One Big Reason to Like This Canadian Small Cap

Description

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Dear Fellow Fools,

Think of an iconic brand. Something you see and use every day. Google. Starbucks. Disney. What do the vast majority of brands like these have in common?

Yes, these are major U.S.-based entities, but the real answer is: humble beginnings and an individual entrepreneur (or two) that really drove the business into prime time.

Much of our time as investors is spent trying to analyze a business from a multitude of angles, many of which are quantitative. The numbers, however, are really just an extension of the employees that run the business. Good numbers tend to be produced by good people. And there are few better ways to ensure that you're investing in good people than to have the founding individual(s) still at the helm.

"No one washes a rented car"
Even more important than having the founder still at the helm is having the founder financially tied to the business with a sizeable ownership stake.

With the founder in charge and his or her ownership interests aligned with outside investors (that's us!), a lot of the variables we Fools pine for in a business are taken care of. This includes such things as the disbarment of short-termism (every Fool's enemy), a focus on growing per-share value, and the motivation to make investments that will increase the value of the firm over the long term.

A perfect example
This week, we're going to take a look at a Canadian company that has its founder firmly at the helm — with a still sizeable ownership stake, no less — and since entering the public market about seven years ago, it has demonstrated all three of the variables mentioned above.

The company is **AutoCanada** (TSX:ACQ), Canada's largest multi-location (and only publicly traded) franchise automobile dealership group.

AutoCanada was born in 2006 as a spin-out from a private entity called Canada One Auto Group (COAG). COAG still owns 23% of AutoCanada, and is in turn 80% owned by its founder, and AutoCanada's CEO, Patrick Priestner. This structure means that Mr. Priestner effectively owns about 18% of AutoCanada's shares.

Just like the respective founders of Google, Starbucks, and Disney, Priestner's beginnings in the auto business were humble. He began selling cars in an Edmonton dealership one summer in the mid-1970s as a way to handle his tuition. He's never looked back.

AutoCanada exists to not just sell cars and all of the other services that go along with this act, but to roll up the Canadian auto-dealership industry. This roll-up strategy began in earnest in 2001 through the private entity COAG when the Canadian automobile manufacturers (OEMs) began to allow dealers to own more than one dealership. AutoCanada was spun out in 2006 with 14 dealerships. There are now 32 under its umbrella, with four having been added thus far in 2013.

Results
This growth in the company's dealership network has translated nicely to the company's financial statements — revenues and earnings per share have effectively doubled since the end of 2005.

Not only has the income statement demonstrated solid growth, but the auto-dealer model is well suited to generating free cash flow (every Fool's favourite!). This figure has been consistently positive over the years, which helps to ensure that the company's current streak of 10 straight quarters with a dividend increase (current yield = 2.4%) is well-justified and, better yet, may be set to continue.

This success has not gone unnoticed by the market. At its current level in the low-$30s, the stock has essentially tripled since its 2006 debut at $10 a share. However, under Priestner's well-aligned guidance, as well as some intriguing industry-related dynamics, there's good reason to believe that over the long term, this company, and stock, has much more to offer its investors.

What the market is missing
The roll-up opportunity is huge. There are currently about 3,500 auto dealers in Canada with approximately 2,000 different owners. Again, AutoCanada has its hand in just 32. Publicly traded peers in the U.S. typically own several hundred.

These Canadian owners are nearing retirement age. According to a PricewaterhouseCoopers study, 70% of Canada's dealers want to be either fully or semi-retired in the next five years. They're going to be looking to cash out. Industry succession is a huge opportunity for AutoCanada.

An equally significant opportunity is with the OEMs that don't currently allow publicly traded entities to own their franchises here in Canada. According to Mr. Priestner, Canada is one of — perhaps the only — country in the developed world where all of the OEMs do not allow publicly traded entities to own their dealerships.

While AutoCanada has good exposure to a variety of OEMs, big names like Ford, Toyota, and Honda are noticeably absent from its lineup. In addition, the company has just gotten its foot in the door with General Motors Canada. There are currently just three GMC dealerships in the AutoCanada empire.

As succession becomes an increasingly significant issue, current dealers are likely to begin lobbying the OEMs to have the right to sell to the highest bidder, regardless of the ownership structure. Should there be a breakthrough on this front and the likes of Ford, Honda, and Toyota warm to the idea of public ownership here in Canada, it would open up another huge pool of consolidation potential for AutoCanada.

And there's this …
Not only is the opportunity for growth huge, but the auto-dealership business is pretty sweet. You shouldn't make the same mistake as I have over the years and disregard this company because of the experience that the Big 3 U.S. OEMs have had over the past decade, or more. Have a look at this laundry list of qualities that make this business great:

- The OEMs control the supply of their franchises. This creates a huge barrier to entry.
- New vehicle customers represent recurring revenue streams — for life, if you treat them well.
- The parts/service and financial portions of the dealership are hugely profitable. So much so that 90% of AutoCanada's dealership fixed expenses are covered by just the part/service division.
- Independent repair shops, historically another form of competition, are fading fast as cars become ever more complicated.
- New/used vehicle sales are counter-cyclical, helping to steady the impact that economic cycles might have. Right now, new vehicle sales are carrying the day for the company, but in less certain economic times, used car sales help pick up the slack. Further helping to balance the economic cycle is the fact that cars are constantly breaking down and requiring repair.

Lots to like!

The Foolish Bottom Line
To be clear, even though they were used as examples, we're not dealing with another Google, Starbucks, or Disney here. And even though there are counter-cyclical elements to the model, AutoCanada is still likely to feel the impact when our economy once again stalls out.

However, over the long term, even if AutoCanada only adds five new dealerships per year to its network, a feat that is quite achievable, it's not a stretch to foresee an attractive return from this stock. Should the rate of acquisition be greater than five dealerships per year, there could be even more upside.

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'Til next time … happy investing and Fool on!

Sincerely,

Iain Butler

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The Motley Fool Canada

Disclosure: Fool contributor Iain Butler does not own shares of any of the companies mentioned at this time. David Gardner owns shares of Starbucks, Disney, and Google. Tom Gardner owns shares of Starbucks and Google. The Motley Fool owns shares of Starbucks, Disney, and Google.

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1. Investing

TICKERS GLOBAL

1. TSX:ACQ (AutoCanada Inc.)

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1. Investing

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