates that are lower than those countries' 10-year bond rates in many cases.** That hurdle rate may be too low and may be more likely to rise going forward.

Normalized EPS vs GAAP Is Adjusting for Actual One-Time Items

Long time readers know that we do not have a major issue with a company calling out something like a legal settlement or repaying debt early calling the accelerated recognition of deferred debt issuance costs as one-time events. Where we have problems is when companies want to add back stock compensation or FX expenses that occur every year as one time in nature. BUD's reporting isn't perfect, but it is higher quality than many others:

BUD	2019	2018
Profit from Cont. Ops GAAP	$8,747	$3,839
less Non-Controlling Interest	-$108	-$32
Add Non-Recurring Taxes	$6	-$233
Add One-Time Financial Chgs	-$882	$1,982
Add Restructurings	$323	$692
Normalized Profit	$8,086	$6,248
GAAP EPS	$4.32	$1.91
Normalized EPS	$3.99	$3.11

- The restructuring looks one-time to us. It is actual integration payments along with one-time costs to settle legal issues and issue shares.

- The one-time financial charges include some actual one-time events too. In 2019, there was a $188 million charge to write down the value of a subsidiary due to Zimbabwe hyperinflation and a $34 million charge to settle a tax dispute.

- The remaining financial charges relate to changes in derivative values and mark-to-market issues for hedges. In 2018, this produced $2.0 billion in losses and in 2019, the marks reversed to become $1.1 billion in income.

We do not have a problem with these adjustments. We also give BUD credit for not adding back amortization or stock option expense. There are three things we would take issue with:

- In other operating income, **BUD has gains on the sale of property added in for both sets of EPS.** We would put that more into the one-time category. **In 2019 this was $172 million. That added 6-cents to EPS in 2019 and 3-cents in 2018.**

- **BUD is helping EPS by cutting its "sales and marketing expense**." It is falling in absolute terms from $8.3 billion in 2017 to $7.8 billion in 2018 to $7.3 billion in 2019. **This generated 16-cents to EPS in 2019 and 18-cents in 2018.** The company's goal is to drive people to pay higher prices for premium beer. That may be tough with COVID, but it normally requires advertising as part of the cost of pursuing premium prices. We expect marketing to fall during 2020 and won't necessarily consider that a red flag given bars and sporting events were closed. But, longer-term, we would expect marketing to be a headwind.

- **For a company that was built via several acquisitions, it amortizes almost none of the cost.** It is carrying $128 billion in goodwill that is not being amortized. It has another $42.5 of intangible assets and only $2.4 billion of that is being amortized. Amortization of these assets was $445 million in 2019 or a 16-cent headwind to both sets of EPS. Even amortizing the brands and distribution rights over 40-years, would be costing EPS another 36-cents.

FX, Hyperinflation, and Organic Revenue Issues

We have seen several companies who make a point of touting their organic revenue growth defined solely as price x volume while often ignoring FX impacts and acquisition/divestiture items. BUD actually does a good job in this area:

- It often points out that it gets 70% of its revenues in non-US dollars.
- BUD notes that it tries to lock in its expected exposure to key currencies in Brazil, Argentina, and Mexico
- The company provides some sensitivity analysis around FX issues where possible.
- It does not pull out FX in adjusted results.
- It highlights in total and segment results – where the FX issues are occurring, and it carries the FX impact all the way through costs to income.
- It further provides tables showing the impacts of hyper-inflation so it can be isolated for the impact on EPS.

So, while we follow some companies like Sealed Air where at first glance investors would think South America is the engine driving the whole company – we give BUD some applause for trying to honestly call attention to what is real growth and what is inflation driven.

BUD provided this data for 2019 and 2018:

Impact of FX	2019	2018
Revenues	-$2,664	-$1,823
EBITDA	-$1,123	-$955
Income Cont. Ops	-$582	-$684
EPS	-$0.27	-$0.26

Furthermore, BUD provides disclosure for just the hyperinflation impacts that tend to show up as FX losses. In 2019, hyperinflation hurt EPS by 6-cents and in 2018, it was lower by 11-cents. It also has South America isolated on its own where half the FX hit came from:

South America	2018	FX	Org Growth	2019	Org. Growth
Volumes	135.6		3.8	139.7	2.8%
Revenues	$10.2	-$1.4	$0.9	$9.8	9.0%
Gross Profit	$6.4	-$0.9	$0.2	$5.8	3.2%
EBIT	$3.7	-$0.5	-$0.1	$3.2	-2.8%
EBITDA	$4.7	-$0.6	$0.0	$4.1	0.4%

The organic growth without the FX (and minor acquisitions/divestiture impact) is shown. However, the actual results with the FX hits is also shown. Plus, the hefty FX adjusted revenue growth is shown alongside falling profits. The adjusted EBITDA margin fell 403bp. That is all great disclosure in our view.

The one place we have an issue is BUD still does point out its focus on boosting prices to drive margins and earnings growth. It notes that 2019 revenue grow 4.3% on only 1.1% volume growth. But looking more closely, the places they are getting the most pricing are in the inflationary spots with FX issues that offset it. The cuts to marketing discussed in the prior section may have an impact here going forward:

2019 BUD	Rev Growth	Volume	Pricing	FX impact	FX in $
Total BUD	4.3%	1.1%	3.2%	-5.0%	-$2,664
North Am.	0.2%	-2.4%	2.2%	0.0%	-$49
Middle Am.	7.2%	3.8%	3.4%	-3.3%	-$381
South Am.	9.0%	2.8%	6.2%	-13.5%	-$1,383
EMEA	3.4%	3.4%	0.0%	-6.3%	-$528
APAC	1.9%	-2.9%	-1.0%	-4.7%	-$314

Just pulling the organic growth from South America out of the 4.3% company growth rate, would cut organic growth to 3.1%. Given that total organic growth in South America was $924 million but it is offset with $1.4 billion in FX losses – we think this adjustment should be made also for the discussion of real organic growth. **Also, Middle America's 3.4% pricing impact is essentially wiped out by the negative 3.3% FX issues. The only place with clean price hikes is North America and it has negative volume.**

Debt Pay Down Is Almost Exclusively Coming from Asset Sales

Before the SABMiller deal, BUD had essentially a debt/EBITDA ratio of 2.3-2.5x. Debt was $42 billion, and EBITDA was $18 billion. It paid $124 billion for SABMiller with $6.7 billion in normalized EBITDA. Simultaneously, it sold several parts of the company: the SAB stake in Miller/Coors, Some SAB European brands, Some SAB Eastern European brands, SAB's stake in China Snow beer, and the African bottling operation. That lowered net debt and EBITDA. When those deals were complete, BUD reported Net Debt at $104.5 billion and normalized EBITDA in 2017 of $22 billion for a ratio of 4.75x. The asset sales generated $24.6 billion in cash.

The focus was still to pay down debt further going forward, but there simply wasn't much free cash flow left:

BUD	2019	2018	2017	2016
Cash from Ops	$13.4	$14.2	$15.4	$10.1
CapX	$5.2	$5.0	$4.7	$5.0
Dividends Paid	$5.0	$7.8	$9.3	$8.5
Net Change in Debt	-$8.0	-$4.7	-$10.0	$62.7

In 2017, the asset sale proceeds helped cover the debt repayment and in 2018, BUD used more of the cash from prior borrowing and asset sales to pay down debt. It also cut the dividend in half in 2018 to reduce that cash outflow going forward and preserve cash flow for further debt retirement.

In 2019, even with the lower dividend, BUD needed another asset sale to enable debt reduction – the sale of a portion of the APAC unit in Hong Kong for $5.6 billion to cover the difference between free cash flow after the dividend.

In 2020, BUD has cut the dividend again and completed the sale of Carlton & United Breweries in Australia for $11 billion in June. It drew its revolver for $9 billion and issued $11 billion in bonds as well and likely that incremental borrowing is offset by a rise in cash on the balance sheet. We do not see a liquidity problem here with COVID and coming out of COVID.

We see four problems:

- BUD's target is to cut Net Debt/EBITDA to 2.0x. Net Debt should be about $80-$85b now after the Carlton sale (assuming the new bonds and revolver are offset by the cash raised). EBITDA before COVID was $21 billion – so Debt is still at 4x EBITDA

- It is still not in a position to retire debt in meaningful amounts from operations. Free Cash Flow is about $9 billion and if they cut both dividends in half to about $2.5 billion – it will take 7-years to reach that goal. That's still much faster than when the dividend was consuming $5 billion in cash before the latest cut.

- The company claims it already achieved synergies from the SAB merger of $3.2 billion – so those are in the $21 billion EBITDA figure.

- Any time BUD sells assets – it cuts debt, but it also lowers EBITDA. Plus, they are selling assets for a lower multiple of EBITDA than they paid for SAB. They paid over 18x EBITDA for SAB, the largest sales happened at multiples of 11x, 9x, and 15x.

Given that COVID will mean lower sales and earnings for a while and BUD wants to preserve liquidity; that may slow debt repayment and make the effective debt/EBITDA figure rise. BUD's order of cash usage is 1) investment in the operating business, 2) debt repayment, 3) mergers/acquisitions, and 4) shareholder payments via dividends and repurchases.

It is probably worth remembering that at the time of the SAB deal, many of the divestures were already known, but BUD talked about reaching $100 billion in sales by 2020 driven by Africa. Some of this goal was likely what was supposed to be retiring debt and/or boosting EBITDA to lower the debt/EBITDA ratio. That would have required about 9% sales growth for several years. BUD is nowhere close to these forecasts:

- Revenue in 2019 came in at $52.3 billion. Taking out the Carleton deal cost BUD only $1.4b in sales.

- Volume growth was only 1.1% and adding back FX charges and adjusting for divestments – dollar growth was 4.3%. In 2018, Volume growth was only 0.3%, adding back FX and adjusting for divestments – dollar growth was 4.8%. We think that is being helped by inflation in South America.

- African sales are in the EMEA unit where total volume growth was 3.4%, helped by South Africa at mid-single-digit gains, Tanzania and Mozambique were down, other countries were up. In 2018, EMEA volumes were up 2.3%, but South Africa was down by mid-single digits, and Africa without South Africa was down low-single digits.

- EMEA dollar revenues fell 5% and Normalized EBITDA margins fell 290bp. In 2018, EMEA dollar revenues rose 4.1% and Normalized EBITDA margins fell 100bp.

Many Potential Contingencies Remain that Could Consume Cash Flow

None of these issues are very large by themselves. Many have been outstanding disputes for several years as well. We doubt that BUD would need to suddenly write a check for all of this at any one time and any payments may be stretched out over time. We would consider any one of these to be fairly immaterial. However, we think investors should be aware that:

- In total, these various contingencies represent a material amount of liabilities.

- They should not be viewed in the context of BUD having a pre-COVID EBITDA of $21 billion. Instead, we think they should be viewed in the context that Free Cash Flow has been $8 billion with a dividend of $5 billion (now perhaps $2.5 billion).

- Any contingency payments need to come out of the remaining $3-$5 billion available that is supposed to be retiring debt.

We are simply going to list these and not try to assess timing or probability.

- Deferred consideration for prior acquisitions - **$1.6 billion**

- The Pension plan is underfunded by **$2.7 billion**. This rose last year on a 100bp drop in the discount rate. Also, BUD has been paying about $300 million per year into the pension plan, which would already be reflected in the free cash flow figures.

- Tax matter on foreign earnings in Brazil – estimated exposure **$1.8 billion** – probable loss $13 million.

- Tax matter on InBev Goodwill in Brazil – estimated exposure **$2.5 billion**.

- Tax matter on BAH Goodwill in Brazil – estimated exposure **$2.2 billion**.

- Tax matter on CND Holdings Goodwill in Brazil – estimated exposure **$0.3 billion**.

- Tax loss offset dispute in Brazil – estimated exposure **$0.1 billion**.

- Disallowance of non-deductible expenses for Brazilian taxes – estimated exposure **$1.2 billion**.

- Disallowance of taxes paid abroad – estimated exposure **$2.5 billion**.

- Dispute over Presumed Profit method of calculating taxes – estimated exposure **$0.5 billion.**

- Dispute over Interest on Capital deduction – estimated exposure **$1.0 billion.**

- Dispute over Free Trade Zone Credits – estimated exposure **$1.0 billion**.

- Excise tax dispute – estimated exposure **$0.4 billion**.

- Three disputes over legality and differences in assessment of tax credits – estimated exposure **$2.5 billion** in total.

- Dispute over non-compliance in a tax incentive agreement – estimated exposure **$0.1 billion.**

- Tax dispute over bonus payments to customers – estimated exposure **$0.6 billion**.

- Mexico tax dispute over intercompany transactions – estimated exposure **$0.3 billion.**

In total, this is $21.3 billion in contingencies. We didn't list a minor one in Australia as that may have transferred with the sale of Carleton. Most of these disputes are in Brazil. We again want to emphasize that we do not think all of these will need to be

paid in full. However, it may not be unreasonable to forecast that BUD will make payments of $0.5 - $1.5 billion per year for 2-4 years. And in our view, the cash flow to cover those payments isn't very big and it is now impaired by Covid.

Virus issues straining the government may also lead Brazil to make an offer to BUD – let's clear the decks – and offer a settlement of all these disputes for a one-time payment of $3-$5 billion. That is pure speculation on our part, we are simply looking at all of this in total and thinking, BUD is unlikely to lose all of these, but it probably doesn't win every dispute either.

What About the Carrying Value of the Intangibles?

As noted earlier, BUD is carrying $42.5 billion of intangibles with $40.0 billion not being amortized and another $128 billion of Goodwill. Those items are over 70% of assets and 200% of equity. Despite making several divestitures at EBITDA multiples lower than what BUD paid for SABMiller – there have not been impairments. Despite offering a plan to grow sales at 9% compounded for several years to reach $100 billion in revenues and missing – there have not been impairments.

Normalized EBITDA is basically $21 billion and has been that level for three years. We also know that the basic business needs about $5 billion per year in cash flow. Debt and Equity were $180 billion at the end of 2019. That makes ROI 8.9% on EBITDA less capital spending. At this point, we know COVID is hurting EBITDA and we know net debt has fallen after the Australian sale. We are not going to speculate other than guidance would indicate that ROI is lower now with COVID. Based on 2018, ROI was 9.1%. We are going to view that as what the non-COVID BUD is doing for ROI – basically 9%.

BUD considers the operating units where Goodwill is less than 9x EBITDA to be unlikely to suffer an impairment. For those that have Goodwill above 9x EBITDA, it does a discounted cash flow analysis. There are four main regions where this next step comes into play accounting for 51% of Goodwill:

Region	Goodwill	% total Goodwill	W.A.C.C
Columbia	$18.6	15%	6%
Rest Mid Am	$25.3	20%	9%
South Africa	$13.5	11%	7%
Rest of Africa	$6.7	5%	10%

BUD does not believe a 1% change in the discount rate would create an impairment. We have an issue that the discount rates may be more than 1% too low. South African 10-year bonds are over 9%, Columbia's are over 6%, Mozambique is over 10% to point to a few of those places. And shouldn't a beer company with considerable marks due to FX changes have a higher hurdle rate than the 10-year bond? A recession may also move those rates higher by more than 100bp.

By comparison, the other intangibles are 55% located in the US. Columbia (9%), Rest of Middle Americas (10%), South Africa (9%), Rest of Africa (3%) make up 31% so there are still some issues. BUD uses a similar process to value the intangibles and test for impairment. Low interest rates may be lowering hurdle rates and helping avoid an impairment. But we think a company with a 9% ROI when things were great may still have an impair

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

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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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