AutoCanada Inc.: This Growth Play Still Has Massive Potential

Description

As I type this, **AutoCanada Inc.** (TSX:ACQ) shares are off more than 10%, falling all the way from $31 each to $27.77.

The culprit is weak earnings. Although revenue from existing and new dealerships rose by 6.9% and gross profit was up 8.7%, weak results from the company's dealerships in Alberta pulled down net earnings. The company earned $11.7 million in net profit for the quarter, which works out to $0.48 per share. That's a decrease of more than 24% compared with the same quarter last year, when earnings came in at $0.74 per share.

When you strip out the growth AutoCanada got from new stores, the results looked particularly ugly. Same-store sales slumped nearly 7%, while same-store gross profit fell by more than 14%.

These abysmal same-store results are because of the company's exposure to Alberta. Approximately 50% of its dealerships are located in the province, which is being affected by low energy prices. Energy patch employees are too nervous to buy new trucks, which have higher margins than cars.

In response to Alberta's weak numbers, management has told investors that they plan to concentrate expansion efforts to the eastern part of Canada in an attempt to diversify. Just a few months ago management seemed excited by the weakness in Alberta, telling investors they hoped to pick up some bargain-priced assets in the province.

No matter what Alberta does in the short term, the long-term car dealership consolidation model remains a very compelling growth opportunity.

A very fragmented industry

A privately held company called Dilawri is Canada's largest owner of auto dealerships, owning 54 from coast to coast. AutoCanada is next with 48, and various other companies round out the top 10 with 20-30 different dealerships. In total, the top 10 own 315 different dealerships.

That leaves 3,154 other dealerships that are owned by single owners or as part of small groups of dealerships. More than 90% of the market is ripe for consolidation.

Additionally, many of these owners are now reaching retirement age and have children who have no interest in taking over the family business. At that point, selling to one of the established players makes a whole lot of sense.

It isn't just AutoCanada that wants to cash in on this trend. Warren Buffett bought Van Tuyl Group as an entry into this sector in the United States, betting on the same long-term consolidation. Both Bill Gates and Eddie Lambert have big investments in **AutoNation**, the largest dealership company in the United States. And up here in Canada, billionaire Jim Pattison is looking to expand his network of nearly 30 dealerships.

It's obvious the trend is coming. All of these billionaires probably aren't wrong.

A bet on Alberta, too

When AutoCanada shares shot up to $90 per share in 2014, it was obvious that the company was overvalued. It earned just $2.30 per share in 2014. No matter how exciting the growth prospects were, it's hard to justify nearly 40 times earnings.

There's an argument to be made that shares have now overshot on the downside. Through the first nine months of 2015 the company earned $1.23 per share. Analysts' estimates for 2015 are listed at $1.80 per share, which I think is a little high.

Let's assume the stock will earn $1.50 per share for 2015. That puts shares at just 18.7 times earnings, which is a reasonable price to pay for a company with that much growth potential. And remember, earnings from half of its dealerships are temporarily depressed. When things get back to normal in Alberta, it's easy to make the argument that the stock could earn $2.25 or $2.50 per share.

It's tough for AutoCanada investors to look past the short term. But five years from now, I'd be willing to bet those people who saw the long-term potential in the company will be happy with the results.

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1. TSX:ACQ (AutoCanada Inc.)

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